

ON THE ROLE AND REGULATION OF PROXY ADVISORS

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INTRODUCTION

In anticipation of proxy season—the springtime ritual where companies prepare and deliver proxy statements in preparation for annual shareholder meetings—U.S. public companies typically reexamine their corporate governance structures and policies. Many corporate governance structures that were acceptable ten years ago are now considered outmoded or even evidence of managerial entrenchment. For example, consider the classified board of directors. In recent years, many companies have shifted from a classified board of directors to an annually elected board. A company might adopt an annually-elected board structure for a number of reasons. A classified board can serve as an entrenchment device, for instance, and so the company may hope to increase the accountability to shareholders that such a structure entails. Likewise, there may be legitimate reasons to retain a classified board of directors, such as the negotiating leverage a classified structure provides the board in the context of a hostile takeover. As a company considers such a change, however, high-minded considerations of the optimal governance structure do not always, and probably do not regularly, drive the discussion. Instead, the primary consideration is often that Institutional Shareholder Services (“ISS”) or another proxy advisor is opposed to classified boards, and the firm feels compelled to make the change in order to improve its corporate governance rating even though the change may have no beneficial effect on the firm’s corporate governance or performance.

I have heard a number of similar tail-wagging-the-dog stories repeated by corporate counsel and public company officers and directors, usually expressed with frustration over some proxy advisors’ approach to governance—particularly with respect to those firms adopting what seems to be a one-size-fits-all methodology for evaluating corporate governance. The role of proxy advisors has increasing relevance because the Securities and Exchange Commission has recently undertaken a review of the mechanisms of proxy voting—less gracefully but perhaps aptly described as “proxy plumbing”—and the role of proxy advisors in that process. Commentators have identified a number of concerns with proxy advisors and the corporate governance industry in which they operate. One is the inherent conflict of

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interest in the business model of many of these firms—providing governance advice to corporate clients while also providing voting advice to investor clients—which gives reason to doubt the accuracy of their ratings and advice.¹ Compounding this problem is the fact that figuring out exactly what matters in corporate governance is quite difficult.

I. THE VALUE OF PROXY ADVISORS

We have some evidence that some metrics used by ratings firms can meaningfully predict performance, but at least some of these studies were commissioned by the subject ratings firms themselves.² Other independent work suggests that the ratings used by various firms do not accurately predict firm performance.³ To emphasize the obvious, these firms are, after all, businesses. They must have something of value to offer their clients, and they must differentiate their products. It would be problematic for these firms if something basic—for example, share ownership by independent directors, as Professors Bhagat, Bolton, and Romano suggest—is a more reliable predictor of performance than the rating firms' multitude of metrics. A simple, single metric could be produced by the clients—institutional investors—relatively cheaply. Instead, ratings firms offer a profusion of proprietary rating systems, each constantly tweaked and recalibrated—a process that could be described as “methodology churn”. No two are alike, although the ratings are often offered as though there were a single grand unified theory of corporate governance, perfectly expressed by their proprietary methodology. Even Professor Bebchuk, whom I think it is fair to say is allied with governance ratings firms in the general goal of promoting shareholder empowerment, has argued that ratings that try to impose a great number of “good governance” metrics on firms are less useful predictors than simply keying on a few problematic entrenchment devices such as poison pills. In other words, it seems easier to spot “bad governance” structures than it is to effectively prescribe “good governance” structures.⁴

If we doubt at least some of firms' ability to make useful firm performance predictions, the interesting question then is why anyone buys what they are selling. Scholars and other observers have offered several non-

1. RiskMetrics' 2009 annual report acknowledges this problem, stating that the “perceived conflict of interest between the services we provide to institutional clients and the services, including our Compensation Advisory Services, provided to certain corporate clients” must be managed. RiskMetrics Group, Inc., Annual Report (Form 10-K), at 22 (2010), available at <http://www.sec.gov/Archives/edgar/data/1295172/000104746910001246/a2196648z10-k.htm>. It admits that “in the event that we fail to adequately manage these perceived conflicts of interest, we could incur reputational damage.” *Id.*

2. E.g., Sanjai Bhagat et al., *The Promise and Peril of Corporate Governance Indices*, 108 COLUM. L. REV. 1803 (2008).

3. Robert Daines, et al., *Rating the Ratings: How Good are Commercial Governance Ratings?* (Stan. Law & Econ., Working Paper No. 360, 2010), available at <http://ssrn.com/abstract=1152093>.

4. Lucien Bebchuk et al., *What Matters in Corporate Governance?*, 22 REV. OF FIN. STUDIES 783, (2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=593423.

exclusive reasons. First, investors buy ratings simply to obtain the underlying data. This seems plausible, since it is indeed costly for individual investors to collect data on firms, and governance ratings firms provide this very useful service more efficiently.⁵ Second, firms buy ratings as protection against future claims of breach of fiduciary duty, or even merely as, in the words of Professor Ribstein, “criticism insurance.”⁶ I agree that this is an important, and perhaps the primary, reason why firms buy the ratings. In response to concerns that managers were too powerful and imposed high agency costs on firms, academics and regulators in the 1980’s and 1990’s increasingly pushed the idea that dedicated institutional investors could reduce these costs by better monitoring. However, monitoring is costly, and few institutional investors other than CalPERS were willing to expend resources on monitoring from which they could only expect to extract a small, pro-rata gain. Regulators incentivized institutional investors to dedicate resources to monitoring efforts by underscoring that proxy voting is a fiduciary duty. As a market response, the corporate governance ratings industry developed into the force we are discussing today.

A third possibility is that independent researchers are wrong, and that at least some ratings firms do have accurate models and metrics. Even without the benefit of research on particular ratings models, we know that some of them must be wrong because they often do not agree on whether a particular firm has “good” governance. Over the long term hopefully we will see that ratings produced by firms that engage in detailed, company-specific research will outperform ratings that apply a one-size-fits-all approach to ratings. Finally, Professors Calomiris and Mason also suggest in a recent paper that institutional investors may prefer a distracting and “noisy” signal⁷ because “low-quality ratings make it harder to hold them accountable for poor decision making or poor outcomes associated with those investment decisions.”⁸

Let me offer another possible reason, perhaps related to the “noise” hypothesis, why some institutional investors might value corporate governance ratings even if they have little or no value in predicting firm performance. This reason should inform not just potential regulation of proxy advisory firms, but also rulemaking that empowers shareholders. In recent years, the corporate governance ratings industry has eroded directorial and managerial power and enhanced shareholder power. Even if ISS, for example, is wrong that a particular firm should have an annually elected board, as a general matter institutional investors (at least those that tend to be activist share-

5. This conclusion is also supported with evidence supplied by Stephen Choi, Jil Fisch and Marcel Kahan in *Director Elections and the Role of Proxy Advisors*, 82 S. CAL. L. REV. 649 (2009), available at <http://weblaw.usc.edu/why/students/orgs/lawreview/documents/ChoiforWebsite.pdf>.

6. Larry Ribstein, *Larry Ribstein on The Corporate Governance Industry*, The Conglomerate, June 12, 2006, http://www.theconglomerate.org/2006/06/the_corporate_g.html.

7. Charles W. Calomiris & Joseph R. Mason, *Conflicts of Interest, Low Quality Ratings, and Meaningful Reform of Credit and Corporate Governance Ratings*, e21, Apr. 19, 2010, at 7, available at http://economics21.org/files/pdfs/commentary/04_19_2010_calomiris_mason_governance.pdf.

8. *Id.* at 12.

holders, such as some pension funds) have an interest in a powerful ratings industry that is allied with institutional investor power. It is no coincidence that aggressive, activist investors are affecting corporate decisions with increasing success in recent years—the rise of the corporate governance industry has made such activity inevitable. Although the initial goal of the shareholder empowerment movement—to reduce wasteful agency costs by shirking managers and directors—appears benign, the crucial issue is whether such enhanced shareholder power is being used to support long-term prosperity or is instead focused on short term gains. I fear that it is often being used for short term gains. And powerful shareholders may use their influence to extract gains at the expense of less powerful, less activist shareholders, such as retail investors. Rather than ultimately reducing agency costs from management shirking, we instead have a new set of agency costs borne by small investors and perhaps also by the beneficial owners of the activist funds that do not share in the particular gains enjoyed by the fund's management.

II. ENCOURAGING BETTER-QUALITY RATINGS BY PROXY ADVISORS

The corporate governance ratings industry itself is a market response: firms effectively resolve the collective action problem faced by institutional investors who have a fiduciary duty to vote proxies in the best interests of their beneficiaries. But the market for governance ratings is not working as it should: ratings firms produce poor-quality ratings whose validity cannot be tested because the underlying metrics are proprietary and are not disclosed. Even if they were disclosed, it is likely that we would end up merely assuring ourselves that none of them are very useful.

Arguably, increased competition will encourage users of ratings to “vote with their feet.” My first inclination is that a purely market-driven response is preferable; again, depending on the availability data, firms producing one-size-fits-all ratings (which almost surely benefit from cheaply producing poor quality ratings) may be shown to underperform based on empirically sound company and issue-specific analysis. Firms that produce poor-quality ratings will be exposed and investors *will* vote with their feet. However, market pressures may not be as robust as we might like, because a significant portion of investors may be either (1) hiring a corporate governance ratings firm merely as a kind of insurance against fiduciary breach claims or criticism (which would probably support hiring the market leader: if a majority of funds hires ISS, ISS appears to be the safest choice, which perpetuates their advantage); or (2) the investors are indifferent to whether the advice results in better long term financial performance, but instead are interested in acquiring more leverage against boards and management in order to pursue short term or private gains.

If the market indeed is resistant to change through normal competitive pressures, we should then turn to other pressure points in the market. Perhaps potential liability for ratings firms could protect against poor quality ratings. Potential liability could take the form of SEC rules governing dis-

closure of methodologies of governance ratings firms, similar to the new rules applicable to credit ratings agencies. I also assume that poor quality should be more easily detected with enhanced disclosure of methodology even if, as with the credit rating agency rules, only a “sufficiently detailed” description of the methodology is produced. The danger with SEC regulation of corporate governance ratings is that, similar to what happened with the Nationally Recognized Statistical Rating Organizations, the SEC risks simply entrenching market leadership. The SEC could reduce this risk by taking the position that one-size-fits-all methodologies are not appropriate, of course, but that seems out of step with current regulatory trends.

Another pressure point is the institutional investor client of corporate governance ratings firms. If these investors do indeed have a fiduciary duty to their beneficiaries, that duty should not be assumed to have been met by a casual acceptance of a proxy recommendation without some assurance that the mechanisms that produced the recommendation are both reliable and free of conflict. The SEC has spoken to the conflicts issue in a pair of letters to ISS and Egan-Jones. The ISS letter states:

Consistent with its fiduciary duty, an investment adviser should take reasonable steps to ensure that, among other things, the [proxy advisory firm] can make recommendations for voting proxies in an impartial manner and in the best interests of the adviser’s clients. Those steps may include a case by case evaluation of the proxy voting firm’s relationships with Issuers, a *thorough* [emphasis added] review of the proxy voting firm’s conflict procedures and the effectiveness of their implementation, and/or other means reasonably designed to ensure the integrity of the proxy voting process When reviewing a proxy voting firm’s conflict procedures, an investment adviser should assess the adequacy of those procedures in light of the particular conflicts of interest that the firm faces in making voting recommendations. An investment adviser should have a thorough understanding of the proxy voting firm’s business and the nature of the conflicts of interest that the business presents, and should assess whether the firm’s conflict procedures negate the conflicts. The investment adviser should also assess whether the proxy voting firm has fully implemented the conflict procedures.⁹

There is anecdotal evidence that some large public funds left ISS for other ratings firms because of ISS’s potential for conflicts. However, ISS’s efforts to develop a firewall between its corporate and investor advisory groups has likely reassured many investors, as suggested by the 2007 GAO report on proxy advisors, which stated:

All of the institutional investors—both large and small—we spoke with that subscribe to ISS’s services said that they are satisfied with the steps that ISS has taken to mitigate its potential conflicts. Most institutional investors also reported conducting due diligence to obtain reasonable assurance that ISS or any other proxy advisory firm is independent and

9. Institutional Shareholder Services, Inc., SEC No-Action Letter (Sept. 14, 2004), *available at* <http://www.sec.gov/divisions/investment/noaction/iss091504.htm>.

free from conflicts of interest. As part of this process, many of these institutional investors said they review ISS's conflict policies and periodically meet with ISS representatives to discuss these policies and any changes to ISS's business that could create additional conflicts.¹⁰

I suspect that some—maybe most—of these investors conduct due diligence on conflicts by merely reading ISS's statement that it is free from conflicts created by its corporate and investor advisory businesses. If that is true, then those firms do not appear to be complying with the guidance offered by the SEC. Furthermore, as the GAO's report points out, the possible conflict between a proxy advisor's corporate and investor advisory businesses is just one of several potential conflicts. According to the GAO, other possible conflicts include:

1. Owners or executives of proxy advisory firms may have a significant ownership interest in or serve on the board of directors of corporations that have proposals on which the firms are offering vote recommendations.
2. Institutional investors may submit shareholder proposals to be voted on at corporate shareholder meetings. This raises a concern that proxy advisory firms will make favorable recommendations to other institutional investor clients on such proposals in order to maintain the business of the investor clients that submitted these proposals.
3. Several proxy advisory firms are owned by companies that offer other financial services to various types of clients, as is common in the financial services industry.¹¹

Given the voting power of active institutional investors, the SEC has focused relatively little attention on enforcing the fiduciary duties created by its proxy voting rules. To give the SEC some credit, in 2009 it brought a case alleging breach of fiduciary duty with respect to proxy voting against INTECH, a registered investment adviser.¹² INTECH engaged ISS to vote proxies in accordance with AFL-CIO proxy voting recommendations. According to the SEC, INTECH followed the AFL-CIO recommendations because it was participating in the annual AFL-CIO key votes survey that ranked investment advisers based on their adherence to the AFL-CIO's recommendations. INTECH hoped that improving its ranking in the AFL-CIO survey would help it maintain existing union clients and recruit new ones. INTECH failed to note in its disclosures the material conflict of interest between INTECH and its clients who did not share the AFL-CIO's voting policies. Indeed, in its proxy voting policies INTECH noted that because it

10. Gov't Accountability Office, GAO-07-76, Report to Congressional Requesters: Issues Relating to Firms That Advise Institutional Investors on Proxy Voting (June 2007), at 11, available at <http://www.gao.gov/new.items/d07765.pdf>.

11. *Id.* at 11-12.

12. Press Release, Securities and Exchange Commission, SEC Charges Investment Adviser for Proxy Voting Rule Violations (May 8, 2009), available at <http://www.sec.gov/news/press/2009/2009-105.htm>.

relied on ISS, it did not “expect[] that any conflicts w[ould] arise in the proxy voting process.”¹³

In the end, despite guidance such as the ISS letter, I think the SEC has not adequately encouraged investors to scrutinize not just potential conflicts of interest, but also the content of the advice they receive from corporate governance raters and proxy advisors. Unless the SEC provides better guidance on what such scrutiny should entail and undertakes a sustained enforcement program to detect and discipline fiduciaries who fail to meet their duties, the beneficiaries of the funds these institutional investors manage will suffer.

Finally, poor quality ratings by corporate governance ratings firms have serious consequences not just for the investors who purchase deficient ratings and advice, but also for the economy as a whole. Capital is allocated and crucial corporate governance decisions are often driven on the basis of these ratings and advice. An executive of a corporate governance ratings firm once described advising institutional investors as akin to herding cats. While that may often be true (and let us hope that it is, because it suggests that at least some are not blindly accepting ratings and advice), these firms still wield significant influence over institutional investors, as proxy solicitors and corporate secretaries assert. This influence is not always evident in proxy voting; indeed, the traces of the influence are probably more likely to appear in the corporate governance choices of public companies from year to year. It is not a stretch to say that corporate governance ratings firms serve as a *de facto* regulator, with some firms offering a set of one-size-fits-all best practices that directors and executives ignore at their peril.

13. *Id.*