Michigan Business & Entrepreneurial Law Review

Volume 9 | Issue 2

2020

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https://doi.org/10.36639/mbelr.9.2.proxy

THE PROXY PROBLEM: USING NONPROFITS TO SOLVE MISALIGNED INCENTIVES IN THE PROXY VOTING PROCESS

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INTRODUCTION

Proxy advisory firms and their influence on the proxy voting process have recently become the subject of great attention for the Securities and Exchange Commission ("SEC") among other constituencies. A glance at recent proxy season recaps and reports, many of which devote space to discussing proxy advisory firm recommendations, reveal the significance of this influence on institutional voting. As Sagiv Edelman puts it, "proxy advisory firms exist at the nexus of some of the most high-profile corporate law discussions—most notably, the shareholder voting process, which has recently been the subject of much scholarly and legal debate."[1] The SEC has responded by announcing that it intends to reform the regulations, or lack thereof, surrounding proxy advisory firms.

Recently, the SEC issued proposed amendments to Exchange Act Rule 14(a)-1 which would effectively codify their earlier interpretation of solicitation under this rule. The proposed amendment would "condition the availability of certain existing exemptions from the information and filing requirements . . . for

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* J.D. Candidate May 2020, University of Michigan Law School. The author would like to thank Professor Adam Pritchard for his invaluable support and guidance in writing this article. Many thanks also to my close friends, mentors, and to Jerome.

1. Sagiv Edelman, *Proxy Advisory Firms: A Guide to Regulatory Reform*, 62 EMORY L. J. 1369, 1369 (2013).

proxy voting advice businesses upon compliance with additional disclosures and procedural requirements."[2] Furthermore, the amendments would clarify when a lack of disclosure of certain information in proxy voting advice compromises the accuracy of the advice and misleads within the meaning of the rule.[3] The SEC believes that these extra requirements will "help ensure that investors who use proxy voting advice receive more accurate, transparent, and complete information on which to make their voting decisions."[4] Based on this proposal, it is apparent that the SEC is intent on rectifying some of the problems of transparency and conflicts of interest associated with proxy advisory firms.

Given the increasing influence of proxy advisory firms, the misalignment of incentives between proxy firms and the institutional shareholders who use proxy firm services is troubling. This Note identifies inherent problems and concerns with proxy advisory firms and offers solutions to these issues with a focus on eliminating conflicts of interest. Using Henry Hansmann's theory of ownership, this Note argues that nonprofit ownership of proxy advisory firms eliminates both information asymmetry and conflicts of interest inherent to the current ownership structure.

Part I provides a brief overview of the problems and concerns associated with proxy advisory firms. Part II suggests two potential solutions: that Rule 206(4)-6 of the Investment Adviser Act of 1940 should be repealed or alternatively, that nonprofit ownership through investment company associations is a more effective way for investment management companies to comply with their fiduciary duties. Because profit incentive has created conflicts of interest that lead to proxy advice that may not always be in the best interest of investment manager clients, nonprofit ownership promotes transparency that allows parties who rely on the advice to make more independent decisions. Part III argues that nonprofit ownership is the most viable alternative to the status quo.

PART I: FAILURES OF THE PROXY ADVISORY FIRM

The importance of shareholder voting is a universally accepted principle of corporate law which has been regarded as "a traditional lynchpin that . . . legitimizes the theoretical foundations of modern corporate structure . . . ."[5] Since the 1940s, the SEC has intermittently used its rulemaking authority to enhance shareholder access to proxy voting. For example, Exchange Act Rule 14a-8 prevents exclusion of shareholder proposals in company proxy materials to increase proxy access to shareholders. With this increased access came increased protection of the proxy voting process through the SEC's 2003 passage of Rule

2. Amendments to Exemptions from the Proxy Rules for Voting Advice, 84 Fed. Reg. 66518, 66518 (proposed Nov. 5, 2019), (to be codified at 17 C.F.R. pt. 240).

3. *Id.*

4. *Id.*

5. Edelman, *supra* note 1, at 1372.

206(4)-6 of the Investment Advisers Act of 1940 which expanded institutional investors' fiduciary duties.

In order to improve transparency and ensure alignment between clients' voting objectives and voting determinations, Rule 206(4)-6 requires that registered investment management companies disclose the policies and procedures that they use to determine how to vote proxies. Rule 206(4)-6, in conjunction with investment manager's fiduciary duties, created a need for a more detailed analysis of the portfolio companies that institutional shareholders were invested in. Enter proxy advisory firms. Two main providers—Institutional Shareholder Services ("ISS") and Glass Lewis—dominate the market for proxy advisory services.[6] These firms, as service-oriented businesses, provide proxy voting advice and other corporate governance solutions to their clients. At face value, this seems like a cost-effective way for institutional shareholders to satisfy their fiduciary and statutory duties. But there are problems inherent to the ownership structure and the breadth of services these firms provide.

Proxy advisory firms have substantial influence on asset managers and the proxy voting process. These firms exert considerable influence because "there are only two major proxy advisory firms, and . . . their recommendations themselves are quite correlated."[7] Although many investment management companies do not give total authority to proxy advisory firms, empirical evidence suggests that their recommendations are extremely influential—even to the extent of robo-voting.[8] A study by the American Council for Capital Formation shows that many asset managers automatically vote in line with the recommendations given by ISS and Glass Lewis.[9] In reality, robo-voting is almost as bad as not voting at all—the very problem the disclosure is intended to solve. This influence, coupled with the conflicts associated with the current ownership of proxy advisory firms, has fueled calls for reform.

The ownership structure of ISS and Glass Lewis exposes some of the problems with proxy advisory firms. Glass Lewis is owned by the Alberta Investment Management Corporation and the Ontario Teachers' Pension Plan while ISS is owned by Genstar Capital. On the one hand, the entities which own the proxy advisory firms are largely motivated by profit. On the other hand, the in-

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6. Svea Herbst-Bayliss & Jessica DiNapoli, *New Glass Lewis Chief to Expand Abroad Amid U.S. Regulatory Clamp Down*, REUTERS (Oct. 4, 2019), https://www.reuters.com/article/us-glasslewis-future/new-glass-lewis-chief-to-expand-abroad-amid-u-s-regulatory-clamp-down-idUSKBN1WJ1J4 (explaining that Institutional Shareholder Services and Glass Lewis hold 97% of the market share for proxy advisory firms). With this in mind, this Note will focus its discussion on these two main providers.

7. Chester S. Spatt, *Proxy Advisory Firms, Governance, Failure, and Regulation* (June 25, 2019) HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG., https://corpgov.law.harvard.edu/2019/06/25/proxy-advisory-firms-governance-failure-and-regulation/.

8. Timothy M. Doyle, *The Realities of Robo-Voting* (Nov. 29, 2018) HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG., https://corpgov.law.harvard.edu/2018/11/29/the-realities-of-robo-voting/; Spatt, *supra* note 7.

9. Doyle, *supra* note 8.

stitutional shareholders are motivated to comply with their fiduciary duties to their clients. Ultimately, the differing motivations between the owners of proxy advisory firms and institutional shareholders suggests that their interests do not align. The Ontario Teachers' Pension Plan's ownership of Glass Lewis presents an additional conflict: labor unions generally have strong views in favor of environmental, social, and governance proxy proposals.[10] For example, in its 2020 Corporate Governance Principles and Proxy Voting Guidelines, the Ontario Teachers' Pension Plan expressed that they "encourage companies to consider how climate change impacts their business" and that they "typically support proposals requesting improved governance and oversight of [climate change]."[11]

As for-profit entities, proxy advisory firms seek to maximize their profits—a goal that may conflict with the goals of their clients. This conflict appears in the different services that proxy advisory firms provide. In addition to voting advice, proxy advisory firms provide their clients a range of services. For example, ISS not only offers proxy voting and research services to institutional shareholders but also offers compensation modeling to companies and board members.[12]

These services are widely used: 70% of public companies report that they "consult proxy firms on executive compensation."[13] ISS offers these services to "help companies design and manage their corporate governance, executive compensation, and sustainability programs to align with company goals."[14] In the same way, ISS will provide voting guidance on an issuer's executive compensation.[15] ISS also helps issuers model their compensation programs and assigns a compensation expert to help the issuer make decisions about executive

10. Matteo Tonello, *Corporate Investment in ESG Practices* (Aug. 5, 2015) HARV. L. SCH. F ON CORP. GOVERNANCE & FIN. REG., https://corpgov.law.harvard.edu/2015/08/05/corporate-investment-in-esg-practices/.

11. *Ontario Teachers' Pension Plan,* CORPORATE GOVERNANCE PRINCIPLES AND PROXY VOTING GUIDELINES 49 (2020), https://www.otpp.com/documents/10179/20940/-/bf03be90-a413-433f-bc4a-24a266ae17bb/2020%20Corporate%20Governance%20Principles%20and%20Proxy %20Voting%20Guidelines.pdf.

12. *ISS Executive Compensation Data*, INSTITUTIONAL SHAREHOLDER SERVICES, https://www.issgovernance.com/solutions/iss-analytics/execcomp-analytics/ (last visited Nov. 11, 2019).

13. The Editorial Board, *The Proxy Protection Racket*, WALL ST. J. (Nov. 10, 2019, 3:30 PM ET), https://www.wsj.com/articles/the-proxy-protection-racket-11573417818.

14. *ISS Corporate Solutions*, INSTITUTIONAL SHAREHOLDER SERVICES, https://www.isscorporatesolutions.com/ (last visited March 20, 2020).

15. INSTITUTIONAL S'HOLDER SERVS., UNITED STATES PROXY VOTING GUIDELINES: BENCHMARK POLICY RECOMMENDATIONS 40 (Dec. 6, 2018), https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf (recommending voting against members of the Compensation Committee or full board if the company recently approved problematic compensation practices).

compensation.[16] Providing these services creates a misalignment of incentives between proxy advisory firms, the institutional shareholders that use their services, and the companies the proxy advisory firms rate.

This profit incentive further motivates proxy advisory firms to stir controversy. Illustrative of this conflict is Glass Lewis's provision of recommendations on "proxy issue[s] put forward by one of its owners, encouraging its owners, as well as other special-interest investors with similar agendas, to put forward more contentious proxy issues."[17] For example, the Alberta Investment Management Corporation, part owner of Glass Lewis, co-filed a shareholder proposal called Say on Pay in 2018.[18] Encouraging owners and investors to put forward contentious issues reflects the incentive for Glass Lewis to stir controversy in order to "increase the value of advice about proxy questions."[19] Promoting these contentious issues may not be in the best interest of clients of the institutional shareholders who use proxy advisory services.

Despite claims that proxy advisory firms provide services based on the needs of their institutional clients,[20] this is not entirely accurate. Effectively, Rule 206(4)-6 has created a sham democracy. Although the SEC enacted the rule to improve transparency, institutional shareholders simply rely on proxy advisory firms to do research on companies and make recommendations on how to vote without understanding the advisory firms' underlying methodologies. Proxy voting tends to be regarded as an ancillary duty of investment management companies relative to their duty to make investment decisions.[21] Returns drive fund flows, not voting behavior. Moreover, reliance on proxy advisory firm research is a cost-effective method for compliance with Rule 206(4)-6 because "proxy advisors lower the cost to institutional investors of voting, saving institutions from having to obtain and assess information in deciding how to vote."[22] Thus, investment management companies have both a regulatory and financial incentive to use proxy advisory firms' research without assessing their

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16. *ISS Corporate Solutions*, *supra* note 14 ("If an equity plan is coming up, your advisor will help you navigate the intricacies of the ISS Equity Plan Scorecard. They will explain the ISS methodology, explain how different institutional investors use different metrics, and help you prepare your board to make decisions on equity compensation governance.").

17. Spatt, *supra* note 7.

18. AIMCo*, 2018 Annual Report*, https://www.aimco.alberta.ca/2018-annual-report/pdfs/AIMCo-AR2018.pdf (last visited Feb. 13, 2020).

19. Spatt, *supra* note 7.

20. Letter from Gary Retelny, President and CEO of Institutional Shareholder Services, to the Senate Banking, Housing, and Urban Affairs Committee, https://www.issgovernance.com/file/duediligence/20180530-iss-letter-to-senate-banking-committee-members.pdf ("Said more simply, we are an independent provider of data, analytics and voting recommendations to support our clients in their own decision-making.").

21. Ike Brannon, *Diminishing the Power of Proxy Advisory Firms*, FORBES (Jul. 11, 2019, 8:11 PM), https://www.forbes.com/sites/ikebrannon/2019/07/11/diminishing-the-power-of-proxy-advisory-firms/#5babed78452c.

22. Andrew F. Tuch, *Proxy Advisor Influence in a Comparative Light*, 99 BOS. UNIV. L. R. 1459, 1466 – 67 (2019).

methods and processes. Due to their profit incentive, proxy advisory firms protect their proprietary information concerning research methodologies and lack transparency about the development of their recommendations. Thus, an extreme information asymmetry developed between these firms and the investment management companies they service.

PART II: SOLUTIONS TO THE PROXY ADVISORY CONUNDRUM

In thinking about solutions to the problems and concerns associated with proxy advisory firms, it is important to note that there are different constituencies that use proxy advisor voting guidance. These constituencies operate under different regulatory regimes. While mutual funds and hedge funds who use proxy advisory services are subject to the fiduciary duties under the Investment Advisers Act of 1940, pension funds are subject to fiduciary duties under the Employee Retirement Income Security Act of 1974 (ERISA). Pension funds, mutual funds, hedge funds, and the like are subject to different regulatory regimes and legal requirements, so they may respond differently to proposed changes in the regulatory regimes and ownership structures of proxy advisory firms. For example, pension plans are exempt from the definition of an investment company and consequently are not subject to the Investment Advisers Act of 1940.[23] Due to this exemption, any changes to Rule 206(4)-6 of the Investment Advisers Act of 1940 would not necessarily impact pension funds' reliance on proxy advisory firm services.

1. *Repeal Rule 206(4)-6 of the Investment Advisers Act of 1940*

The Rule 206(4)-6 requirement that registered investment management companies disclose their policies and procedures for determining proxy votes should be repealed. Although the SEC aimed to ensure alignment between client voting objectives and investment management company voting determinations, the disclosure of proxy voting has not succeeded in this goal. The requirement specifically allows for investment management companies to satisfy their obligation "by relying on voting policies developed by an independent, third party agency—such as a proxy advisor."[24] In adopting this check-the-box approach, the SEC gave registered investment advisors an alternative to putting forth their own effort and resources to be more transparent with their clients. Given the level of competition in the investment advisor industry, firms have eagerly availed themselves of this option to minimize their costs.[25]

23. Investment Company Act of 1940, 15 U.S.C. § 80a-3(c)(11) (2018).

24. James R. Copland, David F. Larcker & Brian Tayan, *The Big Thumb on the Scale: An Overview of the Proxy Advisory Industry*, STAN. CLOSER LOOK SER., May 30, 2018, at 2.

25. *See id.* at 2; Suzy Waite, Annie Massa & Christopher Cannon, *Asset Managers with $74 Trillion on Brink of Historic Shakeout*, BLOOMBERG (Aug. 8, 2019), https://www.bloomberg.com/graphics/2019-asset-management-in-decline/.

Repealing the Rule 206(4)-6 requirement would eliminate virtually every conflict of interest involving the current use of proxy advisory firms. The demand for the services of proxy advisory firms arose because the SEC required investment management companies to disclose their processes.[26] When ISS and Glass Lewis developed research reports with recommended voting practices, investment managers had a fail-safe way to furnish the SEC and their clients with detailed reports on their voting process. Returning to the regulatory status quo prior to Rule 206(4)-6 would reduce the demand for proxy advisory services, thereby greatly reducing their influence over voting decisions.

If Rule 206(4)-6 were to be repealed, then investment management companies would no longer outsource research to proxy advisory firms, thereby getting rid of the potential for conflicts of interest. With no regulatory incentive to provide transparency to clients, investment management companies would likely return to their practices prior to the passage of this regulation.

Although this proposal would effectively eliminate the shortcomings of proxy advisory firms, this solution is unlikely to appeal to the SEC given the agency's goal of promoting informed voting. In 2003 when the SEC adopted Rule 206(4)-6, the SEC stated that it designed the rule to "prevent material conflicts of interest from affecting the manner in which advisers vote clients' proxies."[27] It is clear that the SEC believed that by increasing investment management companies' transparency, this would serve as an appropriate check on any existing conflicts of interest. Eliminating this rule returns things to the prior status quo, which leaves room for concern about transparency and voting practices of investment management companies. A return to the pre-Rule 206(4)-6 regulatory scheme is not likely to be implemented by the SEC because of its commitment to proxy voting as an important tool for accountability in the capital markets.

2. *Nonprofit Ownership of Proxy Advisory Firms Is a More Effective Way for Investment Management Companies to Comply with Their Fiduciary Duties*

If the SEC is unwilling to repeal Rule 206(4)-6, nonprofit ownership of proxy advisory firms by investment management companies through investment company associations such as the Investment Company Institute is the best solution to the conflicts of interest associated with proxy advisory businesses. This form of ownership is also a more effective way for investment management companies to comply with their fiduciary obligations and for the SEC's aims for transparency to be fully realized.

In *Ownership of the Firm*, Henry Hansmann explores how businesses are organized and why enterprises are governed and owned in certain ways. To summarize briefly, Hansmann argues that "efficiency will be best served if ownership is assigned [so] that total transaction costs for all patrons are mini-

26. Copland, Larcker & Tayan, *supra* note 24, at 2.

27. 17 C.F.R. § 275(2) (2013).

mized," which means minimizing the costs of market contracting and the costs of ownership.[28] Hansmann identifies the factors that typically lead to higher costs of market contracting as: lack of effective competition with a high degree of market power and information asymmetry.[29] The cost of ownership is influenced by the ability to exercise effective control over management of the firm, the ability to engage in collective decision-making, and the cost of bearing the risk of enterprise.[30]

As Hansmann suggests in *Ownership of the Firm*, nonprofit ownership emerges when "there is an extreme problem of asymmetric information between the firm and some class of its patrons" and "the costs of exercising effective control over the firm are unacceptably large relative to the value of [the patrons'] transactions with the firm."[31] Extreme information asymmetry and high costs of ownership lead to severe inefficiencies such that no class of individuals can be effective owners of the enterprise.[32] This information asymmetry typically develops when patrons are either purchasing goods for a third party and cannot monitor performance cost effectively or when they purchase a public good such that they cannot monitor how their contribution affects the service purchased.[33] Sometimes, however, severe problems of information asymmetry develop when patrons purchase a private good or service for their own consumption—as is the case with regard to proxy advisory services.

In essence, "the nonprofit form abandons any benefits of full ownership in favor of stricter fiduciary constraints on management."[34] In the case of proxy advisory firms, the profit incentives are the root cause of the information asymmetry problem. Profit maximization leads proxy advisory firms to protect their proprietary information concerning research methodologies for proxy voting guidelines. Full disclosure would allow other firms to enter cheaply by copying those methodologies. Due to this lack of transparency, investment management companies are at an informational disadvantage relative to their supplier; all they get is the voting recommendation. Without disclosure of the information or analytic approach used to make recommendations, proxy advisory firms profit from consumers making uninformed purchases. This state of affairs sits uneasily in a securities regulation regime premised on full disclosure.

Moreover, it appears that proxy advisory firms take a one-size-fits-all approach to proxy voting research. The proxy voting guidelines "[do] not directly distinguish how different investors, such as different types of mutual funds and

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28. Henry Hansmann, *Ownership of the Firm*, 4 J. OF L., ECON., AND ORG. 267, 272-73 (1988).

29. *Id.* at 273–75.

30. *Id.* at 275–80.

31. *Id.* at 300.

32. *Id.*

33. *Id.*

34. *Id.* at 301.

ETFs, should vote."[35] This approach is even more apparent with the proxy reports firms publish on shareholder proposals. Each year, proxy advisory firms such as ISS furnish "Voting Guideline" reports for the proxy season.[36] The reports "provide proxy analyses and voting recommendations for common shareholder meetings of publicly-traded U.S.-incorporated companies that are held in [their] institutional investor clients' portfolios."[37] They are general recommendations that come in the form of "vote against" proposals (for example, imposing tenure limits on outside directors), sometimes with factors to consider to assist in a voting decision.[38] Thus, proxy advisory firms further profit by using the same approach to different situations because it is cheaper to do the same thing over and over than to tailor different methods for each customer.

Nonprofit ownership by investment company associations eliminates this information asymmetry problem. Since the development of recommendations would be in the control of an organization whose interests are aligned with those who benefit from the service, a nonprofit proxy advisor would be free to disclose research methodologies and practices to its customers. Thus, this approach would increase transparency concerning the processes and methods that result in voting recommendations—promoting the SEC's underlying goal of reducing material conflicts of interest.

With respect to the costs of ownership, proxy voting is a significant expenditure for investment management companies.[39] Furthermore, investment managers have some of the same information demands with respect to proxy voting. For example, mutual funds and hedge funds are particularly interested in information that helps them understand how different corporate policies may promote shareholder wealth maximization. Given these similarities in informational demands, investment managers can efficiently and effectively organize collective ownership and exercise effective oversight of the proxy services.

Currently, a few investment company associations exist that provide resources and otherwise advance the interests of funds and their shareholders. The Investment Company Institute (ICI) is one of the leading associations of investment management companies and has a longstanding history of providing research and other resources to assist members with proxy voting.[40] These resources consist of ICI Viewpoints Blogs, news releases, and even conferences,

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35. Spatt, *supra* note 7.

36. *See, e.g.*, INSTITUTIONAL S'HOLDER SERVS., UNITED STATES PROXY VOTING GUIDELINES: BENCHMARK POLICY RECOMMENDATIONS (2018), https://www.issgovernance.com/file/policy/2019/americas/US-Voting-Guidelines.pdf.

37. *Id*. at 8.

38. *See, e.g.*, *id.* at 17–19.

39. Copland, Larcker & Tayan, *supra* note 24, at 2 ("The proxy voting process is costly and requires significant time, expertise, and personnel.").

40. *See ICI Resources on Proxy Voting*, INVESTMENT COMPANY INSTITUTE, https://www.ici.org/proxy_voting (last visited Nov. 11, 2019).

among other external sources of proxy voting information.[41] ICI is a 501(c)(6) tax-exempt organization that consists of members (e.g., mutual funds, close-end funds) and a board of governors elected by the membership. As an organization that seeks to provide an avenue for its members to confer and consult with each other and governmental agencies in connection with developments in the regulatory scheme, it is strategically placed to offer conflict-free proxy advisory services.

It is unclear whether ICI or other investment company associations have considered offering proxy advisory services as a part of their membership benefits. As noted by the U.S. Government Accountability Office, "[t]o compete, proxy advisory firms must offer comprehensive coverage . . . and use sophisticated systems to provide research."[42] Since 1985, ISS has had a long-standing history of "working with institutional investors," which has contributed to its dominance in the market.[43] This dominance makes it difficult for other service providers to compete, as market participants are less likely to "subscribe to a potentially inexperienced or less-established proxy advisory firm that may not provide thorough coverage."[44] The startup costs associated with proxy advisory firms are significant.[45] Each firm must develop and implement the technology necessary to provide services.[46]

Nonprofit ownership of proxy advisory businesses by investment company associations also implicates Hansmann's discussion of co-operative ownership. From a practical standpoint, "the roles of customer-owned and nonprofit firms sometimes overlap."[47] The tradeoff between market failure and the cost of control is an important driver of the benefits of co-operative ownership.[48] Market failure can appear in the form of severe information asymmetry and market power.[49] Market contracting can be extremely expensive in the presence of market failures such as monopolies and information disparities. The problems that spawn co-operative ownership are strikingly similar to the problems that spawn nonprofit ownership. Both map onto the issues concerning the current ownership of proxy advisory firms.

Hansmann discusses co-operative ownership in the context of farmer-owned supply co-operatives. Farm supply co-operatives can be local, regional, or na-

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41. *Id.*

42. U.S. GOV'T ACCOUNTABILITY OFF., GAO-17-47, CORPORATE SHAREHOLDER MEETINGS: PROXY ADVISORY FIRMS' ROLE IN VOTING AND CORPORATE GOVERNANCE PRACTICES 8 (2016).

43. *Id.*

44. *Id.*

45. *Id.*

46. *Id.*

47. Hansmann, *supra* note 28, at 301.

48. *See id.* at 272–73, 281.

49. *See id.* at 272.

tional.[50] These co-operatives developed as a result of monopolies in the farm supply business, asymmetric information, and favorable costs of ownership for the consumer.[51] Prior to the formation of farm supply co-operatives, "the markets involved were . . . not highly competitive" and many suppliers were under frequent investigation for restrictive contracts related to prices and sale territories.[52] Ultimately, this had the effect of making consumer ownership an efficient alternative to the status quo.

Thus, "a merger of the purchasing and the selling party through ownership" in the form of a co-operative has no distinct features from nonprofit ownership through investment company associations. Fundamentally, the nonprofit and co-operative ownership structures both serve as useful analogues to the ways in which investment company association ownership rights many of the wrongs inherent to for-profit ownership of proxy services.

a. An Example: Credit Unions

Credit unions provide a relevant model of the potential benefits of nonprofit and co-operative ownership for proxy advisory services. As not-for-profit entities, credit unions are organizations that exist for the service of their members.[53] Much like investor-owned banks, credit unions provide a variety of financial services, including giving loans and accepting deposits.[54] The main difference between investor-owned banks and credit unions is the structure of ownership. Credit unions are co-operatives that are member owned. Thus, credit unions are under the effective control of the people who use their services. This structure "creates a cycle of mutual assistance" whereby "[o]ne member's savings becomes another member's loan."[55]

In *A Fairer Credit Card? Priceless*, Ryan Bubb and Alex Kaufman explore the ways in which the ownership structure of credit unions has benefitted credit union members.[56] For example, many banks increase interest rates for borrowers that do not make minimum payments on time.[57] Credit unions, however, almost never do this.[58] Moreover, "credit union cards actually offer lower annual fees and longer grace periods than regular credit cards."[59] Bubb and Kaufman

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50. *Id.* at 287.

51. *See id.* at 272.

52. *Id.* at 287.

53. Nat'l Credit Union Admin., *What is a Credit Union?*, MYCREDITUNION.GOV https://www.mycreditunion.gov/about-credit-unions/credit-union-different-than-a-bank (last visited Nov 12, 2019).

54. *Id.*

55. *Id.*

56. Ryan Bubb & Alex Kaufman, *A Fairer Credit Card? Priceless*, N.Y. TIMES, June 22, 2009, https://www.nytimes.com/2009/06/23/opinion/23kaufman.html.

57. *Id.*

58. *Id.*

59. *Id.*

argue that these customer-friendly policies are a product of the co-operative ownership structure of credit unions.[60]

Most banks are for-profit entities whose investor-shareholders expect dividends; by contrast, credit unions answer to their member-shareholders who are also customers. In this way, credit unions are directly controlled by those who would use their services and thus have incentives to promote their customers' welfare. Like the co-operatives that Hansmann discusses, credit unions evolved in a market where the costs of ownership are favorable and information asymmetry is problematic. Banks that are investor-owned answer to their shareholders and are mainly concerned with profit maximization. These incentives may lead banks toward practices which disadvantage their consumers.[61] For example, Wells Fargo recently paid fines of $575 million after federal regulators revealed "Wells Fargo employees had for years opened millions of unauthorized bank accounts in customers' names" to meet aggressive sales goals.[62] In this way, the cost of market contracting is relatively high and consumers of investor-owned bank services and credit cards end up paying higher rates than credit union members.

Retail bank customers' interests are relatively homogenous. As Hansmann suggests, the costs of ownership can be prohibitively high when patrons with more heterogeneous interests try to collectively own an enterprise.[63] For patrons of retail banking services, their interests are sufficiently similar in that they seek to obtain the most favorable lending situations or fees when it comes to bank transactions or credit cards. Thus, member ownership in the form of a credit union is less costly for the class of patrons transacting with banks because the cost of aggregating their interests is significantly lower.

Credit unions illustrate the ways in which nonprofit or co-operative ownership by investment managers can help to improve proxy advisory services. Because the service will be owned and controlled by those who use and benefit from it, those owners are more likely to ensure that the service is well-tailored to their needs and fiduciary obligations. This would also effectively solve the information asymmetry problem. Those who use proxy services are also in control, thereby giving them access to the methodologies that will be used to make recommendations.

Moreover, credit unions have the added advantage of their tax-exemptions as nonprofit organizations. As either 501(c)(1) or 501(a) exempt organizations, credit unions are exempt from the corporate income taxes that most other banks must pay, which allows them to return more profits to their members. Nonprofit ownership of proxy advisory services would create the same cost advantage.

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60. *Id.*

61. Stacy Cowley & Emily Flitter, *Wells Fargo Agrees to Pay $575 Million to Resolve State Investigations*, N.Y. TIMES (Dec. 28, 2018), https://www.nytimes.com/2018/12/28/business/wells-fargo-settlement.html.

62. *Id.*

63. Hansmann, *supra* note 28, at 279.

If business leagues such as the Investment Company Institute, which is a nonprofit organization comprised of investment management companies, owned proxy advisory services, then the tax benefits would likely make it cheaper to provide the service.

b. Arguments Against Nonprofit Ownership

Although nonprofit ownership eliminates the conflicts of interests that exist under current ownership, elimination of the profit-incentive can reduce competition that leads to innovation. This may be a cause for concern. However, the current market—dominated by a duopoly—already stifles competition and innovation. As explained previously, ISS and Glass Lewis's large market share for proxy advisory services is based on their reputation and track record of providing comprehensive research and recommendations.[64] Based on their 97% market share, it does not appear that ISS and Glass Lewis currently face significant competition from other proxy advisory firms. ISS and Glass Lewis likely remain dominant due to their market experience and established expertise in researching and consulting. Though it is not clear how much competition currently exists in the market, changing the ownership structure of proxy advisory firms is unlikely to reduce the level of competition.

Furthermore, proxy advisory firms lack transparency, so it is quite possible that the market's two main service providers, ISS and Glass Lewis, are already using similar methods to create recommendations. If there is any innovation regarding research methods, users of proxy advisory services remain unaware. Thus, the competitive situation cannot get any worse than present. Proxy advisory firms tend to use a one-size-fits-all approach to give generic recommendations on proposals as opposed to tailoring recommendations to each individual client and situation.[65] Given the status quo, an elimination of the profit incentive would not necessarily reduce innovation.

Indeed, a shift in the form of ownership may promote innovation. The different constituencies who use proxy advisory services could promote different research methods and processes of creating voting recommendations. The needs of pension funds and mutual funds will differ in a way that might cause co-operatives of these groups to develop different research methods for proxy voting advice. For example, the Investment Company Institute, which includes mutual funds, hedge funds, and the like may develop research methods that center on shareholder wealth maximization. At the same time, pension funds may develop research methods that may weigh both shareholder wealth concerns and ESG principles.

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64. U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 42, at 8.

65. *See* INSTITUTIONAL S'HOLDER SERVS., UNITED STATES PROXY VOTING GUIDELINES: BENCHMARK POLICY RECOMMENDATIONS (2019), https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf.

The Ontario Teachers' Pension Plan, an owner of Glass Lewis, already creates its own proxy voting recommendations grounded in environmental, social, and governance factors.[66] These governance factors are a priority for the Ontario Teachers' Pension Plan and would necessitate a research methodology that recognizes how different proposals may hinder or push forward ESG principles. Mutual funds would be more likely to use a methodology that focuses on how a proposal may promote shareholder wealth maximization. A shift to a nonprofit model could promote a diversity of perspectives that is currently lacking.

These different constituencies would be similar to the heterogeneity of interests that can make cooperative ownership of services difficult. Although a large mixture of differing interests can make control of an enterprise more expensive, this problem is solved if the heterogenous constituencies create separate proxy advisory services tailored to their interests. As opposed to increasing the cost of control, the different constituencies who use proxy services could possibly create smaller co-operatives that are more homogenous based on the type of fund. Although smaller co-operatives composed of different constituencies could operate their own proxy services, the problem of economies of scale may limit the number of co-operatives. Given that there are only two providers currently, switching to a nonprofit model is unlikely to produce a smaller number of advisory services.

Another issue raised by nonprofit ownership arises from the SEC's legal authority, or lack thereof, to mandate a certain kind of ownership for proxy advisors. It is not clear whether the SEC has legal authority to mandate a specific form of ownership for proxy advisory services.

SEC's regulation of credit agencies, however, may be a useful model for understanding the reach and limitations of the agency's authority to mandate ownership structures. Credit rating agencies, which have similar conflict of interest problems, have been the subject of SEC regulation since the 1970s. In 1975, the SEC began recognizing credit rating agencies as Nationally Recognized Statistical Rating Organizations ("NRSRO") through its no-action letter process.[67] The creation of the NRSRO reveals the reach of SEC regulation. Although the SEC did not craft a formal definition of the term "NRSRO" until 2006, it used a case-by-case determination of rating agencies that fell under that term.[68] Under Exchange Act Rule 15E(a)(1)(B), the SEC requires agencies that apply for NRSRO status to furnish information such as, "the procedures and methodologies . . . [used] in determining credit ratings [and] the organizational

66. *See* ONTARIO TEACHERS' PENSION PLAN, *Corporate Governance Principles and Proxy Voting Guidelines*, (2019) https://www.otpp.com/documents/10179/20940/-/cfca9682-9368-4cf4-96ce-fe5381d5647e/2019%20Corporate%20Governance%20Principles%20and%20Proxy%20Voting%20Guidelines.pdf.

67. Josh Wolfson & Corinne Crawford, *Lessons from the Current Financial Crisis: Should Credit Rating Agencies Be Re-structured?*, 8 J. BUS. & ECON. RES. 85, 87 (July 2010).

68. *Id.*

structure of the applicant."[69] In this way, the SEC bases its determination of NRSRO status on criteria like form of ownership.

A similar type of determination is possible for proxy advisory firms. To do this, the SEC could create a separate registration category for proxy advisory firms that could use a similar application process as NRSROs that reviews the form of ownership or weighs nonprofit ownership as a factor in favor of conferring status on the proxy advisor. Proxy advisory firms are currently eligible to register based on the solicitation of proxy rules in Exchange Act Rule 14a-9, but this registration process does not require an application to be reviewed by the SEC. Any changes to the registration process for proxy advisory firms would have broader implications for constituencies beyond proxy advisory firms. It is unclear whether this avenue is a viable way for the SEC to mandate nonprofit ownership, but it is worth consideration in light of the SEC's ongoing efforts to regulate proxy advisory firms.

The SEC may also have the legal authority to mandate a certain form of ownership by conditioning exemptions from the Exchange Act Rule 14a-1(l) definition of solicitation on ownership status. Unless a communication falls under an enumerated exemption under Exchange Act Rule 14a-2(b), it is a solicitation which carries with it both required disclosures and anti-fraud liability. The Commission's definition of solicitation is broad and covers "a communication to security holders under circumstances reasonably calculated to result in the procurement, withholding, or revocation of a proxy."[70] In a September 2019 guidance, the SEC determined that proxy voting advice from proxy advisory firms was generally considered to be a solicitation.[71] Although proxy advisory firms have consistently relied on exemptions from this definition in Exchange Act Rule 14a-2(b), recent proposed amendments to these rules would codify the September 2019 guidance and amend Rule 14a-2(b) to condition exemption of proxy voting advice on certain disclosures.[72]

Instead of conditioning exemption on disclosure, the SEC could amend the rules to condition exemption from the definition of solicitation on a proxy advisory firm's form of ownership as a nonprofit. For-profit proxy advisory services like ISS and Glass Lewis would not be prohibited, but they would be denied the exemption they currently enjoy from the proxy solicitation rules. Realistically, the cost of complying with those rules may be prohibitive for those firms, which appear to be largely focused on minimizing costs. This

69. 15 U.S.C. § 78o-7(a)(1)(B) (1934).

70. Commission Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice, Exchange Act Release No. 86,271 4 (Sept. 10, 2019), https://www.sec.gov/rules/interp/2019/34-86721.pdf.

71. *See id.* at 9.

72. *See* SEC Proposes Rule Amendments to Improve Accuracy and Transparency of Proxy Voting Advice, Exchange Act Release 2019-231 (Nov. 5, 2019), https://www.sec.gov/news/press-release/2019-231.

would be a viable avenue for the SEC to mandate nonprofit ownership through its existing regulatory authority over proxy solicitations.

CONCLUSION

Proxy voting is the subject of concern and debate amongst many constituencies involved with the capital markets. Although the SEC has attempted to solve some of the underlying conflict of interest problems associated with investment managers and proxy voting, their efforts have proved to be largely fruitless. Certainly, the SEC's aims of providing greater transparency among investment managers and their clients and preventing major conflicts of interest from materializing are commendable. But there are more effective ways at reaching these ends than the approach of Rule 206(4)-6 and enhanced disclosure by proxy advisory firms.

Repealing Rule 206(4)-6 is an effective strategy to deal with the conflicts of interest that have developed with proxy advisory firms. Rule 206(4)-6 served as the impetus to the rise in influence of proxy advisory firms. Given this causal connection, if the SEC were to repeal this rule, then the use and the influence of proxy advisory firms would decrease. However, it is not a likely strategy to be used by the SEC, which ultimately wants to create better transparency between investment managers and their clients.

Given the SEC's resistance to abandoning Rule 206(4)-6, a more plausible solution is to change the ownership structure of proxy advisory firms. Profit motives have created conflicts of interest attendant to current ownership of proxy advisory firms. Those conflicts have undermined the proxy advisors' legitimacy. Hansmann's theories of nonprofit and co-operative ownership are a useful model for understanding the ways in which this form of ownership may be beneficial for proxy advisory firms. Current ownership has created problems of information asymmetry, and the tax benefits inherent to nonprofits could result in more cost-effective services. Therefore, ownership of proxy advisory firms by investment company associations offers advantages relative to the status quo.

As the SEC continues to make strides toward more effective regulation of proxy advisory firms, it is important to consider that solutions may not necessarily take the form of increased regulation and disclosure. Rather, effective solutions can come in the form of alternative ownership structures with more aligned incentives.