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## THIRD-PARTY INSTITUTIONAL PROXY ADVISORS: CONFLICTS OF INTEREST AND ROADS TO REFORM

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Matthew Fagan\*

### ABSTRACT

*With the rise of institutional activist investors in recent decades—including a purported 495 activist campaigns against U.S. corporations in 2016 alone<sup>1</sup>—the role that third-party institutional proxy advisors play in corporate governance has greatly increased. The United States Office of Government Accountability estimates that clients of the top five proxy advisory firms account for about \$41.5 trillion in equity throughout the world.<sup>2</sup> For several years, discussions have developed regarding conflicts of interest faced by proxy advisors. For example, Institutional Shareholder Services, the top proxy advisory firm in the world, frequently provides advice to institutional investors on how to vote proxies while simultaneously providing corporate clients with advice on how to improve their corporate governance.<sup>3</sup> Situations like these have given rise to debate as to whether such conflicts are truly problematic.*

*At a minimum, institutional investors must be confident in the services that are provided to them by proxy advisors. Without a showing that recommendations are given in a neutral and non-biased way, accidentally or intentionally, the system cannot work effectively to maximize shareholder fairness.*

*This Note posits that, despite the fact that third-party proxy advisors are currently acting within the law, reforms should be made that better address and limit the amount of conflicts of interest that may arise as a result of their business. Such reform should take place through legislation, informal SEC notice and comment, or, potentially, through the voluntary action of proxy advisory firms.*

### INTRODUCTION

Third-party proxy advisors play an immensely important role in matters of corporate governance. Studies find that in the context of

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1. Andrew Birstingl, *2016 Shareholder Activism Trends*, FACTSET INSIGHT (Dec. 12, 2016), accessed at: <https://insight.factset.com/2016-shareholder-activism-trends>.

2. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-765, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING 13 (2007), <http://www.gao.gov/new.items/d07765.pdf>.

3. *Id.* at 4.

“say-on-pay” votes, proxy advisor recommendations are the determining factor in voting outcomes.<sup>4</sup> Another study shows that advisory firms, such as Institutional Shareholder Services (ISS), have an impact on shareholder votes: directors who received negative recommendations received nineteen percent fewer votes at the outcome.<sup>5</sup> While the precise extent of a proxy advisory firm’s influence is widely debated,<sup>6</sup> one thing is certain: third-party proxy advisory firms are key players in corporate governance.

Of the major proxy advisory firms, only ISS is under the regulatory purview of the Securities and Exchange Commission (SEC).<sup>7</sup> Glass Lewis, the world’s second largest proxy advisor, is not under the purview of the SEC.<sup>8</sup> Given the extensive conflicts of interest issues confronted by firms such as ISS and Glass Lewis, it is worth wondering whether more firms should be under closer scrutiny of the SEC. This Note argues that such conflicts of interest are unsustainable and inherently run counter to the values and interests of the institutional investors that third-party proxy advisors regularly represent. Accordingly, this Note proposes a number of reforms meant to specifically deal with conflicts of interest.

Part I of this Note discusses the history of institutional third-party proxy advisors. Part II discusses the role that proxy advisors have come to play in the realm of corporate governance in the United States, the current regulatory environment, and recent regulatory proposals. Part III discusses the legal duties that proxy advisory firms may owe to their clients. Part IV reviews the existing literature on conflicts of interest within proxy advisory firms and seeks to make a determination as to whether or not such conflicts are truly problematic. Finally, Part V advocates three reforms: legislation, a complete regulatory overhaul of the proxy advisory industry, and voluntary SEC disclosure by proxy advisory firms through Form ADV.

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4. Yonca Ertimur, Fabrizio Ferri & David Oesch, *Shareholder Votes and Proxy Advisors: Evidence from Say on Pay*, 51 J. ACCT. RES. 951, 951 (2013); see also *infra* note 37.

5. Jei Cai, Jacqueline L. Garner & Ralph A. Walkling, *Electing Directors*, 64 J. FIN. 2389, 2391 (2009).

6. See generally U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 2.

7. See Institutional Shareholder Services, Inc., Comment Letter to Dodd-Frank Investor Advisory Committee 6 (Dec. 8, 2016), <https://www.sec.gov/comments/265-28/26528-271.pdf>.

8. *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 Serus.*, 114th Cong. 4 (2016) (statement of Society of Corporate Secretaries and Governance Professionals & the National Investor Relations Institute) [hereinafter *Society of Corporate Secretaries Statement*].

## I. THE HISTORY OF THIRD-PARTY INSTITUTIONAL PROXY ADVISORS

Simply stated, proxy advisors give advice to shareholders and institutional investors on how to vote their shares in major corporate decisions, such as mergers and acquisitions, director elections, executive compensation, and various policies related to corporate governance.<sup>9</sup> Several individuals believe the Employee Retirement Income Security Act of 1974 (ERISA) dramatically changed the landscape for corporate governance matters in the United States.<sup>10</sup> ERISA imposes upon voter proxies the duty to vote in a reasonable manner for matters involving fiduciaries of employee benefit plans.<sup>11</sup> Shortly after the enactment of ERISA, those in control of pension plans and other financial vehicles managed by institutional investors began to concern themselves with the placement of board members, the implementation of shareholder proposals, and other matters, in order to comply with this newfound fiduciary duty.<sup>12</sup> However, the vast number of portfolio companies that existed at the time made it difficult to carefully review all of the necessary information.<sup>13</sup>

These circumstances led to the creation of ISS in 1985; ISS was founded for the purpose of “promoting good corporate governance and raising the level of active and informed proxy voting among institutional investors.”<sup>14</sup> Since its establishment, ISS has remained the largest proxy advisory service in the world, “cover[ing] almost 40,000 meetings in 115 countries and having over 1,600 institutional clients.”<sup>15</sup> The next two largest proxy advisory firms are Glass Lewis and, less widely known in the United States, Manifest.<sup>16</sup>

While ERISA created an opportunity for proxy advisory firms to enter the market, a number of SEC rulings in 2003 paved the way

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9. Nadya Malenko & Yao Shen, *The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design*, 29 REV. FIN. STUD. 3394, 3394 (2016).

10. See CTR. ON EXEC. COMP., A CALL FOR CHANGE IN THE PROXY ADVISORY INDUSTRY STATUS QUO: THE CASE FOR GREATER ACCOUNTABILITY AND OVERSIGHT, (2011), <http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf>.

11. Interpretive Bulletin Relating to Exercise of Shareholder Rights, 73 Fed. Reg. 61,731, 61,732–34 (Oct. 11, 2008) (to be codified at 29 C.F.R. pt. 2509).

12. Michael R. Levin, *Proxy Advisors*, ACTIVIST INV., [http://www.theactivistinvestor.com/The\\_Activist\\_Investor/Proxy\\_Advisors.html](http://www.theactivistinvestor.com/The_Activist_Investor/Proxy_Advisors.html) [[https://web.archive.org/web/20180126234707/http://www.theactivistinvestor.com/The\\_Activist\\_Investor/Proxy\\_Advisors.html](https://web.archive.org/web/20180126234707/http://www.theactivistinvestor.com/The_Activist_Investor/Proxy_Advisors.html)] (last visited Jan. 26, 2018).

13. *Id.*

14. *ISS History*, INSTITUTIONAL SHAREHOLDER SERVS., <http://www.issgovernance.com/about/iss-history/> (last visited Jan. 26, 2018).

15. See Malenko & Shen, *supra* note 9, at 3394.

16. See *Company Overview*, GLASS LEWIS, <http://www.glasslewis.com> [<https://web.archive.org/web/20180126235339/http://www.glasslewis.com/company-overview/>] (last visited Jan. 26, 2018); See also MANIFEST, <http://www.manifest.co.uk> (last visited Jan. 26, 2018).

for the exponential influence that these firms hold today.<sup>17</sup> The rules provide increased regulation for proxy advisory firms under the jurisdiction of the SEC and also allow institutional investors to rely on advice from those proxy advisory firms to fulfill their fiduciary obligations to clients when they vote their shares.<sup>18</sup> While this was a good starting point, as explained in Part III, ISS is the only proxy advisory firm registered with the SEC.<sup>19</sup> Thus, while the rule generally has the potential to impose greater regulation on proxy advisory firms, it only relates to one firm in the country.

## II. ROLE OF PROXY ADVISORY FIRMS AND REGULATORY ENVIRONMENT

The role of proxy advisory firms has increased greatly in correlation with the increase in equity ownership by activist investors. The amount of public equity owned by institutional investors, for example, increased from eight percent in 1950 to about sixty-seven percent in 2010.<sup>20</sup> Many scholars attribute this increase to the greater participation that average institutional investors show in mutual funds and exchange traded funds.<sup>21</sup> Regardless of their causes, one thing is certain: with this increased amount of power, institutional investors possess a significant influence over a wide array of corporate governance matters, including executive compensation, director elections, and removals.<sup>22</sup>

### A. *The Role of Proxy Advisory Firms*

Proxy advisory firms are generally thought to provide two types of services to their activist-investor clients:

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17. See Interpretative Releases Relating to the Investment Advisers Act of 1940, 17 C.F.R. § 276 (2017); see also 17 C.F.R. §§ 239, 249, 270, 274 (2017).

18. Allan L. McCall & David F. Larcker, *Researchers: The Power of Proxy Advisory Firms*, STAN. GRADUATE SCH. BUS.: CORP. GOVERNANCE (Jan. 13, 2014), <https://www.gsb.stanford.edu/insights/researchers-power-proxy-advisory-firms>.

19. See Institutional Shareholder Services, Inc., *supra* note 7, at 2.

20. Louis A. Aguilar, Commissioner, Sec. & Exch. Comm'n., Institutional Investors: Power and Responsibility, Address at Georgia State University J. Mack College of Business (Apr. 19, 2013), <https://www.sec.gov/News/Speech/Detail/Speech/1365171515808>.

21. *Id.*

22. See CAROL HANSALL & ROBERT MURPHY, DAVIES WARD PHILLIPS & VINEBERG LLP, THE ROLE OF THE PROXY ADVISORY FIRM: WHAT DIRECTORS NEED TO KNOW 1 (2011), <https://www.dwpv.com/sites/shareholdervoting/media/TheRoleoftheProxyAdvisoryFirm.pdf>.

First, they provide their clients with the complex mechanics of managing their voting rights. Second, they provide research and analysis relevant to the issues on which their clients are entitled to vote and make recommendations about how those votes should be cast. Although these two types of services are separate (and some institutions use one service, but not the other) they are highly synergistic. Many institutional investors see economies in outsourcing all of the functions associated with exercising their voting rights to one proxy advisory firm.<sup>23</sup>

The increase in the role of proxy advisory firms has unsurprisingly brought with it a lot of concern from different players in the corporate world. Because of this increase, the SEC has numerous times called for proposals and roundtables to discuss the topic.<sup>24</sup> For example, former SEC Commissioner Michael Piwowar in 2013 commented, “proxy advisory firms may exercise out-sized influence on shareholder voting” and the “Dodd-Frank provisions, such as mandatory say-on-pay votes, make proxy advisory firms potentially even more influential.”<sup>25</sup> Public and private concerns, thus, have paved the way for a—albeit weak—regulatory regime surrounding proxy advisory firms.

The amount of influence firms actually have on voting outcomes has been widely debated.<sup>26</sup> In 2009, three professors, using empirical evidence, determined that available corporate governance rankings provided by proxy advisors were not useful information for shareholders.<sup>27</sup> In coming to this conclusion, the authors examined Corporate Governance Quotients (CGQ), GMIs (a measure of governance quality produced by Governance Metrics International), and TCLs (a rating produced by The Corporate Library).<sup>28</sup> Regarding CGQ, a higher rating from ISS was associated with lower Tobin’s Q (a ratio of the market value of a company’s assets), and

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23. *Id.* at 3.

24. *See, e.g., Proxy Advisory Services Roundtable*, SEC. & EXCHANGE COMMISSION, <https://www.sec.gov/spotlight/proxy-advisory-services.shtml> [<https://web.archive.org/web/20180127000733/https://www.sec.gov/spotlight/proxy-advisory-services.shtml>] (last visited Jan. 26, 2018).

25. Michael S. Piwowar, Commissioner, Sec. & Exch. Comm’n, Address at the Proxy Advisory Services Round Table (Dec. 5, 2013), <https://www.sec.gov/news/public-statement/2013-12-05-opening-statement-roundtable-msp>.

26. *See* Letter from Ken Bertsch, Exec. Dir., Council of Institutional Inv’rs to U.S. Senate Comm. on Banking, Hous., & Urban Affairs, The Regulation of Proxy Advisory Firms (Sept. 6, 2016), <https://corpgov.law.harvard.edu/2016/09/26/the-regulation-of-proxy-advisory-firms/>.

27. Robert M. Daines, Ian D. Gow & David F. Larcker, *Rating and Ratings: How Good Are Commercial Governance Ratings?*, 98 J. Fin. Econ. 439, 439 (2010).

28. *Id.* at 440.

in some models more class action lawsuits.<sup>29</sup> Further, and more importantly, ISS “sub-scores” (low scores) that rate the quality of a firm’s audit review and board of directors resulted in better governance ratings yielding worse results.<sup>30</sup> Thus, ratings provided by ISS and other proxy advisory firms are not always clairvoyant and will frequently get things wrong.

Others have pointed out the difficulty of accurately measuring cause and effect of proxy advisory firms due to an omitted variable problem.<sup>31</sup> The problem is that the “same unobservable firm characteristics that lead ISS to give a negative recommendation can also lead shareholders to withdraw their support for the proposal, leading to an upward bias in the estimates of the ISS effect.”<sup>32</sup>

Scholars on the other side of the argument assert that, at the very least, there is a positive correlation between recommendations and shareholder votes.<sup>33</sup> Findings have shown that a negative recommendation from ISS has an influence on between 13.6% and 20.6% of votes cast on “management-sponsored proposals.”<sup>34</sup> Further, during 2011, “no company that received a positive recommendation failed its say-on-pay vote, and 12% of companies that received a negative recommendation from ISS failed their say-on-pay vote.”<sup>35</sup>

Whether or not recommendations to *corporate clients* have a large impact on corporate governance policy is seldom a subject of great debate. For example, corporations like Aetna and GE that employed ISS services to recommend governance changes saw the changes lift their ratings from 10% to more than 90%.<sup>36</sup> Additionally, it is generally understood that third-party proxy advisors have somewhat of an effect on “say-on-pay” outcomes, depending principally on the ownership structure of a given corporation.<sup>37</sup>

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29. *Id.*

30. *Id.*

31. *See, e.g.*, Malenko & Shen, *supra* note 9, at 3395.

32. *Id.*

33. *See, e.g.*, Ertimur, Ferri & Oesch, *supra* note 4, at 951; David F. Larcker et al., *Outsourcing Shareholder Voting to Proxy Advisory Firms*, 58 J.L. & ECON. 173, 173 (2012); David F. Larcker et al., *The Influence of Proxy Advisory Firm Voting Recommendations*, DIRECTOR NOTES, Mar. 2012, at 1, [https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-survey-2012-proxy-voting\\_0.pdf](https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-survey-2012-proxy-voting_0.pdf).

34. Larcker et al., *The Influence of Proxy Advisory Firm Voting Recommendations*, *supra* note 33, at 3.

35. *Id.*

36. *See, e.g.*, Daines et al., *supra* note 27, at 440; *see also* Monica Langley, *ISS Rates Firms—And Sells Roadmap to Boosting Score*, WALL ST. J. (June 6, 2003, 12:38 AM), <https://www.wsj.com/articles/SB105485006531971100>.

37. Randall S. Thomas & Christoph Van Der Elst, *Say on Pay Around the World*, 92 WASH. U. L. REV. 653, 657 (2015).

### B. *The Regulatory Environment for Proxy Advisory Firms*

The proxy advisory industry is subject to few, if any, regulations. Indeed, some have referred to the regulations as a “patchwork quilt.”<sup>38</sup> One such regulation within the “patchwork quilt” is the Investment Advisors Act of 1940, which ISS is registered under.<sup>39</sup> While critics maintain that the rules of this particular Act do not accurately reflect the role that proxy advisory firms play (for example, proxy advisory firms don’t select securities),<sup>40</sup> registration with this Act has led to SEC enforcement in the past and at the very least, shows that the firm is under some sort of scrutiny.<sup>41</sup>

While ISS has regulations to comply with, the second largest firm, Glass Lewis, is not registered as an investment adviser.<sup>42</sup> In fact, Glass Lewis is not registered under any securities statutes whatsoever, meaning that it is not subject to any statutes enforced by the SEC.<sup>43</sup> Thus, no fiduciary duty is enforced against Glass Lewis—a company whose customers as of 2005 managed nearly \$8 trillion total.<sup>44</sup>

Another feature of the current regulatory framework provides advisory firms with leeway in the United States: Exchange Act Rule 14a-2(b).<sup>45</sup> This is an SEC created exemption for proxy advisors subject to SEC regulation. The rule provides that proxy advisory firms are not required to abide by the solicitation and disclosure rules applicable to other proxy participants.<sup>46</sup> The effect is that their reports are not subject to outside review or oversight of any kind.<sup>47</sup>

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38. See *Society of Corporate Secretaries Statement*, *supra* note 8, at 4. “Patchwork Quilt,” as used above, refers to the terminology used by the National Investor Relations Institute when describing the regulatory state for third-party institutional proxy advisors. It essentially means that the regulations currently in place allow for many loopholes and evasion by proxy advisory firms.

39. 15 U.S.C. §§ 80b-1 to -21 (2012).

40. See generally CTR. ON EXEC. COMP., *supra* note 10.

41. See, e.g., Institutional S’holder Servs., Exchange Act Release No. 3611, 2013 WL 11113059 (May 23, 2013) (ISS was charged with willfully violating 15 U.S.C. § 80b-4a (2012) when an employee provided proxy solicitation materials to an insider).

42. *Society of Corporate Secretaries Statement* *supra* note 8, at 4; CTR. ON EXEC. COMP., *supra* note 10, at 33.

43. *Society of Corporate Secretaries Statement* *supra* note 8, at 4.

44. Press Release, Glass Lewis, Glass Lewis Achieves Dominant Market Share Among Largest Money Managers and Plan Sponsors (Dec. 19, 2005), <http://www.glasslewis.com/glass-lewis-achieves-dominant-market-share-among-largest-money-managers-and-plan-sponsors/>.

45. 17 C.F.R. § 240.14a-2(b) (2017).

46. *Id.*

47. *Id.*



Rule 14a-2(b)(3) of the Exchange Act also requires proxy advisory firms to disclose any significant relationship with a soliciting company, shareowner proponent, or material interest in a matter that is materially related to the subject of a voting recommendation provided by the firm.<sup>48</sup> Anti-reform advocates argue that this regulation is sufficient to adequately protect from conflicts of interest and other transparency concerns.<sup>49</sup> The problem, however, is that not all proxy advisory firms are subject to this statute.<sup>50</sup> Thus, whatever regulatory implications may exist, application of the rule is inconsistent towards the industry as a whole.

### C. *Recent Attempts at Ramping Up the Regulatory Environment for Proxy Advisors*

Despite the “patchwork quilt” regulating proxy advisory firms,<sup>51</sup> there have been many different attempts to increase transparency and oversight in the industry over the years. Two pieces of proposed legislation in the most recent Congress—the Corporate Governance Reform and Transparency Act (CGRTA) and the Financial Choice Act of 2016—made this attempt and sparked a lot of debate amongst industry insiders.<sup>52</sup>

The CGRTA, proposed by Congressman Sean Duffy, sought to “improve the quality of proxy advisory firms for the protection of investors and the U.S. economy, and in the public interest, by fostering accountability, transparency, responsiveness, and competition . . . .”<sup>53</sup> Principally, the bill: (1) required proxy advisory firms to register with the SEC;<sup>54</sup> (2) required commission oversight of firms in making their voting recommendations available to companies in advance of publication;<sup>55</sup> (3) required that advisory firms employ an ombudsman to receive complaints;<sup>56</sup> (4) required firms to disclose potential conflicts of interest;<sup>57</sup> and (5) required firms to

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48. § 240.14a-2(b)(3).

49. Letter from Fiona Reynolds, Managing Dir., Principles for Responsible Inv., to Hon. Jeb Hensarling, Chairman, House Comm. on Fin. Servs., & Hon. Maxine Waters, Ranking Member, House Comm. on Fin. Servs. (June 13, 2016), [https://www.unpri.org/download\\_report/21526](https://www.unpri.org/download_report/21526).

50. See *Society of Corporate Secretaries Statement*, *supra* note 8, at 4–5.

51. See *Society of Corporate Secretaries Statement*, *supra* note 8, at 4.

52. Financial Choice Act of 2016, H.R. 5983, 114th Cong. (2016); Corporate Governance Reform and Transparency Act, H.R. 5311, 114th Cong. (2016).

53. H.R. 5311 at 1.

54. *Id.* § 15H(a).

55. *Id.* § 15H(g)(1).

56. *Id.*

57. *Id.* § 15H(f)(1).

disclose procedures and methodologies for formulating proxy recommendations.<sup>58</sup> The proposed bill was met with considerable criticism and never made it out of committee.<sup>59</sup>

The Financial Choice Act of 2016, introduced by House Financial Services Committee Chairman Jeb Hensarling,<sup>60</sup> took a larger approach by focusing beyond the realm of proxy advisory firms. The Act, like the CGRTA, required registration of proxy advisory firms with the SEC.<sup>61</sup> But additionally, the Act mandated that firms disclose annually to the SEC methodologies and procedures in developing recommendations, the organizational structure of firms, potential conflicts of interest, and many financial details.<sup>62</sup> The Act, framed as an alternative to Dodd-Frank, was also subject to criticism and later died in committee.<sup>63</sup>

### III. LEGAL DUTIES OF PROXY ADVISORY FIRMS

It is worth briefly mentioning that some proxy advisory firms do have legal duties imposed on them. The determining factor for whether a proxy advisory firm is subject to fiduciary duties is if they are registered as “investment advisers” with the SEC.<sup>64</sup> As previously stated, ISS, the world’s largest proxy advisory service,<sup>65</sup> is registered under the Investment Advisers Act of 1940 and is subject to fiduciary duties.<sup>66</sup>

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58. *Id.* § 15H(l); see also Bonnie Barsamian & Marc Leaf, *Proxy Advisory Firms in the Regulatory Spotlight*, LAW360 (Dec. 8, 2016, 11:10 AM), <https://www.law360.com/articles/869646/proxy-advisory-firms-in-the-regulatory-spotlight>.

59. *See Actions Overview: H.R. 5311*, CONGRESS.GOV, <https://www.congress.gov/bill/114th-congress/house-bill/5311/actions> [<https://web.archive.org/web/20180128202255/https://www.congress.gov/bill/114th-congress/house-bill/5311/actions>] (last visited Jan. 26, 2018); see, e.g., David Bogoslaw, *Major Investors Gear Up to Oppose Bill Regulating Proxy Advisors*, IR MAG. (July 19, 2016), <https://www.irmagazine.com/articles/proxy-voting-annual-meetings/21534/major-investors-gear-oppose-bill-regulating-proxy-advisers/>; Jeff Mahoney, *2 House Bills That Could Harm Investors*, CORP. COMPLIANCE INSIGHTS (Oct. 17, 2016), <http://www.corporatecomplianceinsights.com/2-house-bills-harm-investors/>; Gary Retelny, *Taking the Ax to Corporate Accountability*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (July 13, 2016), <https://corp.gov.law.harvard.edu/2016/07/13/taking-the-ax-to-corporate-accountability/>.

60. Financial Choice Act of 2016, H.R. 5983, 114th Cong. (2016).

61. *Id.* § 1082; see Cydney Posner, *Undo Dodd-Frank?*, COOLEY PUBCO (Nov. 9, 2016), <https://cooleypubco.com/2016/11/09/undo-dodd-frank/>.

62. H.R. 5983 § 15H(b).

63. *See Actions Overview: H.R. 5983*, CONGRESS.GOV, <https://www.congress.gov/bill/114th-congress/house-bill/5983/actions> (last visited Jan. 26, 2018).

64. *See* Institutional Shareholder Services, Inc., *supra* note 7, at 5.

65. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 2.

66. *See* Institutional Shareholder Services, Inc., *supra* note 7, at 5. Section 206 of the Investment Advisers Act of 1940 has a list of prohibited transactions for investment advisers

The leading case on fiduciary duty under the Investment Advisers Act of 1940 is *SEC v. Capital Gains Research Bureau, Inc.*<sup>67</sup> The Supreme Court in *Capital Gains* determined that the Act reflects Congress's recognition of the fiduciary nature of an investment advisory relationship.<sup>68</sup> Proxy advisory firms meet the definition of investment adviser because they are paid to give analyses regarding securities and provide advice on their value.<sup>69</sup> Due to this, ISS has the "affirmative duty of utmost good faith, and full and fair disclosure of all material facts, as well as an affirmative obligation to employ reasonable care to avoid misleading [its] clients."<sup>70</sup>

*Capital Gains* thus imposes a fiduciary duty on those registered under the Investment Advisers Act and also forces them to disclose material conflicts of interest.<sup>71</sup> However, the conflicts disclosures made by ISS have been criticized for their vagueness and lack of information.<sup>72</sup> Furthermore, Glass Lewis and other large proxy advisory firms are not registered under the Act (or any other legislation), and thus owe no fiduciary duties to their clients and are not forced to disclose material conflicts of interest.<sup>73</sup> The only reason that ISS is even subject to the Investment Advisers Act is because other parts of its business fall within it.<sup>74</sup> The question examined in the next two sections is whether disclosure is enough, and if not, what else should be required of proxy advisory firms?

#### IV. CONFLICTS OF INTEREST IN PROXY ADVISORY FIRMS

There are four principal potential conflicts of interest that may arise at proxy advisory firms: (1) ISS and other firms "advise[ ] institutional clients on how to vote their proxies and at the same time provide consulting services to help corporations develop management proposals and improve their corporation governance";<sup>75</sup> (2)

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and has the effect of creating a fiduciary duty on those advisers to not engage in those transactions. *See* 15 U.S.C. § 80b-6 (2012).

67. *See* Institutional Shareholder Services, Inc., *supra* note 7, at 5.

68. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

69. Concept Release on the US Proxy System ("Concept Release"), Exchange Act Release No. 34-62495, 75 Fed. Reg. 42982, 43010 (July 22, 2010) (codified at 17 CFR pts. 240, 270, 274 (2017)).

70. *Capital Gains Research Bureau, Inc.*, 375 U.S. at 194 (internal quotations omitted) (footnotes omitted).

71. *Id.*

72. *See Capital Gains Research Bureau, Inc.*, 375 U.S. at 194.

73. *See Society of Corporate Secretaries Statement*, *supra* note 8, at 6.

74. *See* Institutional Shareholder Services, Inc., *supra* note 7, at 4. (explaining how ISS became subject to fiduciary duties due to its connection with ERISA).

75. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 2, at 4.

there are potential conflicts related to firms providing recommendations on shareholder initiatives backed by owners or institutional investors who are also clients;<sup>76</sup> (3) there are conflicts where owners, executives, or staff of proxy advisory firms have ownership interests, or serve on the board of, companies which they make recommendations on;<sup>77</sup> and (4) there are conflicts when proxy advisory firms are “owned by firms that provide other financial services to various types of clients.”<sup>78</sup>

A few problems could plausibly arise due to these conflicts. First, advising on both sides could result in corporations feeling obligated to retain proxy advisory services in order to obtain favorable voting recommendations.<sup>79</sup> Scholars have argued that it is impossible for firms such as ISS to meet their fiduciary duties while providing both of these services.<sup>80</sup> The second concern that arises is 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.”<sup>81</sup> There are persuasive arguments on both sides of this debate as to whether and to what extent such conflicts of interest pose problems. Put succinctly by the Government Accountability Office (GAO):

ISS could help a corporate client design an executive compensation proposal to be voted on by shareholders and subsequently make a recommendation to investor clients to vote for this proposal. Some industry professionals also contend that corporations could feel obligated to subscribe to ISS’s consulting services in order to obtain favorable proxy vote recommendations on their proposals and favorable corporate governance ratings.<sup>82</sup>

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76. CTR. ON EXEC. COMP., *supra* note 10, at 42.

77. *Id.*

78. *Id.*

79. *Id.*; see also U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 2, at 4.

80. CTR. ON EXEC. COMP., *supra* note 10, at 61; see also SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963); George W. Dent, Jr., *A Defense of Proxy Advisors*, 2014 MICH. ST. L. REV. 1287, 1321–26 (2014).

81. See U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 2, at 12; see also *Capital Gains Research Bureau, Inc.*, 375 U.S. at 201 (explaining that the high standards of business morality which regulate the securities industry don’t permit an investment adviser to trade on the market effect of their own recommendations without fairly revealing his personal ties in these recommendation to their own clients).

82. See U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 2, at 10.

Despite what many scholars would argue, this is a huge problem that must be addressed by Congress, the SEC, or the industry itself.<sup>83</sup> Corporations should only employ advisory firms if they *want* to, and shareholders need to be able to trust that the recommendations they receive are neutral and non-biased.

The leading advocate for reform regarding third-party proxy advisors is Tao Li, Finance Professor at Warrington College of Business. His article, “Outsourcing Corporate Governance: Conflicts of Interest Within the Proxy Advisory Industry,” was the first to provide empirical evidence that “conflicts of interest are a real concern in the proxy advisory industry . . . .”<sup>84</sup> Professor Li showed this effect by examining the entry of Glass Lewis into ISS’s market space. His findings demonstrated that increased competition led to ISS becoming tougher with its possible corporate clients, compared to non-client corporations.<sup>85</sup> Li inferred that ISS’s change in behavior upon Glass Lewis’s entry into the market showed that an increase in competition forced proxy advisory firms to act less on the biases that are created by conflicts of interest.<sup>86</sup> While increased competition would undercut the idea that conflicts of interest cause skewed corporate governance rankings, it is not often the case that two proxy-advisory firms compete head-to-head.

Li’s findings showed that ISS’s average “For” recommendation for shareholder proposals at large firms increased 11.9% after Glass Lewis’s coverage began.<sup>87</sup> This suggested that ISS “is more likely to be lenient with its possible corporate clients before Glass Lewis enters—after which it would be more difficult for ISS to treat client firms more favorably.”<sup>88</sup> Similarly, Li found that ISS’s negative recommendations for governance-related proposals submitted by management increased by 2.7% after Glass Lewis entered.<sup>89</sup> Changes in behavior from ISS were even more pronounced in the context of executive compensation proposals from management.<sup>90</sup>

Consider the following example: Advisor A is providing vote recommendations to shareholders for Company C. If C is in the market for consulting on issues related to corporate governance, who will C seek help from? Of course, the answer is A. A is advising

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83. See *infra* Part V.

84. Tao Li, *Outsourcing Corporate Governance: Conflicts of Interest within the Proxy Advisory Industry*, MGMT. SCI., Dec. 2016, at 5.

85. *Id.* at 3.

86. *Id.*

87. *Id.* at 20.

88. *Id.* at 21.

89. *Id.*

90. *Id.*

potential adversaries on how good C's corporate governance is, so why not take advice from the most influential person in those decisions? A, as the law stands, may enter into these agreements. Now take into account the fact that Li has shown empirically that when one firm is doing all of the services for a company (A doing all of the work for C—both recommending for shareholders and consulting for management), its recommendations and analysis changes when another advisor, say B, enters the mix.<sup>91</sup> It is thus Li's assertion that the entrance of a competitor leads to less biased votes, which leads to investors having more accurate and neutral recommendations for their proxies.<sup>92</sup> This would indicate that proxy advisory firms are less critical of management when their analysis isn't under the scrutiny of competitor proxy advisory firms. In short, full-service advisory firms have less of a check on their powers when they have no competition.

Another aspect of the problem is that companies have few options in choosing advisors given that the two preeminent firms are ISS and Glass Lewis.<sup>93</sup> When faced with the decision of hiring a prestigious and widely known firm, such as ISS or Glass Lewis, as compared with a lesser-known firm, the choice is obvious for most. This is particularly true when your adversaries are using one of the two services—who would you give business to in order to gain favor?

While Li may be the first to produce empirical support for the assertion that conflicts of interest pose real problems, many others generally support the assertion that proxy advisors suffer from inherent conflicts of interest in their business models.<sup>94</sup> The extent of such conflicts, however, has been downplayed by many—including the advisory firms themselves.<sup>95</sup>

George W. Dent Jr.'s "Defense of Proxy Advisors" offers one of the more prominent criticisms of the conflicts of interest argument.<sup>96</sup> Focusing on ISS, Dent argues that concerns about conflicts of interest are unwarranted because: (1) ISS is already subject to

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91. *Id.*

92. *Id.*

93. See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 2, at 7.

94. See Cynthia E. Clark & Harry J. Van Buren III, *Compound Conflicts of Interest in the US Proxy System*, 116 J. BUS. ETHICS 355, 361–62 (2013); see also U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 2, at 2–6; Emily Chasan, *SEC to Examine Potential Conflicts of Interest at Proxy Advisers*, WALL ST. J. (Nov. 5, 2013, 4:53 PM), <http://blogs.wsj.com/cfo/2013/11/05/sec-to-examine-potentialconflicts-of-interest-at-proxy-advisers/>; Dent, *supra* note 80, at 1321–27.

95. *Policy on Potential Conflicts of Interest*, INSTITUTIONAL SHAREHOLDER SERVS., INC. (June 19, 2014), <https://www.issgovernance.com/file/duediligence/2014-ISS-Conflicts-Policy-6-19-2014.pdf>; *Conflict of Interest Statement*, GLASS LEWIS <http://www.glasslewis.com/conflict-of-interest/> [<https://web.archive.org/web/20180128213434/http://www.glasslewis.com/conflict-of-interest/>] (last visited Jan. 26, 2018).

96. See Dent, *supra* note 80.

fiduciary duties under the Investment Adviser's Act;<sup>97</sup> (2) imposing duties on smaller proxy advisory firms will diminish competition;<sup>98</sup> (3) the growth of competing firms like Glass Lewis reduce concerns of inherent coercion;<sup>99</sup> and (4) the only individuals complaining about conflicts of interest are corporate managers, who are upset because of the role advisory firms have played in reducing the managers' power.<sup>100</sup> In support of this position, Dent claims—incorrectly—that “no complaints have been filed against [ISS] for failing to discharge these duties.”<sup>101</sup>

Dent makes several good points—particularly his argument that competition in the proxy industry reduces concerns about conflicts of interest. But, several of his points are unpersuasive. First, the fact that ISS is subject to a fiduciary standard under the Investment Adviser's Act fails to answer broader concerns regarding conflicts of interest in the industry. ISS may be subject to a fiduciary standard, but it is not the only firm in the marketplace. And some of those competing firms, such as Glass Lewis, are not held to a fiduciary standard.<sup>102</sup>

Second, the ISS example contradicts Dent's point because it suggests that more regulation is needed, not less. Dent suggests that holding ISS to a fiduciary standard effectively controls conflicts of interest. Many smaller firms, however, are not held to a fiduciary standard under the current law. This suggests that regulators ought to hold a larger variety of firms to a fiduciary standard, therefore increasing the scope of regulation. Some might be concerned that increasing the scope of fiduciary duties will serve as a barrier to entry, therefore harming clients by reducing competition. These arguments are unpersuasive, and ignore the reality that massive firms, with a client-base worth \$26 trillion, are currently exempt from fiduciary standards.

Third, Dent's claim that only disgruntled corporate managers are complaining about conflicts of interest misses the mark. This Note has shown that a large and diverse array of stakeholders and scholars have raised concerns about conflicts of interest, including the Wall Street Journal and the SEC.<sup>103</sup> Furthermore, corporate manager complaints should not be disregarded entirely because of a possible self-interested motive. Corporate managers are some of

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97. See generally *id.*

98. *Id.*

99. *Id.*

100. *Id.* at 1327.

101. Dent, *supra* note 80, at 1323.

102. See *Society of Corporate Secretaries Statement*, *supra* note 8, at 4.

103. See *supra* notes 24, 36.

the biggest players in corporate governance, and have many legitimate reasons to criticize the status quo.

Finally, it is misleading to suggest that firms other than ISS are “small.” Marco Consulting Group, an advisory firm on the “smaller” side, has clients collectively worth \$85 billion.<sup>104</sup> Imposing fiduciary duties on a firm of such power is unlikely to dissuade the firm from continuing to do business, and therefore is unlikely to reduce competition.

As the next section will point out, the proxy advisory industry is dominated by a small number of firms. Competition is important but, at present time with barriers to competition already in place, imposing fiduciary duties on the few powerful advisors would likely not significantly harm them. For example, ISS’s prominence and success has increased exponentially while under the imposition of such duties due to the 2003 SEC Rules.<sup>105</sup>

The major rebuttal to the argument that proxy advisory firms suffer from conflicts of interest that taint their recommendations is the fact that these firms disclose all of their potential conflicts of interest,<sup>106</sup> and have put procedures in place to protect neutrality through the use of internal software firewalls.<sup>107</sup> The disclosures used by some advisers, however, 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.<sup>108</sup> Further, ISS, when providing consultant services on the corporate side, treats clients as confidential.<sup>109</sup> This inevitably creates difficulty when trying to analyze “disclosures.” These steps are simply not enough.

Whether the conflicts are *actually* problematic or *potentially* problematic is immaterial. Regulators should not allow conflicts like these to exist in such an important industry. The growing prominence of proxy advisory firms in recent years and the aggressive tone taken by activist investors in the period from 2010 through the present highlights the importance of maintaining neutrality. It is not just by chance that the Wall Street Journal, the SEC, the U.S. Congress, and many others have called for change in recent years.

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104. Douglas Appell, *Marco Founders Pass “Heavy Lifting” to Key Staffers*, PENSIONS & INV. ONLINE (Apr. 18, 2011), <http://www.pionline.com/article/20110418/PRINT/304189983/marco-founders-pass-heavy-lifting-to-key-staffers>.

105. See generally U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 2.

106. See Dent, *supra* note 80, at 1323.

107. See Dent, *supra* note 80, at 1323; see also U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 2, at 10.

108. See CTR. ON EXEC. COMP., *supra* note 10, at 69.

109. See Dent, *supra* note 80, at 1324.



More oversight and transparency is needed to ensure that management and shareholders continue to have faith in voting recommendations. The free market principals touted by anti-regulators such as Professor Dent do not work in this industry at this point in time. The market is not “free” or “fair”—it is dominated by a select few. Those who employ the services of proxy advisors should be confident in the recommendations and suggestions made by those firms, and resolving conflicts of interests will go a long way towards achieving that goal.

## V. THE ROAD TO REFORM

The proxy advisory industry is in need of reform. The business models upon which the major players operate are best suited to an era of corporate governance that no longer exists. The rise of activist investors and the increased importance of proxy advisors as a response, mandates change in this area. Major conflicts of interest—potential and actual—should not be allowed to exist in an area that demands trust, neutrality, and loyalty in order to work effectively. The reforms advocated for in this Note seek to remedy the issue through increases in competition, legislation, voluntary filing from other major firms that aren’t under the SEC’s jurisdiction, and amending Form ADV used by the SEC for proxy advisors.

In advocating for these reforms, this Note makes two key assumptions. First, this Note presumes that recommendations of proxy advisors are valued and used to make decisions regarding corporate governance. While empirical evidence supports this assertion,<sup>110</sup> disagreement persists.<sup>111</sup> Second, aside from very briefly, this Note, for the most part, will not address in depth the practical political difficulties with implementing these reforms—specifically in regard to legislative reform.

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110. Matteo Tonello, *The Influence of Proxy Advisory Firm Voting Recommendations*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (Apr. 8, 2012), <https://corpgov.law.harvard.edu/2012/04/08/the-influence-of-proxy-advisory-firm-voting-recommendations/>; cf. Ertimur, Ferri & Oesch, *supra* note 4, at 955 (“[Proxy Advisory Firms] key economic role, rather than identifying and promoting superior compensation practices, is processing and organizing a substantial amount of executive pay information for institutional investors, reducing their cost of making informed voting decisions.”); Larcker et al., *The Influence of Proxy Advisory Firm Voting Recommendations*, *supra* note 33, at 1 (“However, the impact of [Proxy Advisory Firms] on governance quality and shareholder value is still unknown.”).

111. Daines, *supra* note 27, at 441. Whether proxy opinions matter, and to what degree, is an interesting question. That question, however, is beyond the scope of this Note.

A. *Increased Competition Through SEC Market Analysis and Corresponding Legislation*

The proxy advisory industry is dominated by a select few companies, with the top two—ISS and Glass Lewis—having the greatest market share.<sup>112</sup> As aforementioned, empirical evidence has shown that the increase of competition in particular areas of proxy advising has led to different behavior by ISS in its recommendations.<sup>113</sup> This suggests that an increase in competition will dilute the effects that these conflicts of interest have on the proxy advisory industry.<sup>114</sup> Statistics and analysis aside, this seems to comport with common sense. When only a select few players have control of a market, a natural type of inherent coercion comes to exist.

The question then, has to be, how do we increase competition in this field so as to decrease conflicts of interest? The answer is partly by lowering barriers to entry.<sup>115</sup> First and foremost, the SEC should conduct research and write a report on the market conditions of the proxy advisory industry and the barriers to entry that the market poses to would-be competitors. Such a report would prove valuable for those looking to enter the market and, if nothing else, provide information on what makes being competitive in this area most difficult. Second, after identifying the main barriers to competition, legislation should be put in place to aid in fostering competition.

Legislation should be promulgated by Congress in accordance with the SEC's report on barriers to market entry. For example, if capitalization were the main barrier to entry for aspiring proxy advisory firms, then legislation should be implemented to specifically address and remedy that issue. Providing subsidies in order to spur competition (or squash it) has been used often in American legislation and widely throughout the world.<sup>116</sup> Also common and widely

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112. See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 2, at 13.

113. See Li, *supra* note 84.

114. See *generally id.*

115. It is worth briefly pointing out an implicit contradiction in my argument: the idea that reducing barriers is necessary coupled with the fact that I will next argue for more regulation (something seen as a traditional barrier to entry). The response to that, however, is that more regulation, and as a result, trust by consumers, is as much of a benefit to advisory firms as it is to shareholders.

116. See, e.g., Agricultural Adjustment Act, 7 U.S.C. § 601 (2012) (providing subsidies to farmers during the Great Depression in order to decrease competition for agricultural products). See *generally* GLOB. FORUM ON COMPETITION, ORG. FOR ECON. COOPERATION & DEV., ROUNDTABLE ON COMPETITION, STATE AIDS AND SUBSIDIES (2010), <http://www.oecd.org/competition/sectors/48070736.pdf>.

used are government sponsored grants to foster competition in a particular area of the economy.<sup>117</sup>

If the main issue related to market competition, contrarily, were due to a lack of interest, that too may be remedied through legislation. For example, in recent years there has been a vast shortage of individuals within the United States who are qualified to work in STEM (science, technology, engineering and mathematics) fields.<sup>118</sup> In response to this, the White House, in conjunction with the Department of Education, put in place a program aimed at increasing the amount of STEM jobs by 2020.<sup>119</sup> The program includes educational grants, the establishment of a committee of agencies to work on solving the specific issue, and many other innovative competition-increasing strategies.

Obviously, there are major differences between stimulating an interest in STEM fields compared to proxy advisory work. The point, however, is that if a lack of competition emanates from a lack of interest or education surrounding the topic, it can be solved. This goes to the greater point: whatever the multitude of different reasons that may exist for the lack of competition in proxy advisory services, historically speaking, there are legislative remedies available. As such, the SEC should call for research into the matter and Congress should respond through legislation accordingly, in order to properly resolve this problem.

### B. *Legislation Overhauling the Industry as a Whole*

When looking at avenues for reform, there is no better option than implementing legislation. Codifying something into law ensures compliance and affirmatively states society's interest in following a certain policy course. Given its immense consequences, implementing wide-ranging high-impact legislation is also the most difficult avenue of reform. Putting aside the political difficulties in implementing such legislation, Congress could implement a more modest version of the Financial Choice Act of 2016 and the CGRTA.

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117. See, e.g., Derek W. Black, *Education's Elusive Future, Storied Past, and the Fundamental Inequities Between*, 46 GA. L. REV. 557, 597–602 (2012) (examining the Obama Administration's "competitive grant program" to foster competition in education).

118. Jonathan Rothwell, *Short on STEM Talent*, U.S. NEWS & WORLD REP. (Sept. 15, 2014, 8:00 AM), <https://www.usnews.com/opinion/articles/2014/09/15/the-stem-worker-shortage-is-real>.

119. See *Science, Technology, Engineering and Math: Education for Global Leadership*, U.S. DEP'T EDUC., [www.ed.gov/stem](http://www.ed.gov/stem) [<https://web.archive.org/web/20180129002056/https://www.ed.gov/stem>] (last visited Jan. 26, 2018).

The Financial Choice Act of 2016 and the CGRTA contemplated a regulatory overhaul of the proxy advisory industry.<sup>120</sup> Had it passed, it would have required registration with the SEC, disclosure of procedures for formulating recommendations, disclosures of conflicts of interest, and the creation of an ombudsman to receive complaints.<sup>121</sup> Both bills were met with heavy criticism, therefore, the practicality of implementing a carbon copy of either of these bills is bleak. This Note proposes that legislation should be implemented that requires proxy advisors to register under the Securities and Exchange Act of 1933, thereby imposing fiduciary duties upon proxy advisors in a way similar to how § 206 of the Investment Advisers Act of 1940 does.<sup>122</sup> Unlike the CGRTA, however, this legislation will not ask for disclosure of methodologies or organizational structures, and it will not require programs for combatting conflicts of interest.

Removing a provision forcing action on the part of proxy advisory firms in dealing with conflicts of interest goes against one of the core tenets of this Note. However, it might be necessary for purposes of political compromise. The imposition of fiduciary duties on proxy advisors, as envisioned by this legislation, would, for now, put a check on advisors by allowing consumers to sue when actual conflicts of interest arise that create bias in voting recommendations. The imposition of a fiduciary duty on firms like Glass Lewis would resolve conflicts of interest to an extent similar to how proxy advisors being forced to implement entire programs would resolve conflicts of interest. In the current political climate, legislation forcing corporations to put into place systems to deal with these issues and the other requirements of the CGRTA are impractical and have historically failed time and time again.

### *C. Greater Imposition on ISS and Voluntary Inclusion of ADV Forms*

As previously stated, ISS is registered under the Investment Advisers Act of 1940.<sup>123</sup> The firm must therefore annually file an “ADV Form.”<sup>124</sup> An ADV Form is a form that provides the SEC with basic

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120. Financial Choice Act of 2016, H.R. 5983, 114th Cong. (2016); Corporate Governance Reform and Transparency Act, H.R. 5311, 114th Cong. (2016).

121. H.R. 5311 § 15H.

122. 15 U.S.C. § 80b-6 (2012) (imposing fiduciary duties on proxy advisors); *see* 15 U.S.C. § 77a–77aa (2012) (not limiting fiduciary duties on proxy advisors).

123. *See* Institutional Shareholder Services, Inc., *supra* note 7, at 2.

124. SEC. & EXCH. COMM’N, REGULATION OF INVESTMENT ADVISERS BY THE U.S. SECURITIES AND EXCHANGE COMMISSION 16 (2013), [https://www.sec.gov/about/offices/oia/oia\\_investman/rplaze-042012.pdf](https://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf).

information about advisers, such as the amount of assets under management, principal business locations, and other important information.<sup>125</sup> One way that regulators could bypass the tedious legislative process would be to simply beef up the ADV Form.

The ADV Form, in its current existence, is short, skeletal, and lacking a lot of in depth information that might be useful in determining threats to institutional investors.<sup>126</sup> While it does make a cursory attempt to identify conflicts of interest, it is not enough.<sup>127</sup> Since ISS is already under the jurisdiction of the SEC, changing the ADV Form would not require an Act of Congress. Thus, this Note calls for a notice and comment period to discuss the implications of asking ISS for more detailed conflicts of interest information on required ADV Forms—so as to better educate the SEC on how they might affect shareholders.

Finally, it is worth pointing out the common practice of “voluntary filers” of the SEC.<sup>128</sup> On the corporate side, many public companies who are otherwise not required by the government to file with the SEC, regularly do.<sup>129</sup> These companies file 10-Q, 10-K, and 8-K forms on an annual basis that provide the SEC with a vast amount of information.<sup>130</sup> While these forms do not apply to advisory firms, the ADV Forms do. The voluntary completion of the ADV Form by advisors such as Glass Lewis would go a very long way towards gaining—and maintaining—trust in the services provided by third-party proxy advisors.

## CONCLUSION

The increasing role of proxy advisory firms in the sphere of corporate governance mandates change. No longer are proxy advisory firms minor players in the sphere of corporate governance; these firms have essentially become indispensable in the eyes of the institutional investor clients that they serve. The government must

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125. *Fast Answers: Form ADV*, SEC. & EXCHANGE COMMISSION, <https://www.sec.gov/fast-answers/answersformadv.htm> (last updated Mar. 11, 2011).

126. *See id.*

127. *See id.*

128. *See Securities Act Rules Question 131.07*, SEC. & EXCHANGE COMMISSION, <https://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm> (last updated Nov. 6, 2017) (defining “voluntary filer” as an “issuer that submits Exchange Act reports on a voluntary basis”).

129. GLOSSARY: VOLUNTARY FILER, Westlaw (database updated Jan. 2018).

130. Matthew J. Stout, *What is a Voluntary Filer?*, OTCLAWYERS, <http://otclawyers.com/what-is-a-voluntary-sec-filer/> [<https://web.archive.org/web/20180129004345/http://otclawyers.com/what-is-a-voluntary-sec-filer/>] (last visited Jan. 26, 2018).

respond to this trend by increasing regulation in the area of corporate governance. With each of the big firms representing a total of \$41.5 trillion in equity throughout the world,<sup>131</sup> it is only a matter of time until one of the proxy advisory firms causes severe economic harm to its clients, a corporation, and/or the corporation's public shareholders.

It is paramount that shareholders trust the recommendations given by these firms. In particular, shareholders must be able to trust that recommendations are not biased or impacted by the conflicts of interest that all firms willingly acknowledge exist. The wrong advice for the wrong reasons could potentially lead to enormous shareholder injury—an injury that the SEC is tasked with preventing.<sup>132</sup> Allowing such brazen conflicts of interest to exist runs counter to, and is impossible to reconcile with, a firm's supposed ability to make unbiased recommendations on behalf of their clients. Whereas all other areas of finance and law directly addresses and resolves conflicts of interest, it is unclear why conflicts of interest issues for proxy advisory firms remains unaddressed by those in control of protecting shareholders—especially given the large amount of money that is involved.

The government, through Congress and the SEC, has a number of options on the table. This Note seeks to shed light on those options and effectively advocate for their exploration. Legislation, notice and comment periods, and voluntary disclosure by firms through ADV Forms would increase shareholder trust and decrease the negative effects that conflicts of interest pose to proxy advisory firms. The government should act now in exploring this issue to prevent the potential for future shareholder injury.

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131. See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 2, at 2.

132. *About the SEC*, SEC. & EXCHANGE COMMISSION, [www.sec.gov/about.shtml](https://www.sec.gov/about.shtml) [<https://web.archive.org/web/20180129004429/https://www.sec.gov/about.shtml>] (last visited Jan. 26, 2018).