A Distraction in Disguise:

How a Focus on Regulating the Proxy-Advisory Industry Fails to Address the Unnecessary Creation of an Extra Layer of Conflict

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INTRODUCTION

If you have taken your loved ones out for dinner to Applebee's, worn a suit from Hugo Boss, or hiked covered in outdoor gear from Helly Hansen, you have felt the impact of the Ontario Teacher's Pension Plan ("OTPP")[1], a private institutional-shareholder organization that has assets in all of the aforementioned publically traded companies. Institutional-shareholder organizations – like OTPP – invest large, aggregated pools of capital into the open market. For example, as of December 31, 2015, the OTPP managed $171.4 (Canadian dollars) billion in net assets, investing the assets of roughly 316,000 working and retired Ontario teachers into many different companies.[2] A pension plan is only one form that an institutional-investment organization may come in; other organizations come in the form of mutual funds[3], insurance companies, banks or hedge funds.[4] With such large aggregations of assets, the presence of institutional-shareholder organizations can be seen and felt in a large number of publically traded companies that impact the day-to-day lives of a plethora of individuals.

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[1] Chris Taylor, *These Canadians Own Your Town,* FORTUNE, December 2, 2015, http://fortune.com/2015/12/02/ontario-teachers-pension-fund/

[2] *See generally,* ONTARIO TEACHERS' PENSION PLAN, https://www.otpp.com/corporate/about-teachers (last visited March 11, 2017).

[3] *See generally* T. ROWE PRICE, https://www3.troweprice.com/usis/personal-investing/home.html (last visited March 24, 2017) (T. Rowe Price offers mutual-fund services and, thus, is an example of a mutual-fund institutional investor); *see also* BLACKROCK, https://www.blackrock.com/investing/financial-professionals/defined-contribution/investor-pulse (last visited March 24, 2017) (BlackRock is another institution that offers mutual-fund services).

[4] This paper will primarily focus on the regulatory regime that mainly surrounds and impacts pension plans and mutual funds. Although it recognizes that institutional shareholders may come in the form of insurance companies, banks or hedge funds, this paper will not analyze any specific regulatory practices regarding these entities.

This industry's growth came with time, however; the influential presence of institutional-shareholder organizations was not as large years ago as it is today. For example, "[i]n the 1950s, it was estimated that institutional shareholders [only] held shares representing approximately 10 percent of the wealth invested in publically traded companies."[5] By the 1990s, this number leaped to 50 percent.[6] And, as of 2012, the shares of institutional shareholders represented roughly 75 percent of all shares held in publically traded companies.[7] The expansion of this industry can even be seen by solely examining one type of institutional-investment organization: mutual funds. In 1992, mutual funds only represented 7.4 percent of corporate equity in all publically traded companies; by 2002, these represented 18 percent, holding "$2.0 trillion in publically traded U.S. corporate equity."[8]

Institutional-shareholder organizations are not only impacting companies they *invest* in. These investment organizations are also changing the face and structural identity of the corporate-finance sector. For example, the niche area of institutional-investment corporate governance has become an area in corporate finance where women are exerting an increased presence in top executive positions.[9] "The corporate governance heads at seven of the 10 largest

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[5] Joseph E. Bachelder III, *Institutional Shareholders and Their 'Oversight' of Executive Compensation* (July 23, 2012, 9:31 a.m.), HARVARD L. SCH. FORUM ON CORPORATE GOVERNANCE AND FIN. REGULATION, *available at*, http://blogs.law.harvard.edu/corpgov/2012/07/23/institutional-shareholders-and-their-oversight-of-executive-compensation
[6] *Id.*
[7] *Id.* (citing MATTEO TONELLO & STEPHEN RABIMOV, 2010 INSTITUTIONAL INVESTMENT REPORT: TRENDS IN ASSET ALLOCATION AND PORTFOLIO COMPENSATION, CONF. BOARD TRUSTED INSIGHTS FOR BUS. WORLDWIDE 27, *available at*, https://www.conference-board.org/publications/publicationdetail.cfm?publicationid=1872&centerId=5) (This report indicates that, as of 2009, the average institutional shareholder equity ownership at the top 1,000 U.S. corporations was approximately 73 percent. The report also gives a breakdown of the percentages of ownership according to certain categories of institutional shareholders).
[8] U.S. SECURITIES AND EXCHANGE COMMISSION, EXECUTIVE SUMMARY, FINAL RULE: DISCLOSURE OF PROXY VOTING POLICIES AND PROXY VOTING RECORDS BY REGISTERED MANAGEMENT INVESTMENT COMPANIES (2003), *available at*, https://www.sec.gov/rules/final/33-8188.htm
[9] Alexandra Stevenson & Leslie Pickler, *A Rare Corner of Finance Where Women Dominate*, N.Y. TIMES, January 16, 2017, https://www.nytimes.com/2017/01/16/business/dealbook/women-corporate-governance-shareholders.html?_r=0

institutional investors in stock are women."[10] And, "[t]hose investors oversee $14 trillion in assets."[11]

In addition to increasing their prominence in general ownership and societal influence, institutional-shareholder organizations have, as a result, begun to have a more-established impact on voting through their shares, as well. With a larger concentration of shares, institutional shareholders have the potential to carry significant clout when it comes to voting on company matters.[12] Institutional shareholders have shown that they are not just sitting on their votes, either; they are implementing and utilizing them. In 2016, only 28 percent of retail-held shares were voted; in contrast, 91 percent of institutional shares were voted.[13]

Institutional shareholders' attempted usage of voting as a bargaining chip was made evident when the technology company Snap Inc. ("Snap"), the parent company of Snapchat (a tech-based, photo-app venture), announced that it was going to be publically traded. Prior to its initial public offering ("IPO"), Snap raised the possibility that public shareholders would have zero voting shares once it went public.[14] Snap is not the first company to adopt this facially discriminatory approach in regards to voting. In 2004, Google offered public shareholders one vote per share, while board members and insiders received shares that carried 10 votes per

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[10] *Id.*
[11] *Id.*
[12] *See* Tamara Belinfanti, *The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control*, 14 STAN. J. L. BUS. & FIN. 384, 385 (2009) (Belinfanti highlights the growth of mutual funds – setting forth that these funds are the largest owners of publically traded shares in the United States – and further notes that they have, as a result, substantial "voting clout").
[13] SULLIVAN & CROMWELL LLP, 2016 U.S. SHAREHOLDER ACTIVISM REVIEW AND ANALYSIS, November 28, 2016, 3, *available at*, https://sullcrom.com/siteFiles/Publications/SC_Publication_2016_U.S._Shareholder_Activism_Review_and_Analysis.pdf (citing PROXY PLUS, 2016 PROXY SEASON REVIEW).
[14] Steven Davidoff Solomon, *When Snap Goes Public, Some Shareholders' Voting Rights May Disappear,* N.Y. TIMES, January 24, 2017, https://www.nytimes.com/2017/01/24/business/dealbook/when-snap-goes-public-some-shareholders-voting-rights-may-disappear.html

share.[15] Other tech companies, such as Facebook, Zynga and Groupon, have all followed suit, offering dual-class share structures, where founders or owners retain higher voting shares than public shareholders.[16] In effect, this dual-structure voting approach allows these companies to figuratively have smaller ownership while retaining more control – serving as a way for public companies to say to public shareholders (institutional shareholders included), "give us your money, but save your opinion on corporate governance."

Word of Snap's possible no-vote approach immediately triggered a reaction from T. Rowe Price, an institutional-shareholder organization, which, as of January 2017, co-managed at least $7 million worth of Snap shares.[17] T. Rowe Price opposed the no-vote approach that Snap was likely going to pursue and noted that it was "quietly and persistently advocating for change."[18] Prior to this, T. Rowe Price also publically announced that it would, through proxy voting, oppose company directors and members of corporate-governance committees that supported dual-class share structures.[19] However, despite this opposition, T. Rowe Price later stated that it was in its investors' *best interest* to invest in Snap.[20] On March 3, 2017, Snap, in

[15] Emily Chasan, *Google's Multi-Class Stock Structure Made Alphabet Move Unique*, WALL STREET J. CFO J., August 12, 2015, 4:47 p.m., *available at*, http://blogs.wsj.com/cfo/2015/08/12/googles-multi-class-stock-structure-made-alphabet-move-unique/

[16] Steven Davidoff Solomon, *When Snap Goes Public, Some Shareholders' Voting Rights May Disappear*, N.Y. TIMES, January 24, 2017, https://www.nytimes.com/2017/01/24/business/dealbook/when-snap-goes-public-some-shareholders-voting-rights-may-disappear.html

[17] Paresh Dave, *Big Investor T. Rowe Price Challenges Snapchat Founders' Power*, L.A. TIMES, January 19, 2017, http://www.latimes.com/business/technology/la-fi-tn-snapchat-voting-20170119-story.html

[18] *Id.* (citing Jonathan Shapiro, *T. Rowe Price to Contest Snapchat Founders' Plan For Voting Shares*, AUSTL. FIN. REV., January 19, 2017, http://www.afr.com/business/banking-and-finance/financial-services/t-rowe-to-contest-snapchat-founders-plan-for-voting-shares-20170119-gturaq))

[19] Lorraine Mirabella, *T. Rowe Price Takes Stand Against Stock Structures That Create Unequal Shareholder Rights*, BALT. SUN, March 19, 2016, http://www.baltimoresun.com/business/bs-bz-t-rowe-price-oppose-dual-class-stock-20160319-story.html

[20] Paresh, *supra*, n. 17.

fact, announced that it would sell 200 million of its shares, maintaining that investors who bought Class A stock would have no voting rights.[21]

The "Snap saga" described above simply shows how the increased concentration of institutional-shareholder organizations' presence on the market can serve as a way for these shareholders to exert influence through voting – particularly seen when T. Rowe Price announced that it would vote against directors and/or committee members endorsing dual-structure shares. However, Snap's journey to its public offering also highlights that institutional-shareholder organizations have an obligation to factor in the "best interest" of their clients when making decisions. Thus, Snap's approach, in effect, forced T. Rowe Price to weigh its disagreement with Snap's business-judgment decision regarding dual-structured shares against the potential profit it could gain from remaining a shareholder of Snap.

Investment-plan advisers and Employee Retirement Income Security Act ("ERISA") fiduciaries owe their clients a "best interest" analysis because they are fiduciaries to the many individuals who contribute their assets to the aggregated pool that gets collected to be invested in the open market.[22] As fiduciaries, investment advisers/plan managers are "not to subordinate the

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[21] Caitlin Huston, *Snapchat Founders, Investors Cash Out Nearly $1 Billion in Snap IPO*, MARKET WATCH, March 3, 2017, 8:24 p.m., *available at*, http://www.marketwatch.com/story/snapchat-founders-and-investors-sell-millions-of-shares-in-snap-ipo-2017-03-01

[22] U.S. SECURITIES AND EXCHANGE COMMISSION, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS AS REQUIRED BY SECTION 913 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT, iii (2011), *available at*, https://www.sec.gov/news/studies/2011/913studyfinal.pdf (referring to investment advisers registered under the Investment Advisers Act of 1940) [hereinafter "Study on Investment"]; *See also* U.S. SECURITIES AND EXCHANGE COMMISSION, INFORMATION FOR NEWLY-REGISTERED INVESTMENT ADVISERS (2010), *available at*, https://www.sec.gov/divisions/investment/advoverview.htm; *See also SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) (interpreting Section 206 of the Investment Advisers Act of 1940 ("Advisers Act")); *See also* 29 USC § 1002(21)(A) (Fiduciary duties applied to plan managers of plans under the Employee Retirement Income Security Act: (A) Except as otherwise provided in subparagraph (B), a person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan. Such term includes any person designated under

interest of their beneficiaries for personal benefit."[23] Investment advisers are fiduciaries that owe a duty of loyalty and care to their clients, which means that they are required to eliminate or disclose material conflicts.[24] Fiduciary obligations are applied to investment advisers/plan fiduciaries as they vote on behalf of their shareholders through proxies, as well.[25] What Snap's IPO most poignantly shows is the balancing of power in regards to voting – e.g. it can be utilized as a mechanism for power so long as it does not infringe on the best interest of the shareholder.

With their overwhelming market presence, their increased impact through voting, and the need for advisers and plan managers to meet their fiduciary obligations – particularly, their duty of remaining un-conflicted or disclosing such conflicts when voting proxies – institutional-shareholder organizations began looking to proxy-advisory firms for guidance on how to vote on proxies. These proxy-advisory firms, in turn, provide their expertise and research to advisers/plan fiduciaries, steering them on what to do when it comes to proxy voting. Can advisers/fiduciaries allocate portions of their duties to such proxy firms? To date, yes. And, in

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section 405(c)(1)(B) (29 USCS § 1105(c)(1)(B)); *see also* 29 CFR § 2510.3-21 (this rule defines what type of advice must be given to qualify an investment adviser as a fiduciary per ERISA) (Note that the Department of Labor's "Fiduciary Rule" would replace §2510.3-21 and expand the definition of "fiduciary" under ERISA. The Fiduciary Rule became effective June 7, 2016 and was set to be applicable April 10, 2017. However, on February 3, 2017, President Trump signed a Presidential Memorandum directing the Department of Labor to examine this rule, putting the fate of the rule at a stand-still, and the Department of Labor has delayed the implementation of the rule by 60 days, *see* Fiduciary Rule, 81 Fed. Reg. 20,946 (April 8, 2016), *available at*, http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=28806; *see also* https://www.dol.gov/agencies/ebsa/laws-and-regulations/rules-and-regulations/completed-rulemaking/1210-AB32-2; *see also* http://clsbluesky.law.columbia.edu/2017/04/14/kl-gates-discusses-fiduciary-rule-delay-important-compliance-takeaways/#.WPCk-v3uts0.email)).

[23] *Study on Investment, supra*, n. 22; *see also* 29 USC §1104 (2017) (stating that ERISA fiduciaries shall carry out duties for exclusive purpose of benefitting its participants).

[24] *Study on Investment, supra,* n. 22.

[25] *See* 17 C.F.R § 275.206(4)-6 (this rule applies to investment advisers defined in the Investment Advisers Act of 1940 and it notes that investment advisers must consider best interest when voting on behalf of their clients); *see also* Letter from Alan D. Lebowitz, Deputy Secretary, U. S. Department of Labor, to Helmuth Fandl, Chairman of the Retirement Board, Avon Products, Inc., (Feb. 23, 1988), 1988 ERISA LEXIS 19 at *5 and 6 (this letter applies, specifically, to the fiduciary obligations of fiduciaries of ERISA-plan beneficiaries).

fact, the Securities and Exchange Commission ("SEC" or the "Commission"), to some extent, has paved the path for this hand-off of duties.[26]

As of 2016, there were five main proxy advisory firms in the United States: Institutional Shareholder Service ("ISS"), Glass Lewis & Co., LLC ("Glass Lewis"), Egan-Jones Proxy Services ("Egan Jones"), Marco Consulting Group ("Marco") and ProxyVote Plus ("ProxyVote").[27] Of these five firms, ISS and Glass Lewis are the two firms that dominate the proxy-advisory industry.[28] Based on its long-standing history and reputation, ISS is the most-dominant proxy advisory firm of the five available firms.[29] However, Glass Lewis is not far behind. As of 2011, Glass Lewis captured over 40 percent of the market share.[30] While advisers and fiduciary plan managers have been turning to these firms, they have also been criticized because (1) there are conflicts of interest in how these firms are structured[31]; (2) there is a lack of transparency in the analytical models utilized by these firms – thus, there is a lack of certainty as

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[26] *See* Letter from Douglas Schiedt, Associate Director and Chief Counsel, Division of Investment Management U.S. Securities and Exchange Commission, to Kent S. Hughes, Managing Director, Egan-Jones Proxy Services (May 27, 2004), *archived at,* http://perma.cc/KSJ2-JP5N (In this letter, the SEC set forth that an "investment adviser could demonstrate that its vote of its clients' proxies was not a product of conflict of interest if the adviser voted the proxies in accordance with a pre-determined policies based on the recommendations of an independent third party. An investment adviser that votes client proxies in accordance with a pre-determined policy based on the recommendations of an independent third party will not necessarily breach its fiduciary duty of loyalty to its clients even though the recommendations may be consistent with the adviser's own interests. In essence, the recommendations of a third party that is in fact independent of an investment adviser may cleanse the vote of the adviser's conflict.") [hereinafter "Egan-Jones Letter"].
[27] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-17-47 CORPORATE SHAREHOLDER MEETINGS PROXY ADVISORY FIRMS' ROLE IN VOTING AND CORPORATE GOVERNANCE PRACTICES 6 (2016), *available at*, https://www.gao.gov/assets/690/681050.pdf [hereinafter "GOA 2016"].
[28] *Id.* at 8.
[29] *Id.* (citing U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-765, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING (2007)).
[30] Tao Li, *Outsourcing Corporate Governance: Conflicts of Interest and Competition in the Proxy Advisory Industry*, 4 (U. of Warwick Bus. Sch. Working Paper No. 389, 2013), *available at*, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2287196
[31] CENTER ON EXECUTIVE COMPENSATION, A CALL FOR CHANGE IN THE PROXY ADVISORY INDUSTRY STATUS QUO: THE CASE FOR GREATER ACCOUNTABILITY AND OVERSIGHT 1 (2011), *available at*, http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf [hereinafter "Center on Executive Compensation"].

to the accuracy of these firms' findings[32] and (3) these firms' material creates a conveyance of inaccurate information to shareholders[33].

Many have responded to some of the issues surrounding proxy-advisory firms with a call for increased regulation of the proxy-advisory industry. Some have suggested that the SEC model regulations of the proxy-advisory firm to those applied to credit-rating agencies[34], or that the SEC create an oversight board, such as the Public Company Accounting Oversight Board ("PCAOB") to oversee the proxy-advisory industry.[35] Others have further posed the idea of mandatory registration for all proxy-advisory firms under the Investment Advisers Act of 1940, which would impose stricter disclosure requirements upon industry participants.[36] And, Congress proposed legislation that would have amended the Securities and Exchange Act of 1934 to require all proxy advisory firms to register under the Exchange Act, which would have exposed the proxy-advisory industry to specific disclosure requirements and oversight by the Commission.[37]

What all of these regulatory proposals fail to address is the *inherent* fiduciary duty that lies within the initial institutional portfolio manager – e.g. the investment adviser or plan manager/fiduciary who is managing a mutual-fund portfolio or an ERISA plan. These regulatory "fixes" fail to address the fact that it is these fiduciaries that should be the arbiters of how and why a proxy firm's services will impact their institutional clients. Thus, this paper is taking the position that rather than continuing to attempt to regulate the inherently flawed structure of

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[32] *Id.*
[33] *Id.*
[34] Belinfanti, *supra*, n. 12 at 432.
[35] *Id.* at 436-37.
[36] Sagiv Edelman, *Proxy Advisory Firms: A Guide for Regulatory Reform*, 62 EMORY L.J. 169, 1379-81 (2013).
[37] H.R. 5311, 114th Cong. (2016), *available at*, https://www.congress.gov/114/bills/hr5311/BILLS-114hr5311rh.pdf

proxy-advisory firms, governmental agencies should re-shift their focus towards addressing the initial fiduciaries that are charged with managing their institutional clients' portfolios.

Part I will provide an in-depth breakdown of the initiatives that led to the relationship between institutional-shareholder organizations and proxy-advisory firms. Part II will provide background information about the two largest proxy-advisory firms and the issues surrounding these firms' presence in the investment market.[38] Part III will analyze the inefficiencies of the currently existing regulatory framework and proposed regulatory solutions aimed at addressing the issues of proxy-advisory firms. Part IV will propose an alternative approach to addressing the current relationship between institutional-shareholder organizations and proxy-advisory firms, primarily focusing on how governmental agencies should re-focus resources on ensuring that investment advisors (and ERISA-plan fiduciaries) who are initially charged with investing institutional shareholders' assets are managing their clients' portfolios in the best interest of their clients while voting proxies.

PART I:

INITIATIVES THAT SOLIDIFIED THE PARAMETERS OF THE RELATIONSHIP BETWEEN INSTITUTIONAL-SHAREHOLDER ORGANIZATIONS AND PROXY-ADVISORY FIRMS

There were a series of governmental initiatives that sparked the relationship between institutional-shareholder organizations and proxy-advisory firms. This relationship became more concrete with time and more pronounced through the actions of the U.S. Department of Labor ("DoL"), the SEC and Congress (more broadly). Thus, to better understand the nature of why and how institutional-investment organizations turn to proxy advisory firms, an assessment of these governmental initiatives is appropriate.

[38] While Part II of this paper will predominantly focus on assessing ISS and Glass Lewis; this paper is not claiming or setting forth that the issues and conflicts regarding ISS and/or Glass Lewis are unique to those firms.

1. INITIATIVES BY THE U.S. DEPARTMENT OF LABOR:

a) *The "Avon Letter:" The Beginning of the Path Towards Defining Fiduciary Duties in Regards to Proxy Voting*

In 1974, the Employee Retirement Income Security Act ("ERISA") was passed, and, as result, the DoL began "requiring private pension plan fiduciaries to act solely in the interests of their plan participants and beneficiaries."[39]

Following the passage of ERISA, in 1988, Allan Lebowitz, then Deputy Assistant Secretary of the Pension Welfare Benefits Administration at the U.S. DoL, sent a letter to the Chairman of the Retirement Board of Avon, Inc., Helmuth Fandl.[40] Years later, this letter from Lebowitz to Fandl would become known as the infamous "Avon Letter." In this letter, the DoL set forth that shareholder voting rights are considered "valuable plan assets under ERISA."[41] As such, the letter solidified that the duty of prudence also applied to proxy voting.[42] In sum, the Avon Letter established that plan fiduciaries responsible to beneficiaries that fell under ERISA had to be cognizant of their duty of prudence when carrying out proxy voting on behalf of such beneficiaries.

b) *The DoL's 2008 Interpretive Bulletin: Fleshing Out How Fiduciaries Are to Carry Out Their Duties Regarding Proxy Voting*[43]

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[39] *Center On Executive Compensation, supra*, n. 31 at 17; *see also* 29 USC § 1002(21)(A) (Describing who is a fiduciary under ERISA); 29 USC §1104 (Fiduciary shall discharge duties with regards to plan solely in the interest of the participants and beneficiaries).
[40] *Id.* at 17 (citing Letter from Alan D. Lebowitz, Deputy Secretary, U. S. Department of Labor, to Helmuth Fandl, Chairman of the Retirement Board, Avon Products, Inc., (Feb. 23, 1988), 1988 ERISA LEXIS 19)).
[41] *Id.*
[42] *Id.*
[43] U.S. DEPARTMENT OF LABOR INTERPRETIVE BULLETIN §2509.08–2, FEDERAL REGISTER, VOL. 73, NO. 202 (OCTOBER 17, 2008) 61733, *available at*, https://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocID=21630 (Pursuant to Sec. 404a of ERISA, plan fiduciaries can appoint investment managers; however fiduciaries still have a duty monitor to the investment manager's activities and investment managers may violate their duties if they do not follow terms of statement of investment policy established by named fiduciary). [hereinafter "DoL 2008 Interpretive Bulletin"].

On October 17, 2008, the DoL issued an interpretive bulletin that expanded the Avon Letter. In its interpretive bulletin, the DoL set forth the following:

> The fiduciary obligations of prudence and loyalty to plan participants and beneficiaries require the responsible fiduciary to vote proxies on issues that may affect the economic value of the plan's investment. However, the fiduciaries also *need to take into account costs when deciding whether and how to exercise their shareholder rights*, including the voting of shares. Such costs include, but are not limited to, expenditures related to developing proxy resolutions, *proxy-voting services* and the analysis of the likely net effect of a particular issue on the economic value for the plan's investment. Fiduciaries must take all of these factors into account in determining whether the exercise of such rights, independently or in conjunction with other shareholders, is expected to have an effect on the economic value of the plan's investment *that will outweigh the cost of exercising such rights*.[44]

In this same interpretive bulletin, the DoL also addressed the topic of shareholder activism. In doing so, the DoL noted that fiduciaries had an obligation to ensure that they were voting proxies wisely – thus, with that being set forth, the plan fiduciary must be able to show that his or her decision to proxy vote is rooted in a rationale that will "more likely than not" increase the economic value of the plan.[45] "The mere fact that plans are shareholders in the corporations in which they invest does not itself provide a rationale for a fiduciary to spend plan assets to pursue, support or oppose such proxy proposals."[46] The DoL further said that any use of pension-plan assets must have a connection to furthering economic value to ensure that such assets are not solely being used to further political issues.[47]

2. INITIATIVES BY THE U.S. SECURITIES AND EXCHANGE COMMISSION:

   a) *Rule 275.206(4)–6: Establishing an Investment Adviser's Duty to Consider "Best Interest" When Voting Proxies*

[44] *Id.* [Emphasis added].
[45] *Id.* at 61734.
[46] *Id.*
[47] *Id.*

In 2003, the SEC adopted a rule pursuant to the Investment Advisers Act of 1940 ("Advisers Act").[48] §275.206(4)–6 establishes that investment advisers registered under the Advisers Act are required to:

> (a)[a]dopt and implement written policies and procedures that are reasonably designed to ensure that [it] vote[s] client securities in the *best interest of clients*, which procedures must include how [it] address[es] conflicts that may arise between [its] interests and those of [its] clients;
> (b) disclose to clients how [it] may obtain information from [it] about how [it] voted with respect to their securities; and
> (c) describe to clients [its] proxy-voting policies and procedures and, upon request, furnish copy of the policies and procedures to the requesting client.[49]

The Advisers Act generally defines an "investment adviser" as

> any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.[50]

This rule is of importance because the management of mutual funds and pension-plan assets is often delegated to an investment adviser who is subject to the Investment Advisers Act.[51] There are certain criteria surrounding registering under the Investment Advisers Act. For example, pension-plan consultants who give advice to ERISA plans that manage more than $200,000,000 million in assets *must* register under the Advisers Act.[52] Further, those (which may include advisers to non-ERISA plans) who have assets under management of more than $100,000,000 *may* register under the Advisers Act, but those who manage $110,000,000 or more in assets *must* register under the Advisers Act.[53]

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[48] U.S. SECURITIES AND EXCHANGE COMMISSION, FINAL RULE: PROXY VOTING BY INVESTMENT ADVISERS, Release No. 1A-2106 (2003), *available at*, https://www.sec.gov/rules/final/ia-2106.htm#llA2a [hereinafter "Proxy Rule Release"].
[49] 17 C.F.R §275.206(4)-6 (West 2017). [Emphasis added].
[50] 15 U.S.C § 8ob-2(a)(11) (West 2017).
[51] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-765, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING 6 (2007), *available at*, http://www.gao.gov/assets/270/263233.pdf [hereinafter "GOA 2007"].
[52] 17 C.F.R.A §275.203A-2(a)(1) and (2) (Lexis 2017).
[53] 17 C.F.R.A §275.203A-1(a)(1) (Lexis 2017).

In effect, §275.206(4)–6 serves as the SEC's "Avon Letter," largely setting forth that investment advisers under the Advisers Act must conduct a best-interest analysis as they vote proxies, while also maintaining disclosure regarding information on voting methods and general policies and procedures. While the SEC set forth this explanation of investment advisers' duties pursuant to the Advisers Act, it also noted that it was not setting forth that an adviser who failed to vote every proxy would be in violation of their duties; rather, the SEC noted that there may be times when refraining from voting would be in the best interest of the client, like when voting, for example, would out-cost any benefit to the client.[54] This is very similar to what the DoL did in its 2008 interpretive bulletin. Effectively, both agencies have communicated that while fiduciaries are to vote in the best interest of the clients/beneficiaries, they are not required to vote *all* proxies when doing so would go against a rational cost-benefit analysis.

b) *SEC Sends No-Action Letter to Egan-Jones: The Link Between Utilizing Proxy Firms and Fulfilling What is in the "Best Interest" of Clients; SEC's Letter to ISS: Adding to the Egan-Jones Letter*

On March 27, 2004, in a letter to proxy-advisory firm Egan-Jones, the Commission established that investment advisers registered under the Advisers Act could, to ensure that they are in compliance with Rule 275.206(4)–6, vote proxies based on pre-determined policy rooted in recommendations from independent third parties.[55] Turning to the recommendations of third parties would, effectively, show that the adviser's actions were not a "product of conflict of interest."[56] The Commission also noted, however, that, if concerned about conflicts, an adviser

[54] *Proxy Rule Release, supra*, n. 48.
[55] *Egan-Jones Letter, supra*, n. 26.
[56] *Id.*

could adopt and implement a policy of disclosing to its clients the conflict of interest and obtain its clients' consent before voting the proxy.[57]

This letter created the gateway between institutional-shareholder organizations and proxy-advisory firms because investment advisers for institutional investors have turned to proxy advisory firms as the "independent third party" that the Commission alluded to in its letter to Egan-Jones.[58] Thus, the phenomenon that resulted from the Commission's interpretation was that institutional investors were enabled to shift their duties to a third party – e.g. a proxy-advisory firm.[59] When investment advisers turn to proxy-advisory firms, institutional shareholders' assets (e.g. their votes) are metaphorically passing through another party's hands, and, with that, another potential layer of separation is created.

Leo Strine Jr., Chief Justice of the Delaware Supreme Court, captured the relationship between institutional shareholders and proxy-advisory firms best when he said the following,

> Many institutional investors *have, as I mentioned, little desire to do any thinking of their own,* particularly about investments that they often hold for nanoseconds. Into this opportunistic breach has stepped an organization called Institutional Shareholders Services (ISS), which provides institutions with recommendations as to how to vote on corporate governance issues. Following ISS constitutes a form of *insurance against regulatory criticism*, and results in ISS having a large sway in the affairs of American corporations. Moreover, powerful CEOs come on bended knee to Rockville, Maryland, where ISS resides, to persuade the managers of ISS of the merits of their views about issues like proposed mergers, executive compensation, and poison pills. They do so because the CEOs recognize that some institutional investors will simply follow ISS's advice rather than do any thinking of their own. ISS has been so successful that it now has a California rival, Glass Lewis.[60]

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[57] *Id.* at n. 5 (citing U.S. SECURITIES AND EXCHANGE COMMISSION, FINAL RULE: PROXY VOTING BY INVESTMENT ADVISERS, RELEASE NO. IA-2106, RESOLVING CONFLICTS OF INTEREST, *available at*, https://www.sec.gov/rules/final/ia-2106.htm#llA2a)

[58] *See* JAMES GLASSMAN & J.W. VERRET, MERCATUS CTR. GEORGE MASON UNIV., HOW TO FIX OUR BROKEN PROXY SYSTEM, MERCATUS CENTER AT GEORGE MASON UNIVERSITY, 9-10 (2013), *available at*, https://www.mercatus.org/system/files/Glassman_ProxyAdvisorySystem_04152013.pdf

[59] *Id.* at 26.

[60] Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 688 (2005). [Emphasis added].

It is worth noting that although the Commission encouraged the use of an independent third party in its Egan-Jones letter, it did also set boundaries to an investment adviser's "handing off of duties" to said third parties. For example, in that same letter, the Commission also set forth that investment advisers had an obligation to ensure that the proxy firm being utilized "(a) has the capacity and competency to adequately analyze proxy issues and (b) can make such recommendations in an impartial manner in the best interest of the adviser's clients."[61]

The Commission also sent a response letter to ISS in 2004, establishing that investment advisers should obtain information from prospective proxy-voting firms to ensure that the firms that they are obtaining recommendations from are, in fact, independent.[62] This may entail "a case by case evaluation of the proxy voting firm's relationships with Issuers, a thorough review of the proxy voting firm's conflict procedures and the effectiveness of their implementation, and/or other means reasonably designed to ensure the integrity of the proxy voting process."[63] Thus, this letter set forth that investment advisers cannot simply "blindly" follow the recommendations of proxy-advisory firms without making sure that the firm is not giving said information for self-interested purposes.

Since the Egan-Jones and ISS letters, the Commission's two seminal actions were in 2010 and 2013. In 2010, the Commission released its Concept Release, which solicited comments about the possibility of regulating the proxy-advisory industry.[64] In 2013, the SEC conducted a roundtable to discuss the relationship between institutional-shareholder

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[61] *Egan-Jones Letter, supra*, n. 26.

[62] Letter from Douglas Schiedt, Associate Director and Chief Counsel, Division of Investment Management U.S. Securities and Exchange Commission, to Mari Anne Pisarri on behalf of Institutional Shareholder Services, Inc. (September 15, 2004), *archived at,* http://perma.cc/Q8YH-SAXR. [hereinafter "ISS Letter"].

[63] *Id.*

[64] U.S. SECURITIES AND EXCHANGE COMMISSION, CONCEPT RELEASE ON THE U.S. PROXY SYSTEM, Release Nos. 34-62495 (July 14, 2010), *archived at*, https://www.sec.gov/rules/concept/2010/34-62495.pdf

organizations and the proxy-advisory industry.[65] Of importance at this roundtable were the statements made by former Commission Chair Harvey Pitt. At the 2013 roundtable, former Chairman Pitt confirmed that the two no-action letters (sent to Egan-Jones and ISS), in effect, extended §275-206(4)–6; and, the result (albeit also based on other factors) was to "encourage portfolio managers … to use proxy firms."[66]

c) *2014 SEC Staff Legal Bulletin Number 20: Reiterating that Investment Advisers Must Oversee Proxy-Advisory Firms They Retain*

In June of 2014, the Commission issued Staff Legal Bulletin No. 20 ("Legal Bulleting No. 20").[67] In this Bulletin, the Commission said that if an investment adviser were to retain a proxy-advisory firm, it should "adopt and implement policies and procedures that are reasonably designed to provide sufficient ongoing oversight of the third party in order to ensure that the investment adviser, acting through the third party (the proxy firm), continues to vote proxies in the best interest of its clients."[68] Thus, Legal Bulletin No. 20 reiterates, as did the Egan-Jones and ISS letters, that investment advisers to institutional shareholders cannot simply delegate their duties without some level of oversight. Legal Bulletin No. 20 also reiterated another sentiment that has been echoed by both the DoL and the SEC in the past: Investment advisers (fiduciaries) can limit the amount of proxies they are obligated to vote.[69] For example, the Commission set forth that "an investment adviser and its client could agree that the investment adviser will focus resources on only particular types of proposals based on the client's preferences."[70]

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[65] *See generally* U.S. SECURITIES AND EXCHANGE COMMISSION, TRANSCRIPT OF PROXY ADVISORY FIRMS' ROUNDTABLE (December 5, 2013), *archived at*, http://perma.cc/Z57U-QNGW
[66] U.S. SECURITIES AND EXCHANGE COMMISSION, TRANSCRIPT OF PROXY ADVISORY FIRMS' ROUNDTABLE, p. 0026, lines 1-25; p. 0027, lines 1-3 (December 5, 2013), *archived at*, http://perma.cc/Z57U-QNGW
[67] U.S. SECURITIES AND EXCHANGE COMMISSION, STAFF LEGAL BULLETIN NO. 20 (June 20, 2014), *archived at* http://perma.cc/L7KN-MD8R
[68] *Id.*
[69] *Id.*
[70] *Id.*

3. INITIATIVES THROUGH NON-AGENCY LEGISLATIVE ACTION:

a) *The Dodd-Frank Act and the Say on Pay Provision: Another Factor Contributing to the Increase in Proxy Voting, and, in Turn, the Influence of Proxy-Advisory Firms*

In July of 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") was enacted.[71] Section 951 of the Dodd-Frank Act requires that public companies conduct non-binding shareholder votes on executive pay at least once every three years.[72] This requirement has become known as the "say on pay" ("SoP") vote.[73] The trend has been that companies are holding these votes annually, rather than biennially or triennially (as is permitted).[74] Thus, there was an anticipated substantial increase in expected votes (or, at least, the matters being voted on).[75] With that, there has also been an anticipated increased in institutional investors' dependence on proxy firms, as well.[76] "Although institutional investors may have custom proxy voting policies [regarding executive pay], the basis for many, if not most, of these policies is the advisory firm's base policies."[77] Thus, the advent of the Dodd-Frank Act only solidified the built-upon relationship between institutional-shareholder organizations and proxy firms.

The different governmental initiatives mentioned above attempted to create more accountability for investment advisers (plan fiduciaries); the effect, however, of many of the

[71] 12 USC § 5301, *et seq.* (Pub.L. 111–203)
[72] 15 USC § 78n–1
[73] *Id.*
[74] Charles M. Nathan, *Proxy Advisory Business: Apotheosis or Apogee?*, THE HARVARD L. SCH. FORUM ON CORP. GOV. AND FIN. REG. (March 23, 2011), *available at*, https://corpgov.law.harvard.edu/2011/03/23/proxy-advisory-business-apotheosis-or-apogee/
[75] *Center on Executive Compensation, supra*, n. 31 at 4.
[76] *Id.*
[77] *Id.* (Former TIAA-CREF General Counsel and current Governance for Owners U.S. CEO, Peter Clapman, indicated that "the inevitable consequence [of adopting say on pay] would be to transfer considerable discretionary power over individual company compensation practices to the proxy advisory firms. I question that such an approach will serve the long-term best interests of shareholders") (Columbia Law Professor Jeffrey Gordon, indicated that "the burden of annual voting would lead investors, particularly institutional investors, to farm out evaluation of most pay plans to a handful of proxy advisory firms who themselves will seek to economize on proxy review costs").

aforementioned initiatives proved to be a siphoning of duties to proxy-advisory firms under the guise that the initial plan managers of a plan would still "monitor" these proxy firms. Part II of this paper will explain why this siphoning of duties can be problematic.

PART II

ISS AND GLASS LEWIS: AN ANALYSIS OF THE ISSUES SURROUNDING THESE TWO FIRMS' PRESENCE IN THE MARKET

ISS was founded in 1985 by Robert A.G. Monks, a former administrator at the DoL.[78] Monks served as the CEO of ISS from 1985-1990.[79] Today, ISS is the largest proxy-advisory firm in the industry. It covers over 117 markets, has over 1,700 institutional clients and executes about 8.5 million proxy votes annually.[80] In 2014, ISS was acquired by Vestar Capital Partners VI, L.P. ("Vestar") for $364 million.[81] Two board members at ISS carry executive positions at Vestar. Kenneth O'Keefe serves as a board member to ISS and is also the Chief Operating Officer at Vestar.[82] Robert Rosner serves as a board member to ISS and is also the Co-President of Vestar.[83]

ISS has been criticized as being entrenched in conflict.[84] One of the main rationales for this criticism is rooted in the way that ISS operates. While ISS offers advice to institutional shareholders (primarily, to investment advisers) on how they should vote on proxies, it also, according to its website, offers corporate-governance consulting services to clients who may be

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[78] *Id.* at 28.
[79] *Id.*
[80] *See* INSTITUTIONAL SHAREHOLDER SERVICES, https://www.issgovernance.com/about/about-iss/ (last visited March 3, 2017).
[81] *See* VESTAR CAPITAL PARTNERS VI, LLP, http://www.vestarcapital.com/vestar-capital-partners-to-acquire-institutional-shareholder-services-from-msci/ (last visited March 3, 2017).
[82] *See* BLOOMBERG PROFILES (INSTITUTIONAL SHAREHOLDER SERVICES), https://www.bloomberg.com/profiles/companies/77449Z:US-institutional-shareholder-services-inc (last visited March 3, 2017) and BLOOMBERG PROFILES (VESTAR CAPITAL PARTNERS VI, LLP) https://www.bloomberg.com/profiles/companies/22100Z:US-vestar-capital-partners-inc (last visited March 3, 2017).
[83] *Id.*
[84] *Center on Executive Compensation, supra,* n.31 at 7-9.

issuers of securities.[85] Thus, ISS, in effect, could be offering services to a public company while also advising an institutional shareholder on how to vote on that very same company's proxy. This conflict was aptly captured in a statement made by compensation analyst Graef Crystal, who said, "they've got a severe conflict when they work both sides of the street. It's like the Middle Ages when the Pope was selling indulgences. ISS is selling advice to corporations on how to avoid getting on their list of bad companies."[86] As such, some industry professionals note that certain companies may feel obligated to utilize ISS's consulting services as a way to ensure that they receive favorable voting on their proxies.[87]

To mitigate concerns regarding conflict, ISS has adopted a policy of disclosure. According to its website, ISS has set forth that it will disclose "significant relationships" that it has with certain public issuers.[88] A paying issuer who purchases services from its subsidiary, ISS Corporate Solutions, Inc. (its corporate governance-consulting company), is to be considered a "significant relationship" per its policy.[89] It also views public-issuer clients that contribute to five percent or more of ISS's total, consolidated revenue for the fiscal year through purchasing its proxy-service products as a "significant relationship" to be disclosed.[90] Thus, substantial disclosure is provided by ISS to institutional-shareholder organizations' advisers – albeit public-issuer clients who do not contribute to five percent or more of ISS's total consolidated revenue for purchases of proxy-service products will not be disclosed.

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[85] *See* INSTITUTIONAL SHAREHOLDER SERVICES, https://www.isscorporatesolutions.com/ (last visited March 3, 2017).

[86] Leslie Wayne, *Have Shareholder Activists Lost Their Edge?*, N.Y.TIMES, Jan. 30, 1994, at C7, *archived at* http://www.nytimes.com/1994/01/30/business/have-shareholder-activists-lost-their-edge.html?pagewanted=2

[87] *GOA 2007, supra*, n. 51 at 10 (2007).

[88] *See* INSTITUTIONAL SHAREHOLDER SERVICES, DUE DILIGENCE POLICY, *available at*, https://www.issgovernance.com/file/duediligence/significant-relationships-disclosure.pdf (effective 2014).

[89] *Id.*

[90] *Id.*

Glass Lewis is the second-largest firm in the proxy-advisory industry, and its corporate structure also has deep-rooted possibilities for conflict. Glass Lewis was founded in 2003.[91] It has over 1,200 clients and more than 360 employees worldwide.[92] Glass Lewis is a subsidiary of the Ontario Teachers' Pension Plan ("OTPP") and the Alberta Investment Management Corp. ("AIMCo").[93] Glass Lewis is a company registered in Delaware, and the OTPP owns 80 percent of the company while AIMCo owns 20 percent.[94]

As highlighted in the opening of this paper, the OTPP is a highly-active institutional-investment organization that has shares in many public companies – public companies which other institutional shareholders may have ownership in and vote proxies for. Thus, herein lies Glass Lewis' conflict: If Glass Lewis' parent company is the OTPP, it may be inclined to advise other institutional shareholders to vote the proxies that OTPP has an ownership interest in in a manner that is most beneficial to OTPP (and its specific agenda), which may be adverse to the interests of the institutional shareholder.[95] To see the OTPP's active investment practices one only need look to its website; for example, the OTPP has even established that it factors in

[91] *Center on Executive Compensation, supra*, n. 31 at 33.
[92] *See* GLASS LEWIS, http://www.glasslewis.com/company-overview/ (last visited March 3, 2017).
[93] *Id.*
[94] *See* GLASS LEWIS, COMPANY PROFILE ON LEXISNEXIS (last updated as of March 6, 2017), https://advance.lexis.com/document/?pdmfid=1000516&crid=742bcff3-3021-497f-b8cf-9954c5ed46f7&pddocfullpath=%2Fshared%2Fdocument%2Fcompanyfinancial%2Furn%3AcontentItem%3A5DVB-4W31-JC4V-R0K4-00000-00&pddocid=urn%3AcontentItem%3A5DVB-4W31-JC4V-R0K4-00000-00&pdcontentcomponentid=149023&pdteaserkey=sr2&ecomp=r89tk&earg=sr2&prid=0c6d146f-6afd-407d-a814-d5aa83b8038a; *See also* GLASS LEWIS & CO., LLC, available at, http://www.glasslewis.com/aimco-acquires-20-ownership-stake-in-glass-lewis-from-ontario-teachers/ (last visited April 9, 2017).
[95] William Holstein, *The Ownership of Glass Lewis is All Wrong*, CBS MONEY WATCH, (last updated November 6, 2007, 2:12 p.m.), *available at*, http://www.cbsnews.com/news/the-ownership-of-glass-lewis-is-all-wrong/ ("It's hard to believe, however, that there will be no connection between the two entities. Teachers', with about $100 billion in assets, invests in stocks of companies around the world as well as other financial instruments. Earlier this year, it lead a private equity group that bought Montreal-based communications giant BCE Inc., the biggest corporate takeover in Canadian history. So how is Glass Lewis going to evaluate the corporate governance practices of BCE? Indeed, how would it rate the practices of any company where Teachers' has a major investment? And what if Teachers' wants to take over another company? What will the Glass Lewis recommendation be to shareholders? No, it just doesn't wash").

environmental, social and governance factors into its investment decisions[96]; thus, Glass Lewis may be inclined to steer their proxy-voting advice to institutional investors in a direction that aligns with the OTPP's views on environmental, social or governance matters – even though this direction may not be most beneficial to the institutional investor.

Glass Lewis's members have a duty under Delaware law – since it is an organized under Delaware – to carry out its business in a manner that is in the best interest of its parent companies [97] (which, in its current structure, would be the entities that hold a stake in Glass Lewis). Thus, to carry out its duty to its respective parent companies, Glass Lewis might have to give advice that would compromise the interest of other institutional shareholders if that interest is opposite to that of the OTPP.

Glass Lewis, like ISS, has attempted to mitigate its potentially conflicted image. On its website, Glass Lewis includes a Conflict of Interest Statement. In this statement, the firm vows that "neither OTPP nor AIMCo is involved in the day-to-day management of Glass Lewis' business" and "when OTPP or AIMCo has a reportable stake in a corporate issuer, Glass Lewis discloses the conflict on the cover of the relevant research report.[98] Glass Lewis also implements a Research Advisory Council, which is an independent external group of industry experts that are charged with ensuring the comprehensiveness of Glass Lewis's proxy policies.[99] In addition to these measures, Glass Lewis also states that it

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[96] *See* ONTARIO TEACHERS' PENSION PLAN, https://www.otpp.com/investments/responsible-investing/our-principled-approach (last visited March 3, 2017).
[97] *See William Penn P'ship v. Saliba*, 13 A.3d 749, 756 (Del. 2011) (finding LLC managers breached duty of loyalty by entering into self-interested and unfair sale of company); *Anadarko Petroleum Corp. v. Panhandle Eastern Corp.*, 545 A.2d 1171, 1173 (1988) (The *Adadarko* opinion sets forth that the directors of a wholly-owned subsidiary owes a duty to its parent company to manage the business in the best interest of the parent company; while Glass Lewis is not wholly owned by the OTPP, it is majority-owned by the OTPP, and, thus, the court could extend Anadarko to find that Glass Lewis does owe a duty, at the very least, to OTPP and AIMCo).
[98] *See* GLASS LEWIS, CONFLICTS OF INTEREST STATEMENT, http://www.glasslewis.com/conflict-of-interest/ (last visited March 3, 2017).
[99] *Id.*

> maintains conflict management procedures to mitigate potential conflicts when: (i) an issuer contacts Glass Lewis directly with a request to purchase a copy of its report; (ii) an employee or a relative of an employee of Glass Lewis or any of its subsidiaries, a member of the RAC, or a member of Glass Lewis' Strategic Committee, whose members include Glass Lewis owner representatives and former employees, serves as an executive or director of a public company; (iii) an institutional investor customer of Glass Lewis is a public company or is affiliated in some way to an issuer (e.g. division, branch, subsidiary, etc.); (iv) a Glass Lewis customer submits a shareholder proposal, is a dissident shareholder in a proxy contest, or is otherwise publicly soliciting shareholder support for or against a director or proposal.[100]

While both firms affirm that they will disclose conflicts, this disclosure *does not necessarily mean that the root relationship of the conflict is not embedded in the work* that either of these firms conducts. Outside of conflict, these firms' work has also been criticized for being inadequate.[101]

Some critics have pointed out that it is simply impractical to assume that ISS and/or Glass Lewis could handle the sheer amount of voting recommendations that are required in such a concentrated time frame.[102] For example, in 2009, "ISS issued proxy research and voting recommendations for more than 37,000 companies … and Glass Lewis provided similar services for more than 16,000 companies around the world."[103] Most companies hold shareholder meetings between March and June, meaning that most of the proxy-advisory work would be limited to a four-month time span, which imposes an "extraordinary seasonal burden on the proxy advisors."[104] Furthermore, with the SoP-vote requirement, thousands of annual proxy issues are added that would require research – being that many SoP votes are (as mentioned earlier in this paper) conducted annually, rather than biennially or triennially.[105] Thus, based on a bare analysis of practicality, it would be a stretch to set forth that proxy firms' recommendations

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[100] *Id.*
[101] *Center on Executive Compensation, supra*, n. 31 at 58-59.
[102] Nathan, *supra*, n. 74.
[103] *Id.*
[104] *Id.*
[105] *Id.*

can or will be based on an in-depth analysis. Rather, proxy firms have a reputation of applying a "one-size-fits-all" policy that is simplistic in its nature.[106]

Furthermore, there is a showing that some proxy-firm policies are rooted in a rationale that actually goes against principles that have been shown to add value to plans. For example, ISS has indicated in the past that it would support, "on a case-by-case basis, proposals that give shareholders the right to nominate director candidates to the corporate proxy, despite evidence suggesting that proxy access generally fails to add value."[107] And, ISS has opposed golden parachutes when such a business practice has actually been tied to an increase in share prices.[108]

The Center on Executive Compensation ("CEC") and the HR Policy Association ("HRP") also conducted member surveys in 2010 that revealed many inaccuracies in proxy advisory methods.[109] For example, 53 percent of the members that responded to the survey said that "a proxy advisory firm had made one or more mistakes in a final published report on the company's compensation program."[110] Fifty-seven percent of survey respondents said that "a proxy-advisory firm had used a compensation peer group in a preliminary draft of a report that failed to take into account the company's size, industry, complexity or compensation for talent."[111] The CEC and HRP also noted that various factors found in the models that proxy-advisory firms set forth are not made public under the notion that they are considered proprietary.[112] Thus, this promotes a lack of transparency.

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[106] *Id.*
[107] Glassman, *supra*, n. 58 at 15(citing Thomas Stratmann & J.W. Verret, *Does Shareholder Proxy Access Damage Share Value in Small Publicly Traded Companies?*, 64 Stanford L.R. 1431, 1431-68 (2010)).
[108] *Id.* (citing generally Richard A Lambert & David F. Larcker, *Golden Parachutes, Executive Decision Making and Shareholder Wealth*, JOURNAL OF ACCOUNTING AND ECON. 7 (1985)).
[109] *Center on Executive Compensation, supra*, n. 31 at 58.
[110] *Id.*
[111] *Id.*
[112] *Id.* at 60.

Based on the above analysis of the functioning, structure and policy adoptions of the two largest proxy-advisory firms, it is evident that there is such a limited chance that retaining them for advice can be in the "best interest" of an institutional shareholders' clients. As mentioned, the mere disclosure of conflicts does not mean that they do not exist – or continue to influence the decisions made by these proxy-advisory firms. Furthermore, the arguably arbitrary nature and one-size-fits all approach to proxy policies that likely have been adopted by these firms undercuts the probability that these firms' input regarding proxies could be in the best interest of an institutional shareholder's plan. What these firms have are *inherent* flaws in their structure, method and application that are highly susceptible to lead to conflict.

PART III

HOW VARIOUS PROPOSED SOLUTIONS FAIL TO ADDRESS ROOT CAUSE OF THE FLAWS OF THE PROXY-ADVISORY INDUSTRY

The solutions captured in Part III are all attempts to address the issues of the proxy-advisory industry mentioned in Part II. They all fail, however, to address the inherent structural flaws of the industry, as well as the fact that investment advisers (many of whom are ERISA-plan fiduciaries, as well) are already tasked with ensuring that their clients/beneficiaries are shielded from the inherent flaws of industries like the proxy industry.

1. MODELING REGULATIONS FOR THE PROXY-ADVISORY INDUSTRY AFTER THOSE THAT HAVE BEEN APPLIED TO THE CREDIT-RATING-AGENCY INDUSTRY:

The proxy-advisory industry has been held to be analogous to the credit-rating agencies for multiple reasons:[113] (1) both synthesize information to single ratings[114]; (2) the information that these entities release only represents their view of the industry they are rating/assessing[115]; (3)

[113] Belinfanti, *supra*, n.12 at 431.
[114] *Id.*
[115] *Id.* at 432.

there are small numbers of firms that dominate the industry as a whole[116]; and (4) both entities' approaches and/or methodologies have been criticized as being inaccurate[117].

Section 2 of the Credit Rating Agency Reform Act of 2006 sets forth requirements that an organization must comply with to be considered a "nationally recognized statistical rating organization.[118]" To obtain such recognition, agencies must submit an application to the SEC with the following information:

> (1) credit ratings performance measurement statistics over short-term, mid-term, and long-term periods; (2) the procedures and methodologies that the applicant uses in determining credit ratings; (3) policies or procedures adopted and implemented by the applicant to prevent the misuse of material, nonpublic information; (4) its organizational structure; (5) whether it has in effect a code of ethics, and, if not, why; (6) any conflict of interest relating to its issuance of credit ratings; (7) on a confidential basis, a list of the twenty largest issuers and subscribers that use its credit ratings services by amount of net revenues received in the fiscal year immediately preceding the date of submission of the application; and (8) any other information and documents which the SEC may by rule prescribe as necessary or appropriate in the public interest or for the protection for investors.[119]

What this solution fails to address as applied to the proxy-advisory industry is that proxy firms already disclose much of this information. As mentioned above, ISS and Glass Lewis make their organizational structures available; they publish their code of ethics, and they disclose conflicts of interest to investment advisers (or ERISA-plan fiduciaries).[120] It is true that this information does not need to be disclosed to or filed with the SEC if the proxy firm does not fall under the Advisers Act. However, as already established, much of this information has been disclosed to the investment advisers that are captured under the Advisers Act (and/or fall under ERISA).

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[116] *Id.*
[117] *Id.*
[118] (Name redacted) CONGRESSIONAL RESEARCH SERVICES, CREDIT RATING AGENCIES AND THEIR REGULATION 4 (2010), *available at*, https://www.everycrsreport.com/files/20100409_R40613_1d61ef51013055a61bda270b2259e640a92c797f.pdf; *See also* P.L. 109-291.
[119] *Id.*
[120] *Infra,* Part II.

Investment advisers registered under the Adviser Act are under the purview of the SEC. In fact, pursuant to the 2004 Egan-Jones and ISS letters, the SEC has already established that investment advisers have a duty to ensure that proxy-advisory firms are performing adequately and that they can make a decision in an impartial manner.[121] In fact, to reiterate, in its letter to ISS, the Commission also noted that an investment adviser must, to carry out his or her duty, conduct a "case by case evaluation of the proxy voting firm's relationships with Issuers, a *thorough review of the proxy voting firm's conflict procedures and the effectiveness of their implementation, and/or other means reasonably designed to ensure the integrity of the proxy voting process.*"[122] [Emphasis added]. Thus, the Commission has already said that the investment advisor must test the truth of the disclosure of the proxy firm by assessing the "effectiveness" of the firm's conflict procedures.

2. CREATION OF AN OVERSIGHT BOARD FOR PROXY-ADVISORY FIRMS:

Another proposed solution has been to create an oversight board that is similar to the Public Company Oversight Accounting Board ("PCOAB").[123] Features of a proxy-advisory oversight board would include the following factors that are a part of the PCOAB: "(i) the creation of auditing and ethics standards; (ii) the authority to conduct a continuing program of inspections; (iii) a requirement that audit firms register with the PCOAB; and (iv) the grant of enforcement action to the PCAOB to investigate and discipline registered public accounting firms."[124]

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[121] *See* Letter from Douglas Schiedt, Associate Director and Chief Counsel, Division of Investment Management U.S. Securities and Exchange Commission, to Kent S. Hughes, Managing Director, Egan-Jones Proxy Services (May 27, 2004), *archived at,* http://perma.cc/KSJ2-JP5N; *See also* Letter from Douglas Schiedt, Associate Director and Chief Counsel, Division of Investment Management U.S. Securities and Exchange Commission, to Mari Anne Pisarri on behalf of Institutional Shareholder Services, Inc. (September 15, 2004), *archived at,* http://perma.cc/Q8YH-SAXR. [Hereinafter "Egan-Jones Letter"]

[122] *ISS Letter, supra*, n. 62.

[123] Belinfanti, *supra,* n. 12 at 436-37.

[124] *Id.*

While a proposed oversight board for proxy-advisory firms could implement uniformity among the proxy-advisory industry by promoting uniform auditing and ethics standards, this solution also fails to acknowledge that the ultimate entity conducting "oversight" between proxy-advisory firms and institutional shareholders is supposed to be the investment advisers (or ERISA-plan fiduciaries) charged with ensuring that proxies are voted in the "best interest" of their clients.[125] Furthermore, one need not conduct an in-depth analysis to find that certain proxy industries may be inherently conflicted despite the disclosures they offer.

For example, if Glass Lewis has a duty to perform in the best interest of its members/investors (e.g. its parent companies), and the carrying out of such a duty could, in turn, hinder the institutional shareholder because its members' interest are adverse to the interests of the shareholders, the onus should be on an investment adviser to ensure that utilizing Glass Lewis's services is, in fact, going to aid in enhancing the economic value of its client's plan through proxy voting. As stated in the previous section, this is already the expectation that the SEC has of investment advisers.[126]

3. MANDATORY REGISTRATION UNDER THE INVESTMENT ADVISERS ACT OF 1940:

Under the Investment Advisers Act of 1940, an investment adviser (as mentioned earlier in this paper) is an individual who, "for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or . . . issues or promulgates analyses or reports concerning securities.'"[127] The SEC has said that proxy firms fall under the definition of investment adviser and, as such, have duties to their advisory clients, but that does not mean they necessary have to register under the

[125] *See* 17 C.F.R § 275.206(4)–6; *see also* Letter from Alan D. Lebowitz, Deputy Secretary, U. S. Department of Labor, to Helmuth Fandl, Chairman of the Retirement Board, Avon Products, Inc., (Feb. 23, 1988), 1988 ERISA LEXIS 19.
[126] *Egan-Jones Letter*, *supra*, n. 26*; ISS Letter, supra,* n. 62.
[127] *See* 15 U.S.C. §80b-2(a)(11) (2017).

Advisers Act.[128] Registration imposes several additional duties on those who fall under the Advisers Act. These include "disclosure of arrangements that may lead to conflicts of interest with their clients,[129] implementation and annual review of internal compliance programs designed to ensure compliance with the Advisers Act,[130] designation of a chief compliance officer to oversee the compliance program,[131]and the creation and preservation of records to be inspected by an SEC examiner."[132] Although all proxy firms are not required to register under the Advisers Act, all firms are subject to Section 206 of the Advisers Act – known as the anti-fraud provision – meaning that proxy firms cannot "employ and device, scheme or artifice to defraud any client or prospective client."[133]

As of December 8, 2016, ISS confirmed that it is, in fact, a registered investment adviser pursuant to the Investment Advisers Act of 1940.[134] In fact, by 2016, ISS had been a federally

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[128] U.S. SECURITIES AND EXCHANGE COMMISSION, CONCEPT RELEASE ON THE U.S. PROXY SYSTEM, RELEASE NOS. 34-62495, 43010 (July 22, 2010), *archived at,* https://www.sec.gov/rules/concept/2010/34-62495fr.pdf; *see also* 17 C.F.R.A §275.203A-2(a)(1) and (2) (Lexis 2017) (plan consultants who give advice to ERISA plans that manage more than $200,000,000 million in assets *must* register under the Advisers Act); *see also* 17 C.F.R.A §275.203A-1(a)(1) (Lexis 2017) (those (which may include advisers to non-ERISA plans) who have assets under management of more than $100,000,000 *may* register under the Advisers Act, but those who manage $110,000,000 or more in assets *must* register under the Advisers Act).

[129] Edelman, *supra*, n. 36 at 1381 (citing U.S. SECURITIES AND EXCHANGE COMMISSION, CONCEPT RELEASE ON THE U.S. PROXY SYSTEM, RELEASE NOS. 34-62495 113-14 (July 14, 2010), *archived at,* https://www.sec.gov/rules/concept/2010/34-62495.pdf (Part II of Form ADV, or a brochure containing the information in the Form, is required to be delivered to advisory clients or prospective clients by Rule 204-3 under the Advisers Act [17 C.F.R. §275.204-3]. In addition to the disclosure of certain conflicts of interest, Part II contains information including the adviser's fee schedule and the educational and business background of management and key advisory personnel of the adviser. Part II is currently not submitted to the SEC but must be kept by advisers in their files and made available to the SEC upon request and is 'considered filed."')); *see also* U.S. SECURITIES AND EXCHANGE COMMISSION, https://www.sec.gov/answers/formadv.htm and https://www.sec.gov/divisions/investment/iaregulation/memoia.htm (refer to the "Brochure Rule" and "Books and Records to be Retained").

[130] *Id.* (citing 17 C.F.R. §275.206(4)-7(a) to (b) (2017)).

[131] *Id.* (citing 17 C.F.R. §275.206(4)-7(c) (2017)).

[132] *Id.* (citing 17 C.F.R. §275.204-2 (2017)).

[133] U.S. SECURITIES AND EXCHANGE COMMISSION, CONCEPT RELEASE ON THE U.S. PROXY SYSTEM, RELEASE NOS. 34-62495, 43010 (July 22, 2010), *archived at,* https://www.sec.gov/rules/concept/2010/34-62495fr.pdf (this SEC Concept Release also sets forth that proxy firms are prohibited from making false or misleading statements under Exchange Act Rule 14a–9).

[134] INSTITUTIONAL SHAREHOLDER SERVICES, STATEMENT OF INSTITUTIONAL SHAREHOLDER SERVICES INC. TO THE SEC INVESTOR ADVISORY COMMITTEE, File No. 265-28, 5 (2016), *available at*, https://www.sec.gov/comments/265-28/26528-271.pdf

registered investment adviser under the Advisers Act for about 20 years.[135] Thus, ISS is already required to follow many of the registration duties that are required by the Investment Advisers Act – and has been subject to these requirements for a lengthy time. Glass Lewis is not registered under the Investment Advisers Act.[136] However, non-registration is not common-place in the proxy-advisory industry. Marco Consulting and ProxyVote (two other proxy firms) are registered as investment advisers.[137] And while Egan-Jones (again, another proxy firm) is not registered under the Advisers Act, it is registered as a Nationally Recognized Statistical Rating Organization, meaning that it is required to meet standards tied to its credit-rating activity – albeit these requirements do not encompass its proxy-advisory services.[138]

The fact that the majority (particularly, the largest) of proxy-advisory firms are already registered under the Investment Advisers Act[139] shows that registration is not going to fix the issues of the proxy industry – after all, there are continuous concerns despite most of the firms being registered. Furthermore, as of 2007, the SEC noted that it had not pursued enforcement action against any of the proxy firms registered under the Advisers Act.[140]

In 2009, however, the SEC did settle its first case, and it was against INTECH, an investment adviser who had followed ISS's proxy recommendation to follow The American Federation of Labor and Congress of Industrial Organizations' ("AFL-CIO") voting recommendations.[141] The SEC found that INTECH violated Rule 275.206(4)–6 because it failed to maintain written

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[135] *Id. see also* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-17-47 CORPORATE SHAREHOLDER MEETINGS PROXY ADVISORY FIRMS' ROLE IN VOTING AND CORPORATE GOVERNANCE PRACTICES 9 (2016), *available at*, https://www.gao.gov/assets/690/681050.pdf; *see also* George W. Dent Jr., *A Defense of Proxy Advisors*, 2014 MICH. ST. L. REV. 1287, 1311 (2015).
[136] *GOA 2016, supra*, n. 27 at 9 (2016).
[137] *Id.*
[138] *Id.*
[139] As noted in the previous paragraph, ISS, Macro Consulting and ProxyVote are all registered under the Investment Advisers Act.
[140] *GOA 2007, supra*, n. 51 at 12.
[141] *Center on Executive Compensation, supra*, n. 31 at 64 (citing Gibson, Dunn & Crutcher, LLP, *SEC Enforcement Action Focuses on Investment Adviser's Proxy Voting Policies and Procedures* (2009)).

policies and procedures addressing conflicts that arose between INTECH's interests and its clients that were not pro-AFL-CIO.[142] This action by the SEC reflects, as do the Egan-Jones and ISS letters, an emphasis on the duties of the investment adviser to ensure that their client's best interest is met when a proxy firm is utilized – granted that the emphasis was on written-policy maintenance as opposed to an actual assessment of best interest.

4. PROPOSED CORPORATE GOVERNANCE REFORM AND TRANSPARENCY ACT OF 2016, H.R. 5311:

On May 24, 2016, bill H.R. 5311 was introduced to Congress by Representative Sean Duffy.[143] This bill, which was referred to as the Corporate Governance Reform and Transparency Act of 2016, would have amended Section 3(a) of the Securities and Exchange Act of 1934 (15 U.S.C § 78c(a)).[144] The bill did not make it out of committee and has yet to be re-introduced to Congress. The bill, however, captured various aspects of many of the proposed regulatory fixes for the proxy-advisory industry mentioned above.

For example, Section 15H (b)(1)(A) of the bill would have required all proxy-advisory firms to register with the Commission.[145] Under Sec. 15H(b)(1)(B), for a proxy firm to register, it would have to submit the following on an application to the Commission:

> (i) a certification that the applicant has adequate financial and managerial resources to consistently provide proxy advice based on accurate information; (ii) the procedures and methodologies that the applicant uses in developing proxy voting recommendations, including whether and how the applicant considers the size of a company when making proxy voting recommendations; (iii) the organizational structure of the applicant; (iv) whether or not applicant has in effect a code of ethics, and if not, the reasons therefor; (v) any potential or actual conflict of interest relating to the ownership structure of the applicant or the provision of proxy advisory services by the applicant, including whether the proxy advisory firm engages in services ancillary to the provision of proxy advisory services such as consulting services for corporate issuers, and if so the revenues derived therefrom; (vi) the policies and procedure in place to manage conflicts of interest under subsection (f); and (vii) any other information and documents concerning the applicant and any person associated

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142 *Id.*
143 H.R. 5311, 114th Cong. (2016), *available at,* https://www.congress.gov/114/bills/hr5311/BILLS-114hr5311rh.pdf
144 *Id.* Sec. 2(a).
145 *Id.* Sec. (b)(1)(A).

> with such applicant as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.[146]

Sec. 15H(b)(3) of H.R. 5311 would have required that all of the information submitted by a proxy firm on its application to the Commission pursuant to the Act be disclosed to the public through the Commission's website. Sec. 15H(g)(1) of H.R. 5311 would have also required that proxy-advisory firms appoint an ombudsman to receive complaints from the subjects of the proxy firm's voting recommendation regarding the accuracy of information used to create recommendations. And Sec. 15H(h) of H.R. 5311 would have required the appointment of a compliance officer. Sec. 15H(l) would have required proxy firms to make the methodology behind their recommendations available to the public.

With just a glance, it is evident that the requirements under H.R. 5311 are not unique to many of the requirements that are a part of registration under the Investment Advisers Act. Under the Advisers Act, as with H.R. 5311, there is disclosure of conflicts, assurance of compliance through review of compliance procedures and/or appointment of a compliance officer, record keeping of information regarding the proxy firm's structure[147] (for example, including information regarding the firm's ethics practices[148]). What H.R. 5311 would have uniquely done is it would have specifically targeted regulation towards proxy-advisory firms – as opposed to investment advisers in a general sense. H.R. 5311 also had requirements of public disclosure that make it relatively distinct.

This bill, like the proposed regulatory fixes mentioned again, fails to focus on the already existing duties of the investment advisers (and/or ERISA fiduciary) that have been tasked with

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[146] *Id.* Sec. (b)(1)(B).
[147] *Infra*, Part III, n. 129-32.
[148] *See* 17 C.R.F. 257.204–2(a)(12)(i) (Requires that investment advisers keep records of company ethics code).

voting in the best interest of their clients. Had Congress passed H.R. 5311, investment advisers would still be able to slide their duties to another party.

In Sec. 15H(h)(2) of the Bill, Congress would have required that the Commission withdraw the 2004 Egan-Jones and 2004 ISS No-Action letters. While a withdrawal of the 2004 Egan-Jones letter will address the issue that was created by the letter – e.g. many institutional-investment organizations (investment advisers, particularly) utilized it as a reason to outsource their fiduciary duties to proxy-advisory firms – a *mere withdrawal* does not address the duties of the investment adviser who should be seeking the best interest of its client.

Furthermore, a withdrawal of the SEC's 2004 No-Action letter to ISS will remove the guidance to investment advisers that they should obtain information from prospective proxy-voting firms to ensure that the firms that they are obtaining recommendations from are, in fact, independent. Thus, while a *partial* withdrawal of the 2004 Egan-Jones No-Action letter may be one step in the right direction (since it could remove the misconception that retaining a proxy firm ultimately removes conflict), H.R. 5311 would not have adequately addressed enforcement of the expectations and duties of the investment adviser (or plan fiduciary) who is initially hired to manage the portfolio before it is handed off to the proxy-advisory firm.

PART IV

REMOVING THE EXTRA LAYER OF CONFLICT AND CONFUSION: GETTING BACK TO BASICS, ADDRESSING THE DUTIES OF THE INVESTMENT ADVISER (AND ERISA-PLAN FIDUCIARY)

What proposals for regulation of the proxy industry have done are serve as a distraction to the real issue that impacts institutional shareholders. The real issue is governmental agencies' failure to adequately articulate and enforce the expectations of investment advisers registered under the Advisers Act (as well as fiduciaries that fall under ERISA) that are initially charged with managing shareholder assets.

In *How to Fix Our Broken Proxy Advisory System*, James K. Glassman and J.W. Verret summarized this sentiment when they stated: "…[T]he main purpose of the 2003 SEC rule on proxies was to address problems caused by conflicts of interest between institutions and the shareholders whose assets they manage. In fact, the conflicts have merely been shifted to different firms."[149] This conundrum was largely created, as mentioned earlier in this paper, by the SEC's issuance of the 2004 Egan-Jones letter.[150] The Egan-Jones letter, in essence, established that investment advisers charged with managing portfolios could "wash their hands of conflict" if they retained an independent third party to aid them in assessing how to vote on proxies. Thus, as highlighted in this paper, investment advisers began to turn to proxy-advisory firms to alleviate themselves from potential conflict.[151]

However, ridding themselves of conflict was not the only reason that investment advisers (and ERISA fiduciaries) turned to proxy firms. The volume of proxy issues, caused, *in part*, by the SoP vote implemented by Dodd-Frank, also prompted investment advisers to turn to proxy firms.[152] Thus, fixing the issue requires an acknowledgment that "mutual funds [and other fiduciaries] can't possibly make considered judgments about tens of thousands of proxies, and that [it] is not in their best interest to do so."[153]

The issue of proxy volume, however, is a matter that the SEC and DoL have already addressed in the past. In its 2008 Interpretive Bulletin, the DoL set forth that "fiduciaries also

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[149] Glassman, *supra*, n. 58 at 21 (2013).
[150] *Id.* at 26.
[151] *Id.*
[152] *Id.* at 9-10. *See also Infra*, Part I, No. 3(a).
[153] JAMES GLASSMAN & J.W. VERRET, MERCATUS CTR. GEORGE MASON UNIV., HOW TO FIX OUR BROKEN PROXY SYSTEM, MERCATUS CENTER AT GEORGE MASON UNIVERSITY, 28 (2013), *available at*, https://www.mercatus.org/system/files/Glassman_ProxyAdvisorySystem_04152013.pdf

need to take into account costs when deciding whether and how to exercise their shareholder rights, including the voting of shares."[154] [Emphasis added]. And, when passing Rule 275.206(4)–6, the SEC noted that there will be times when choosing not to vote on a proxy will be in the best interest of an investment adviser's client because the cost would outweigh any benefit to the client's plan.[155] Thus, instead of focusing on vigorously regulating the proxy-advisory industry, both the SEC and DoL should shift their focus towards clarifying these two initiatives to ensure that investment advisers (and ERISA-plan fiduciaries) are voting proxies efficiently, making sure that an adequate cost-benefit analysis has been carried out.[156] The SEC and DoL should also specifically note that the costs of retaining and properly overseeing a proxy firm should be factored into a fiduciaries decision to vote or not vote a proxy.

On December 29, 2016, the DoL back-tracked its emphasis on a cost-benefit analysis by withdrawing its 2008 Interpretive Bulletin and replacing it with Interpretive Bulletin 2016-1, which reinstates Interpretive Bulletin 94-2.[157] The DoL does still maintain that plan fiduciaries are to "vote proxies on issues that may affect the value of the plan's investment."[158] To further add to the confusion, however, the DoL also said that "in some special cases, voting proxies may involve out of the ordinary costs or unusual requirements… (such as voting proxies of foreign corporations); [i]n such cases, a fiduciary should consider whether the plan's vote, either by itself

[154] *DoL 2008 Interpretive Bulletin, supra*, n. 43 at 61733.
[155] U.S. SECURITIES AND EXCHANGE COMMISSION, FINAL RULE: PROXY VOTING BY INVESTMENT ADVISERS, RELEASE NO. IA-2106, VOTING CLIENT PROXIES, *available at*, https://www.sec.gov/rules/final/ia-2106.htm#llA2a
[156] Glassman, *supra*, n. 58 at 29 (2013) (Glassman and Verret acknowledge that the DoL has not enforced its 2008 Interpretive Bulletin and that neither the DoL or SEC has "reconciled a need for a benefit-cost analysis with universal active proxy voting policy requirements." These two authors propose limiting proxy voting requirements of mutual funds and pension plans "so that these institutions will be the sole arbiters of when it makes sense to vote using active analysis of the question at hand);" *see also* Charles M. Nathan, *Proxy Advisory Business: Apotheosis or Apogee?*, THE HARVARD L. SCH. FORUM ON CORP. GOV. AND FIN. REG. (March 23, 2011), *available at*, https://corpgov.law.harvard.edu/2011/03/23/proxy-advisory-business-apotheosis-or-apogee/.
[157] DEPARTMENT OF LABOR, INTERPRETIVE BULLETIN 2016-1 9-10 (2016), *available at*, https://www.dol.gov/sites/default/files/ebsa/2016-31515.pdf
[158] *Id.* at 13-14.

or together with the votes of other shareholders, is expected to have an effect on the value of the plan's investment that warrants the additional cost of voting."[159] The DoL noted, in this 2016 Bulletin, that its 2008 interpretation may have served as a means to discourage plan fiduciaries from voting on proxies.[160] It is too early to determine the effect that this interpretive bulletin could have, but it could, very well, further encourage fiduciaries to vote every proxy (or most proxies) as a means of ensuring that they are complying with their fiduciary duties – being that the language of the 2016 Bulletin suggested that the 2008 Bulletin's withdrawal was based on the fact that it may have discouraged voting. Thus, a reinstatement of the 2008 Interpretive Bulletin, along with further guidance that conveys to fiduciaries that they must consider the costs of retaining and overseeing proxy firms in their cost-benefit analysis, would more fittingly ensure that proxies are voted with care – and that initial plan fiduciaries are able to more adequately assess proxies.[161]

H.R. 5311 and some academics have argued that a withdrawal of the 2004 Egan-Jones letter is needed.[162] And, at first glance, this appears to be an appropriate direction towards a solution; after all, time and time again this paper has noted that it was one of the root causes of the creation of the proxy-advisory dependence. However, a vital piece of information was included in this 2004 Egan-Jones letter. The Commission, in this same letter, also said that advisers who were concerned about conflicts could simply disclose such conflicts to their clients and request consent to proceed.[163]

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[159] *Id.*
[160] *Id.* at 7.
[161] *See generally* Nathan, *supra,* n. 74.
[162] Glassman, *supra*, n. 58 at 30 (2013).
[163] Egan-Jones Letter, *supra*, n. 26 (specifically footnote No. 5) (citing U.S. SECURITIES AND EXCHANGE COMMISSION, FINAL RULE: PROXY VOTING BY INVESTMENT ADVISERS, RELEASE NO. IA-2106, RESOLVING CONFLICTS OF INTEREST, *available at*, https://www.sec.gov/rules/final/ia-2106.htm#llA2a).

Thus, a withdrawal of the 2004 Egan-Jones No-Action letter is not necessarily a fix to the overarching issue; it might just serve as a Band-Aid to the issue. An adequate solution would be to imbed portions of the Egan-Jones letter within current Rule 275.206(4)–6. Amended, the rule would read that advisers under the Advisers Act are to:

> (a)[a]dopt and implement written policies and procedures that are reasonably designed to ensure that [it] vote[s] client securities in the *best interest of clients*, which procedures must include how [it] address[es] conflicts that may arise between [its] interests and those of [its] clients;
> (b) disclose to clients how [it] may obtain information from [it] about how [it] voted with respect to their securities; and
> (c) describe to clients [its] proxy-voting policies and procedures and, upon request, furnish copy of the policies and procedures to the requesting client.
> (d) if an investment adviser cannot carry out their duty due to a conflict of interest, the adviser must disclose the conflict to its client and obtain the client's consent before voting on behalf of the client's securities.
> (e) if the investment adviser utilizes a proxy-advisory firm, whether or not that proxy-advisory firm is also registered under the Investment Advisers Act of 1940, the investment adviser must disclose such use to the client, in addition to the following information:
>> (i) potential conflicts of interest that the proxy-advisory firm may have, including the firm's corporate structure and relations that it or any of its parent companies or subsidiaries may have with corporate issuers of securities.
>> (ii) potential inadequacies or limitations in the information provided by the firm.
>
> (f) if the investment adviser utilizes a proxy-advisory firm, whether or not that proxy-advisory firm is also registered under the Investment Advisers Act of 1940, the investment adviser must obtain the client's consent to retain the proxy-advisory firm before voting on behalf of the client's securities.

Provisions (d)-(f) above would serve as amendments to the initial rule, and they would only apply to registered advisers under the Advisers Act.

What this amendment does is it extends and codifies portions of the Egan-Jones letter. In the Egan-Jones letter, the Commission noted that a conflicted investment adviser could disclose such conflict to their client and seek client consent to continue voting on the client's behalf. Thus, this principle should be extended to investment advisers who retain proxy-advisory firms by requiring that advisers disclose the use of the proxy firms to clients and ask for client consent to utilize them when voting the client's proxy. This solution acknowledges the *inherent* structural flaws found in proxy firms. It acknowledges that the very use of a proxy firm could hinder the best interest of the shareholder/beneficiary (because of these firms' conflicted structure) even if information about their practices is disclosed. As such, proxy firms' usage should be treated as a conflict would be treated if the investment adviser himself or herself was directly conflicted.

Some may argue that proxy-advisory firms will be further encouraged to withhold information on the basis that clients will vote against the use of these firms. However, those that are currently registered under the Advisers Act will *have to* continue to disclose relevant information to the SEC (and their clients) and retain relevant policies, regardless. No matter how the impact would be carried out, this solution puts the impetus on the initial fiduciary to ensure that the services they are utilizing are adequate – which might mean that the adviser will choose firms that are registered over those that are not.

This approach puts more power in the hands of the client or beneficiary of institutional-investment organizations. After all, it was at the SEC roundtable in 2013 that Chair White stated, "exercising the vote on important issues is one of the most significant rights that investors have"[164] Thus, if it is of such importance to the investors (who are, ultimately, the clients/beneficiaries), it should be the clients/beneficiaries who have the ultimate say on the decision of an initial plan manager's choice to retain a third party that could be conflicted.

In addition to an emphasis on cost-benefit analysis and further disclosure-and-consent requirements from investment advisers/plan fiduciaries, the SEC should also continue – and possibly increase – its enforcement actions, sending the message that it will hold investment

[164] U.S. SECURITIES AND EXCHANGE COMMISSION, TRANSCRIPT OF PROXY ADVISORY FIRMS' ROUNDTABLE, p. 0008, lines 6-10 (December 5, 2013), *archived at*, http://perma.cc/Z57U-QNGW

advisers accountable as it did in 2009 when it pursued its first enforcement action against an investment adviser regarding its usage of proxy-firm advice[165] – albeit that it was *six years* after Rule 275.206(4)–6 was enacted. Furthermore, an amendment to Rule 275.206(4)–6 will also enable to Commission to make sure that investment advisers not only have written policies to address conflicts, but that they are also disclosing information they specifically have about proxy firms, in addition to seeking client consent on usage of these firms.

CONCLUSION

The main issue at hand is that investment advisers (or plan fiduciaries) have turned to proxy firms, who are not directly managing the plan or its assets and who, based on their structure, are inherently conflicted. Although these investment advisers/plan fiduciaries are required to monitor this delegation of authority, the regulatory framework currently does not adequately impose assurance that this occurs. Thus, the most-effective solution to the proxy-firm dilemma is threefold: It requires an emphasis on reducing investment advisers' (plan fiduciaries') view that every proxy must be voted; disclosure/consent in the usage of proxy firms and the SEC's enforcement of investment advisers' duties in regards to proxy-firm usage.

By encouraging investment advisers to conduct cost-benefit analysis – and pushing them away from voting all proxies – investment advisers can then focus on voting on necessary proxies more efficiently, arguably weakening their dependence on proxy firms.

When proxy firms are needed – because they may be; investment advisers are not always going to be experts in all matters that come up on proxies – disclosure and consent should be required because proxy firms harbor *inherent* possibilities for conflict. And, to ensure that all of

[165] *Center on Executive Compensation, supra,* n. 31 at 64, 75 (citing Gibson, Dunn & Crutcher, LLP, *SEC Enforcement Action Focuses on Investment Adviser's Proxy Voting Policies and Procedures* (2009)).

these above-mentioned moving parts are effective, the SEC should vigorously enforce the duties of investment advisers to further ensure compliance.[166]

[166] The Department of Labor (as mentioned in Footnote 22) has enacted a rule (the "Fiduciary Rule") that would expand the definition of "fiduciary" under ERISA. *See generally* Fiduciary Rule, 81 Fed. Reg. 20,946 (April 8, 2016), *available at*, http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=28806. The Fiduciary Rule became effective June 7, 2016 and was set to be applicable April 10, 2017. However, on February 3, 2017, President Trump signed a Presidential Memorandum directing the Department of Labor to examine this rule, putting the fate of the rule at a stand-still, *See* https://www.dol.gov/agencies/ebsa/laws-and-regulations/rules-and-regulations/completed-rulemaking/1210-AB32-2)). The Department of Labor has said that it will delay the roll out of the rule by 60 days, meaning it will not begin to go into effect until June 9, 2017. *See* Kristina M. Zanotti, Ruth E. Delaney, David R. McCandless, Amanda M. Katlowitz & Robert L. Sichel, *K&L Gates Discusses Fiduciary Rule Delay – Important Compliance Takeaways*, CLS BLUE SKY BLOG, April 14, 2017, *available at*, http://clsbluesky.law.columbia.edu/2017/04/14/kl-gates-discusses-fiduciary-rule-delay-important-compliance-takeaways/#.WPCk-v3uts0.email. There is a possibility that proxy-advisory firms will be captured under the Fiduciary Rule if it does go into effect. The plain language of the rule sets forth that advice regarding the management of securities or other property within the term "investment advice" includes recommendations on proxy voting (unless made to a broad class of investors); thus, there is a possibly that proxy-advisory firms will be under the purview of the Department of Labor pursuant to this rule. *See* Fiduciary Rule, 81 Fed. Reg. 20,967 (April 8, 2016).