October 5, 2020

Office of Regulations and Interpretations
Employee Benefits and Security Administration
Room N-5655
U.S. Department of Labor (DOL)
200 Constitution Avenue NW
Washington, D.C. 20210

RE: 1210-AB91 - Fiduciary Duties Regarding Proxy Voting and Shareholder Rights

Dear Mr. DeWitt,

Having authored a series of papers that have highlighted proxy advisors' conflicts of interest, factual and analytical errors in recommendations, and robo-voting, I was pleased to see the Department of Labor's (DOL) efforts to clarify that fiduciaries, specifically those that fall under the Employee Retirement Income Security Act of 1974 (ERISA), are only to vote on proxies that would impact economic performance, not promote an individual's social or environmental goals as worthy of attention as those issues are for our elected officials to contemplate and furtherance of their public discourse.[1]

However, in addition to what the DOL has proposed, I believe additional action should be taken to further protect individuals' retirement investments. The DOL should consider adding language to limit, if not prohibit, the use of automatic voting or robo-voting, a practice that while more convenient for an investment advisor is clearly inconsistent with the fiduciary duty owed to the ultimate beneficiary.

Attached to this comment is relevant research to the question of robo-voting. I believe this research will shed additional light on the need to include language disabling automatic voting as a simple way to ensure that ERISA plan fiduciaries perform their own due diligence and avoid outsourcing their proxy voting responsibilities.

First is a paper I authored back in 2018, *The Conflicted Role of Proxy Advisors*[2] which noted that the two largest proxy advisors, Institutional Shareholder Services (ISS) and Glass Lewis, control 97 percent of the market and exert significant influence over voting recommendations, with one study showing that a negative recommendation from ISS has the ability to effect up to 25 percent of the vote.[3]

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[1] U.S. Dept. of Labor, *News Release* (Aug. 31, 2020), available at https://www.dol.gov/newsroom/releases/ebsa/ebsa20200831

[2] Timothy M. Doyle, *The Conflicted Role of Proxy Advisors*, American Council on Capital Formation (ACCF) (May 2018) available at: https://accfcorpgov.org/wp-content/uploads/2018/05/ACCF_The-Conflicted-Role-ofProxy-Advisors.pdf.

[3] David Larker, et al. *The Big Thumb on the Scale: An Overview of the Proxy Advisory Industry* (June 2018), available at: https://corpgov.law.harvard.edu/2018/06/14/the-big-thumb-on-the-scale-an-overview-of-theproxy-advisory-industry/

In the paper, I identified several obvious conflicts of interest in the proxy advisory industry. Specifically, ISS has drawn significant criticism for attempting to simultaneously rate companies and sell consulting services to those same companies as the companies seek to improve their ratings. The consulting role remains generally unknown to the public, and potential conflicts of interest are not stated on ISS's website, which carefully outlines the firm's influence as a proxy advisor.

In addition, Glass Lewis's ownership by the Ontario Teacher's Pension Plan (OTPP), calls into question its independence because OTPP is an active shareholder in many publicly traded companies, issuing resolutions which Glass Lewis then formulates recommendations on.

I applaud the DOL's recognition of this issue in the proposal and urge you to finalize language confirming fiduciaries' responsibility to monitor for potential conflicts when using proxy advisors.

In the paper I also identified less obvious conflicts, such as the processes each advisor uses to develop their recommendation guidelines. Both ISS and Glass Lewis annually update the guidelines which form the basis for company specific recommendations, but neither discloses which third parties impact their recommendations, or how they do so.

It is important that proxy advisors disclose any information that is material to the assessment of their advice to better enable investors to assess the objectivity of proxy advisor recommendations, removing the potential for damaging conflicts of interest. ERISA fiduciaries should use new disclosures required by the SEC to monitor for such conflicts.

Also attached is a second paper, I worked on in conjunction with Squire Patton Bogg's Frank Placenti which explores the analytical and methodological errors in proxy advisors' recommendations.[4] The analysis reviewed supplemental proxy filings during the 2016, 2017, and part of the 2018 proxy seasons and found 107 filings from 94 different companies citing 139 significant problems, including 90 factual and analytical errors.[5]

In addition, a subsequent analysis from the 2020 proxy season found a similar rate of errors despite the SEC's 2019 guidance[6] warning investment advisers to evaluate proxy advisory firms' recommendations before make investment decisions.[7] The findings of this second paper suggest that the SEC's 2019 guidance has not been effective in changing asset managers' behavior and validates the SEC's decision to go further and impose a rulemaking.

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[4] Frank M. Placenti, *Are Proxy Advisors Really a Problem?*, ACCF (Oct. 2018), available at: https://accfcorpgov.org/wpcontent/uploads/2018/10/ACCF_ProxyProblemReport_FINAL.pdf.
[5] *Analysis of Proxy Advisor Factual and Analytical Errors in 2016, 2017, and 2018*, available at: https://accfcorpgov.org/wp-content/uploads/2018/10/Analysis-of-Proxy-Advisor-Factual-and-AnalyticalErrors_October-2018.pdf
[6] *Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers* (August 2019), available at: https://www.sec.gov/rules/interp/2019/ia-5325.pdf.
[7] Kyle Isakower, *Are Proxy Advisors Still a Problem?*, ACCF (July 2020) available at: http://accf.org/2020/07/16/are-proxy-advisors-still-a-problem/

The problems created by proxy advisor errors are significantly exacerbated by automatic or robo-voting. In a survey included in Mr. Placenti's report, it explored issuers' experiences with the speed of voting after recommendations and whether they received advanced notice of recommendations. The survey showed that 20 percent of shareholders' votes are cast within three days of an adverse recommendation, suggesting that many asset managers follow proxy advisory firms without taking the time to conduct their own due diligence.

In a third paper titled, *The Realities of Robo-voting*,[8] I specifically addressed issues with robo-voting, and the data revealed that 175 asset managers with more than $5 trillion in assets under management, have historically voted with ISS on both management and shareholder proposals at least 95 percent of the time.

The analysis further found that upon increasing the threshold of what constitutes robo-voting to 96 percent, the list of asset managers reduced only marginally to 151 asset managers with more than $3.5 trillion in assets under management, similarly minor decreases in robo-voting where found at each of the thresholds that we reviewed to 99 percent support. In fact, 82 asset managers with over $1.3 trillion in assets under management voted in line with ISS 99 percent of the time.[9]

Certain investors have attempted to argue that these numbers indicate merely a correlation and not a direct causation of voting patterns. Put another way, they contend that proxy advisors are simply doing their job by formulating recommendations that align with their investment advisors' voting preferences, who thereby are merely following their predetermined preferences.

While this argument may possibly explain the frequency with which certain investment advisers follow proxy advisors' recommendations, it does not address the data showing the speed with which they vote following the issuance of a recommendation.

This point has been corroborated by academic research by Professor Paul Rose, which shows that certain investment advisers openly state that ISS vote their proxies in accordance with their proxy voting guidelines, without additional input.[10] According to Rose,

> "Despite public statements that these advisors are merely data aggregators and independent providers of information, it appears that some institutional investors have become overly reliant on the recommendations of proxy advisors, often outsourcing analysis and voting decisions to the two largest firms in the market without adequate disclosure of that reliance."

Most recently, an academic paper from Chong Shu, a Ph.D. candidate at the University of Southern California Marshall School of Business, found that the rate of robo-voting amongst asset managers has

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[8] Timothy M. Doyle, *The Realities of Robovoting*, ACCF (Nov. 2018) available at: https://accfcorpgov.org/wp-content/uploads/ACCF-RoboVoting-Report_11_8_FINAL.pdf.
[9] Id.
[10] Paul Rose, *Robovoting and Proxy Vote Disclosure*, (Nov. 13, 2019), available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3486322.

increased significantly over the last 15 years. Specifically, Shu found, "… the fraction of ISS customers blindly following its recommendations grew from 5 percent in 2007 to 23 percent in 2017."[11]

The DOL's proposal correctly states that:

> "… the fiduciary may not adopt a practice of following the recommendations of a proxy advisory firm or other service provider without appropriate supervision and a determination that the service provider's proxy voting guidelines are consistent with the economic interests of the plan and its participants and beneficiaries."

However, given the stringent standards set by ERISA, I believe the final rule should also include language explicitly forbidding asset managers from using an automatic voting mechanism when relying on proxy advisors. I fear that the current proposal will lead to fiduciaries disclosing boiler-plate language regarding their policies and procedures overseeing proxy advisors without fundamentally changing any behaviors.

As currently written, the proposed rule does not take the necessary steps to address the use of robo-voting. Without proper oversight and enforcement, many ERISA fiduciaries may continue to rely on the recommendations of proxy advisors without properly reviewing relevant information from the issuers. I strongly recommend the DOL take further action when finalizing the proposed rule to address the importance of robo-voting.

Thank you for your efforts to clarify the responsibility of ERISA fiduciaries. As you know, the issues raised are long-standing and only growing more acute. I believe the proposed changes will improve the health of our public markets and ensure investors realize greater returns on their hard-earned capital.

Sincerely,

Timothy M. Doyle
Principal & General Counsel
Guidepost-Strategies, LLC

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[11]Chong Shu, *The Proxy Advisory Industry: Influencing and Being Influenced,* USC Marshall School of Business Research Paper (June 2020), available here: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3614314.

THE CONFLICTED ROLE OF PROXY ADVISORS

May 2018

Timothy M. Doyle

Vice President of Policy & General Counsel

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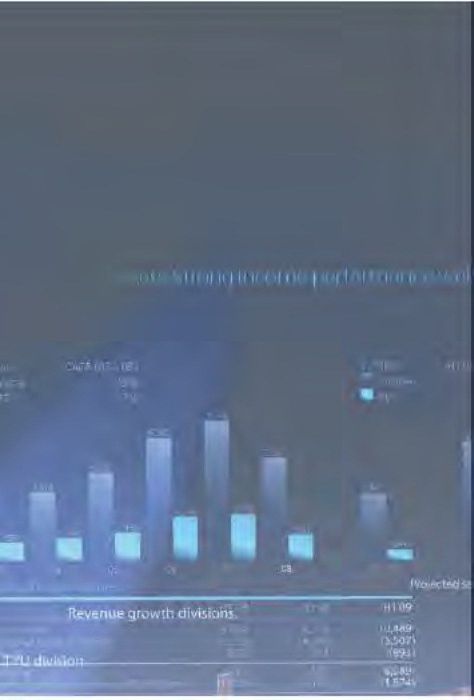
About the Author

Timothy M. Doyle

Timothy Doyle brings a diverse policy and legal background in multiple areas including energy, environment, science, and technology. Tim manages ACCF's broad portfolio of issue areas including economic, energy, environment, regulatory, and corporate governance.

Prior to joining the ACCF, Doyle served as Senior Counsel for the House Science, Space, & Technology Committee and Staff Director for its Oversight Subcommittee. There he successfully managed oversight staff involving multiple investigations. In addition, he established, developed, and maintained strategic relationships at the senior levels in Congress regarding energy policy and its corresponding regulatory framework. Doyle also served as Senior Counsel and Director of Investigations for the House Committee on Natural Resources.

Doyle holds a JD from Michigan State University as well as a BA with a dual major in Political Theory & Constitutional Democracy and Criminal Justice. During law school, he clerked for the Department of Justice in Washington D.C. at the U.S. Attorney's Office. He also worked his way through law school at the Senate Majority Policy Office in the Michigan Senate.



THE **CONFLICTED ROLE** OF PROXY ADVISORS

CONTENTS

EXECUTIVE SUMMARY

In an increasingly complicated investment and financial landscape, investors rely heavily on the services of data and analytics providers to support their investment-related decisions. Proxy voting is the process in which a vote is cast on behalf of a shareholder rather than that shareholder participating physicially in a public shareholder meeting. The reliance on advisory services is readily apparent in the increased influence of proxy advisors like Institutional Shareholder Services ("ISS") and Glass, Lewis & Co. ("Glass Lewis"). Due to their increasing influence, these normally private and opaque proxy advisory firms have come under fire for issues such as conflicts of interest, undue influence, privacy concerns, and the investment value their recommendations provide.

Lest readers think this is an issue with limited impact or import, proxy advisors drive major policies at most publicly traded companies.[1] They provide analysis, recommendations, and consulting services to issuers and companies alike regarding how annual and special proxies should be voted. Recommendations are made on issues ranging from Board appointments to acquisitions to environmental and social issues.

Academics, trade associations, and other institutions educated on this topic have called for reform. As former Securities and Exchange Commission ("SEC") commissioner Daniel M. Gallagher remarked at a meeting of the Society of Corporate Secretaries & Governance Professionals in July of 2013:

> "I believe that the Commission should fundamentally review the role and regulation of proxy advisory firms and explore possible reforms, including, but not limited to, requiring them to follow a universal code of conduct, ensuring that their recommendations are designed to increase shareholder value, increasing the transparency of their methods, ensuring that conflicts of interest are dealt with appropriately, and increasing their overall accountability. I am not alone in raising these issues...what European policymakers and our own Congress have highlighted is that **changes need to be made so that proxy advisors are subject to oversight and accountability commensurate with their role."[2]**

In 2017, proposed legislation was brought to the floor aiming to bring a correction to the corporate governance and proxy advisor space: H.R. 4015 – Corporate Governance Reform and Transparency Act of 2017 co-sponsored by Reps. Sean Duffy (R-WI) and Gregory Meeks (D-NY). The bill was proposed "to improve the quality of proxy advisory firms for the protection of investors and the U.S. economy, and in the public interest, by fostering accountability, transparency, responsiveness, and competition in the proxy advisory firm industry."[3]

Specifically, the bill would require proxy advisory firms like ISS and Glass Lewis to formally register with the SEC and comply with the applicable rules and regulations governing all financial institutions. Within their filings, proxy firms would be required to disclose their potential conflicts of interest and codes of ethics. They would also be required to make publicly available their methodologies for formulating proxy recommendations and analyses.

This legislation would require some of the same baseline standards regulators have for financial institutions and credit ratings agencies to proxy advisors. The House of Representatives passed the bill in December 2017, but is awaiting review in the Senate.[4]

This paper looks at the rationale for the proposed reform, first exploring the history of the proxy advisory firms – how they came to be, their evolving role in the investment ecosystem, and their conflicts of interest. The paper then evaluates the influence proxy advisor recommendations have on shareholder voting, as well as how a mechanism called robo-voting exacerbates that influence. The following section then evaluates their increasingly activist stances on social, political, and environmental issues, and how these are impacting companies.

KEY CONCLUSIONS:

Proxy advisors have immense influence over the way large instiutions vote on corporate issues. This paper cites numerous academic studies that provide quantitative details on the impact of ISS and Glass Lewis recommendations on a company's proxy outcomes. Through an assessment of voting correlation data, this report also finds that institutions vote in-line with ISS and Glass Lewis recommendations the vast majority of the time – more than 80 percent of the time (on average) when the proxy advisors recommend in favor of a proposal, large institutional holders also vote in favor.

1. **Proxy advisors have emerged as quasi-regulators with unchecked power.** ISS and Glass Lewis have asserted themselves into a role of regulator, wielding the aforementioned influence to require disclosure across public companies, without any actual statutory requirements. A proxy advisory recommendation drawn from unaudited disclosure can in many cases create a new requirement for companies – one that has added cost and burden beyond existing securities disclosure.

2. **While often characterized as "neutral" arbiters of good governance, these firms are very much for-profit enterprises.** By design, proxy advisory firms are incentivized to align with the comments of those who pay them the most and to move targets and change policy to create a better market for their company-side consulting services. This problematic offering further complicates the role of proxy advisors and creates a problematic conflict of interest.

3. **Shifting policy has costly impacts for companies.** Consistent policy changes, which are influenced by a non-public annual comment process, move the goalposts for companies, creating burdensome and costly requirements not mandated by law – these burdens are amplified for small and mid-cap companies. While changes to ISS and Glass Lewis's policy recommendations may appear small at any given moment, taken in aggregate this constant evolution has significant ramifications for companies and often adds burden and cost.

4. **Proxy advisors create particular challenges for smaller public companies.** The quasi-regulatory authority creates a bias in favor of large-cap companies with the resources to comply or create a campaign to oppose. This, in turn, creates difficulty for small- and mid-cap companies.

5. **Robo-voting in line with proxy advisor recommendations undermines fiduciary duty to investors.** There are institutions, particularly in the quant and hedge fund space, that automatically and without evaluation rely on proxy firms' recommendations. In addition to potentially breaching fiduciary duty, this extends the power and impact of ISS and Glass Lewis policy recommendations and decreases the ability of companies to advocate for themselves or their businesses in the face of an adverse recommendation.

Ultimately, proxy advisory firms have become intricately woven into the investment landscape. These institutions have essentially become shadow regulators, with implications for the operations and disclosure requirements of companies. As increasing attention is brought by actual regulators and elected officials, it is worth examining the biases, conflicts, and activism of these powerful institutions.

PART I: UNDERSTANDING THE PROXY ADVISOR BUSINESS MODEL – AND ITS INHERENT CONFLICTS

WHAT ARE ISS AND GLASS LEWIS?

Institutional investors have an increasingly difficult task finding value and minimizing risk in today's complex financial environment. Investors have access to more data from issuers and markets than ever before, but sifting through swaths of data, let alone using it in a way that adds value to investments, remains difficult. More and more, institutional investors rely upon external validators and resources to provide an information layer to make data more digestible and assist in making investment and voting decisions.

In the world of proxy voting, the two largest advisory services for institutional shareholders are Institutional Shareholder Services ("ISS") and Glass, Lewis & Co. ("Glass Lewis.") At their core, ISS and Glass Lewis are proxy advisory firms that provide proxy voting recommendations, voting platform services, and consulting services to institutional shareholders and pension funds. They are best known for providing Annual and Special meeting voting recommendations to institutional shareholders, who use their recommendations to inform voting decisions. **Both ISS and Glass Lewis today wield significant control of the market – an estimated 97 percent[5] – and have the ability to impact major voting decisions based on their recommendations.** The influence of these firms on how institutions vote is becoming increasingly important and politicized with their support of certain shareholder proposals that are geared toward social and political movements, rather than tied directly to value.

Proxy advisory firms came to rise with the passage of The Employee Retirement Income Security Act of 1974 ("ERISA")[6], which, among many other requirements, requires institutions managing money for private pension funds to vote at company Annual and Special meetings. In the last two decades, proxy advisory firms have become an increasingly influential voice in shareholder voting. Although all institutions are required to create and make publicly available their proxy voting guidelines, the corporate governance decision-making teams at those institutions are small compared to the amount of proxy voting decisions they need to make. Small and mid-sized institutions, pension funds, and hedge funds[a] may rely heavily on the recommendations of these firms to inform their voting decisions. Over the past few decades, as a greater share of stock market ownership transferred from individual retail investors to mutual funds[b] and hedge funds, the power and influence of proxy advisory firms has increased substantially.

In recent years, these institutions have drawn increased scrutiny for the conflicts of interest inherent in rating and providing voting recommendations concerning public companies while simultaneously offering consulting services to those same companies, including how they can improve their ratings and voting recommendations. Some question the qualifications of proxy advisory firms and the ultimate success of their recommendations.[7] Others claim they have no real incentive to accurately make recommendations that yield shareholder value.[8]

Still many others are concerned that with limited oversight and external guidelines as largely self-regulated entities, ISS and Glass Lewis (along with other startup competitors) are able to significantly influence the direction of a company through their recommendations on shareholder proposals, Boards of Directors, or mergers and acquisitions. "Critics persistently complain that proxy advisory firms' activities lack transparency, that proxy advisors operate in oligopolistic markets, that they have a check-the-box mentality, and that they suffer from conflicts of interest."[9]

a A hedge fund employs a specific, tailored investment strategy to deliver returns for investors. Hedge funds face less regulation than mutual funds and often have a smaller pool of investors, who must be accredited, and often require significant up-front capital investment.

b A mutual fund draws its capital from many small or individual investors and may invest across a wide array of securities, including stocks, bonds, or other asset types.

ISS (INSTITUTIONAL SHAREHOLDER SERVICES)

ISS is the older of the two major proxy advisors and is perceived to be the most influential. Prior studies indicate ISS claims roughly 60 percent of the current share in the market,[10] though the companies themselves cite more similar numbers of customers in recent years. ISS pioneered the development of policy-based proxy voting recommendations, online voting, and providing voting recommendations on proxy proposals; these activities remain the core activities of the firm. However, the company's service offerings, or "solutions," have evolved beyond its initial proxy services and governance research services to include investing data and analytics that inform the development of ISS's corporate rating offering, as well as a host of ratings[11] and consulting[12] services.

ISS's research service analyzes proxy materials and public information that, in turn, informs their voting recommendations for these meetings. The company covers more than 20,000 companies globally and produces proxy research analyses and vote recommendations on more than 40,000 meetings each year.[13] ISS's research arm primarily collects and organizes governance data gleaned from a company's proxy materials, including (most recently) analysis of information and data on environment and social issues through its ISS-Ethix offering.[14] This data informs the company's QualityScore offering, a numeric rating, largely based on what ISS views as fulsome disclosure of a company's risk across Environmental, Social, and Governance categories.[15]

ISS ProxyExchange is a guided platform through which investors can operationally vote their proxies.[16] The company works with clients to execute more than 8.5 million ballots annually, representing 3.8 trillion shares.[17]

Through its Securities Class Action Services, ISS offers litigation research and claims filing.[18]

Additionally, and most controversially, ISS provides consulting through its Governance Advisory Services offering.[19] Although the details of what the company's consulting service entails are not clearly defined on ISS's website, this service has come under much criticism as an attempt to simultaneously rate a company and sell consulting services to companies seeking to improve that rating or alter a poor voting recommendation.[20]

ISS states on its website that over 1,700 institutional clients make use of its services to vote at the approximately 40,000 meetings in 117 countries ISS covers annually.[21] ISS has approximately 1,000 employees spread across 18 offices in 13 countries,[22] but the amount of staff specifically dedicated to analyzing and providing voting recommendations on the 40,000 global meetings annually is not disclosed.

To support the large workload, reports have suggested that ISS engages in significant outsourcing that is not readily disclosed: "To handle its proxy season workload, ISS hires temporary employees and outsources work to employees in Manila. Given the large number of companies that the proxy advisors opine on each year, the inexperience of their staffs, and the complexity of executive pay practices, it's inevitable that proxy report will have some errors."[23]

ISS may not have envisioned the power and influence it carries today. As noted in a recent extensive piece on the proxy advisor's history, Michelle Celarier assesses:

> "That ISS has become the kingmaker in proxy contests between billionaire hedge fund activists and their multi-billion-dollar corporate prey is even more astonishing given that ISS itself is worth less than $1 billion and started out as a back-office support system, helping shareholders cast their ballots on what are typically mundane matters of corporate governance. Says one former ISS executive who now works at a hedge fund: 'ISS sort of stumbled into this powerful role."[24]

ISS was formed in 1985 with the stated aim of helping mutual funds and asset managers better analyze management proposals.[25] The company has changed hands many times since its inception, and has been both privately and publicly held, most recently by MSCI from 2010-2014.[26,27]

In recent years, under current CEO Gary Retenly, ISS has acquired environmental and climate-focused data and analytics companies in an effort to bolster the firm's environmental research and policy offering. In June 2017, ISS acquired the investment climate division of South Pole Group, a Zurich-based environmental advisory firm.[28] In another play to continue to promote a demand for environmental and social data and insights, in January 2017, ISS acquired IW Financial, a U.S.-based ESG research, consulting, and portfolio management solutions firm.[29] IW Financial went on to be integrated into the aforementioned ISS-Ethix. Most recently, ISS acquired oekom research AG, a leader in the provision of ESG ratings and data, as well as sustainable investment research.[30] Announced in March 2018, oekom will be renamed ISS-oekom and will complement the work of ISS's existing responsible investment teams.

All of these acquisitions, the most rapid-fire in a single area in the company's history, can be perceived as a further effort to capitalize on and drive focus to perceived risks related to environmental and social issues at companies across investors and the political community alike. This paper later explores how ISS and its proxy advisor peers have used these acquisitions to fuel increasing political and social activism in its policies.

GLASS, LEWIS & CO.

Glass Lewis is the second largest provider in the marketplace, though significantly smaller than ISS. With over 360 employees in nine offices across five countries, the company claims over 1,200 customers. Of the employee base, the company notes that more than half are dedicated to the research services. As reported by Glass Lewis, their clients manage more than $35 trillion in assets. The company covers more than 20,000 meetings each year, in 100 countries.[31]

The company has five main service offerings. These include: Viewpoint (Proxy Voting), Proxy Papers (Proxy Research), Share Recall, Right Claim, and Meetyl.[32] At its core, the primary focus of Glass Lewis is to support institutional investors during the proxy season and provide voting recommendations on proxy votes. Glass Lewis's proxy voting platform also assists customers with all aspects of proxy voting and reporting.

Glass Lewis has expanded its suite of offerings to include advising on share recall programs and rights claims in class action settlements. Primarily, however, just like ISS, institutional clients typically utilize the company to assist in the proxy voting process.

Glass Lewis was formed in 2003 by former Goldman Sachs investment banker Gregory Taxin and attorney Kevin Cameron.[33] Mr. Taxin previously explained that the origination of the Company was motivated by a series of corporate governance failures including Enron and WorldCom.

In December 2006, Glass Lewis was purchased by the Chinese group Xinhua Finance.[34] The transaction resulted in a number of internal changes at Glass Lewis, including the appointment of a new CEO, Katherine Rabin, as well as the departure of a number of senior executives. One of those executives, Jonathan Weil, a former *Wall Street Journal* reporter and managing director, stated that he was "uncomfortable and deeply disturbed by the conduct, background and activities of our new parent company Xinhua Finance Ltd., its senior management, and its directors."[35]

On October 5, 2007, Xinhua sold Glass Lewis to the Ontario Teachers' Pension Plan (OTPP).[36] At the time of purchase, OTPP was a client of Glass Lewis. In the press release announcement, Brian Gibson, Senior Vice-President, Public Equities at OTPP explained, "We will be involved at the board level for strategy development, not in the day-to-day management of the company. Glass Lewis'[s] operations will remain separate from Teachers'." Glass Lewis CEO Katherine Rabin further explained that given the nature of the business, the company will "thrive under independent ownership, outside of public markets."[37] In August 2013, OTPP sold a 20 percent stake in Glass Lewis to another pension fund, the Alberta Investment Management Corporation ("AIMCo").[38] OTTP and AIMCo's pattern of significant alignment with Glass Lewis's recommendations will be examined in the subsequent section.

POLICY GUIDELINES

On an annual basis, ISS and Glass Lewis develop policy guidelines that act as the basis for their recommendations throughout the year.

ISS develops a set of benchmark country- or region-specific Proxy Voting Guidelines, in addition to Specialty Policies that span a range of niche topics and regulations. ISS recommendations throughout the year should be informed by these policies. According to the proxy advisory firm, its policies are formulated by collecting feedback from a variety of market participants through multiple channels, including "an annual Policy Survey of institutional investors and corporate issuers, roundtables with industry groups, and ongoing feedback during proxy season."[39] The ISS Policy Board then uses this input to draft its policy updates on emerging governance issues.

This practice lacks transparency – ISS does not disclose which institutions, pension funds, NGOs, or corporations comment in the survey, nor does it release the substance of those comments. So while investors are using the recommendations derived from the policy, they have no visibility into who is influencing it (and in what direction).

Similar to ISS, Glass Lewis develops an annual set of Proxy Guidelines that outline how the company comes to its recommendations. These guidelines are updated annually and are intended to reflect Glass Lewis's analysis of proposals, yet Glass Lewis provides no information as to what factors influence their consistently evolving analysis.[40]

Also similar to ISS, Glass Lewis provides no transparency as to what, if any, input they receive from third parties, though there is a form where anyone can submit feedback on the policy guidelines on Glass Lewis's website.

CONFLICTS OF INTEREST

While not all subscribers to the proxy advisory firms follow their recommendation 100 percent of the time, there are still some substantial institutions and funds that do. And still many more appear to follow these firms' recommendations over 80 percent of the time (as evidenced by the high correlation of votes with the proxy advisory firms' recommendations, which is explored later in this paper). This influence on voting decisions has been a regular concern of corporations for many years but has been gaining increased focus from elected officials.

Companies and the elected officials and regulators who represent them highlight the lack of regulation of these proxy advisory firms and the dangers that lack of regulation may cause. The registration of ISS as a registered investment advisor for the past two decades appears to have done little to address these issues. According to the National Investor Relations Institute ("NIRI"),"Although ISS has registered as an investment advisor, the SEC does not provide systematic oversight over the proxy firms' research processes, how the firms interact with companies, and how they communicate with investors."[41]

Complaints range from basing recommendations on inaccurate data to the previously highlighted conflict in offering both ratings and consulting services[42] to improve those ratings. This type of conflict of interest is not tolerated in other industries. Notably, the passage of Sarbanes-Oxley Act of 2002[43] required the separation of those parts of financial institutions that provide ratings on companies and those that conducted advisory work for those same companies, while also requiring disclosure of all relationships between those financial intuitions and the companies they work for when releasing those ratings.

And since the proxy advisory firms provide little-to-no transparency as to what truly impacts their proxy voting guidelines on an annual basis, critics have expressed concern that their changing guidelines may be less related to governance improvements than investors understand. Further, consistently moving the goalposts is lucrative to the proxy advisors who can drive increased consulting fees from newly changed ratings criteria.

Information divulged in historical filings suggest that there is an understanding amongst proxy advisor firms of the perceived and real conflicts of interest inherent to their business practices. Discussing its ISS Corporate Services subsidiary in 2011, MSCI noted:

> "...there is a potential conflict of interest between the services we provide to institutional clients and the services, including our Compensation Advisory Services, provided to clients of the ISS Corporate Services subsidiary. For example, when we provide corporate governance services to a corporate client and at the same time provide proxy vote recommendations to institutional clients regarding that corporation's proxy items, there may be a perception that the ISS team providing research to our institutional clients may treat that corporation more favorably due to its use of our services."[44]

Both ISS[45] and Glass Lewis[46] emphasize the internal conflict mitigation and disclosure policies they have in place, particularly as the regulation of proxy advisors has returned to the U.S. legislative agenda. ISS publishes a policy regarding the disclosure of significant relationships. Similarly, Glass Lewis has set up a "Research Advisory Council,"[47] an independent external group of prominent industry experts. While both ISS and Glass Lewis appear cognizant of the internal conflicts apparent in each company, there continues to be little done to mitigate this conflict and divorce problematic services from either company's offering.

Policies suggest the implementation of information barriers and processes to mitigate potential conflicts of interest that could impede or challenge the objectivity of the firms' research teams. However, the impenetrability of such barriers has been increasingly called into question, which has further led to demands for greater transparency as noted by the H.R. 4015 legislation. The proposed bill is designed to "improve the quality of proxy advisory firms for the protection of investors and the U.S. economy, and in the public interest, by fostering accountability, transparency, responsiveness, and competition in the proxy advisory firm industry."[48]

There is evidence to suggest that the proxy advisors themselves recognize the limitations of their processes to mitigate conflicts of interest. In the aforementioned 10-K from 2011, MSCI disclosed potential risks associated with the ISS business, explaining:

> "The conflict management safeguards that we have implemented may not be adequate to manage these apparent conflicts of interest, and clients or competitors may question the integrity of our services. In the event that we fail to adequately manage perceived conflicts of interest, we could incur reputational damage, which could have a material adverse effect on our business, financial condition and operating results."[49]

While ISS and Glass Lewis may be aware of the potential issues in their services, this does not seem to impede the continuation of the business lines. As Celarier explained, "Historically, ISS has tended to side with activists trying to boost share prices, which should come as no surprise since institutional investors are the bulk of its clients."[50]

The acceptance of proxy advisory firms as credible sources of vote recommendations for the investment community has provided them with a significant platform for influence. Unfortunately, the conflicts of interest inherent in the proxy advisors' current business models are just one of the issues concerning how ISS and Glass Lewis wield their power. The proxy advisors have taken on increasingly activist stances in their policy guidelines, resulting in increased pressure on companies to provide onerous disclosures above and beyond what is mandated by regulators.

PART II: THE PROXY ADVISOR AS AN ACTIVIST

As noted earlier, ISS boasts more than 1,700 institutional clients, while Glass Lewis has more than 1,200; both cite as customers some of the world's largest mutual funds, asset managers, hedge funds, and pension plans, representing trillions of dollars in assets under management. Most of the largest institutions subscribe to the corporate governance research publications of both firms.

Concerns related to the influence of proxy advisors on the institutions that use their analysis have been exacerbated by the increasing amount of investment dollars that have transferred from direct ownership of stocks by individual retail investors to mutual funds, most particularly to large passive mutual funds. As cited in a paper from The Mercatus Center at George Mason University, James K. Glassman & J.W. Verret explains:

> "Institutional stock ownership has risen from 47 percent of assets of the 1,000 largest public corporations in 1987 to 76 percent just 20 years later. Overall mutual fund assets have risen nearly 30-fold since 1987, and total shareholder accounts have quintupled."[51]

The seemingly increasing influence of the proxy advisory firms on the voting of large passive funds – a more than 80 percent voting correlation in the data presented herein – can have a significant impact in voting at large corporations and an even larger impact in the voting at smaller companies, where evidence shows the voting correlation to be even higher.[52]

In order to understand the potential influence of the proxy advisory firms, this paper examines how proxies were voted at some of the largest passive institutions and pension funds.

First, it is important to understand the sheer quantity of proxies that are voted by these institutions. In the 2017 proxy season alone, according to ISS Governance data, BlackRock voted on 494,752 proposals,[53] State Street voted on 232,391 proposals,[54] and Vanguard voted on 400,943 proposals.[55] BlackRock, which has been reported to have the largest corporate governance department (they refer to their voting unit as "Investment Stewardship") had just 31 employees examining and making voting decisions on these proposals – over 5,200 proposals per employee. This total is even more impressive when considering that many proxies are published in languages other than English and that a large percentage of Annual General Meetings occur in just a four-month period.[56]

It isn't a surprise that with the multitude of votes to cast and limited time and resources for analysis, these institutions often and consistently vote in line with the proxy advisors recommendations.

Large Institutional Alignment with ISS & Glass Lewis Recommendations

	"For" Recommendations with ISS	"Against" Recommendations with ISS	"For" Recommendations with Glass Lewis	"Against" Recommendations with Glass Lewis
BlackRock				
2014	85.8%	69.2%	82.9%	57.3%
2015	85.6%	71.3%	85.1%	63.0%
2016	85.4%	68.3%	84.3%	61.2%
2017	87.9%	69.2%	83.0%	51.7%
State Street				
2014	88.3%	83.7%	80.6%	59.7%
2015	87.2%	83.2%	81.4%	61.6%
2016	88.6%	83.9%	80.1%	64.6%
2017	88.2%	80.3%	80.2%	62.3%
Vanguard				
2014	84.1%	69.6%	79.1%	49.7%
2015	83.3%	60.6%	80.7%	48.6%
2016	83.1%	60.7%	81.6%	49.5%
2017	86.4%	59.5%	82.4%	44.4%

Source: Proxy Insight Data

It is worth mentioning that in evaluating the voting patterns of institutions, there is more alignment with the proxy advisors on "for" recommendations than "against" recommendations. The reality is that most proposals still come from management, and are on procedural issues like approval of minutes, uncontroversial Board member nominations, etc. This is a likely indication that, across the board, investors are less inclined to vote against management proposals.

The SEC requires that financial advisers are fiduciaries who owe clients "duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting." This extends to monitoring corporate events and voting the proxies "in a manner consistent with the best interest of its client."[57]

The SEC further amended their previous proxy voting rules to state: "An investment adviser that exercises voting authority over client proxies [must] adopt policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interests of clients, to disclose to clients' information about those policies and procedures, and to disclose to clients how they may obtain information on how the adviser has voted their proxies."[58] Because of this rule, institutions are careful to assert their independence from proxy advisory firm recommendations:

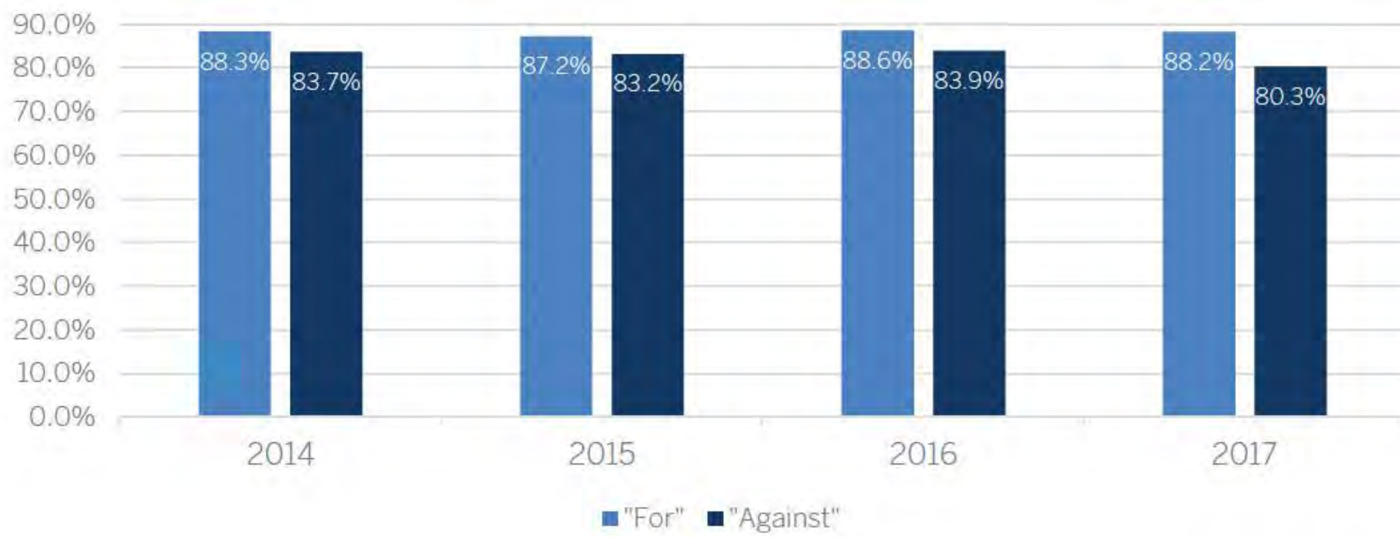
- "We frequently do not vote with them. We vote our own policy," Anne Sheehan, Head of Corporate Governance for the CalSTRS claims.[59]

- Johnathan Feigelson, former Senior Vice President, General Counsel and Head of Corporate Governance for TIAA-CREF notes, "Some critics contend that proxy advisors are controlling or significantly influencing voting outcomes without appropriate oversight. However, we believe these concerns are somewhat overstated...vote mechanics and record keeping are technically 'outsourced', but the institution itself retains the ability to customize the policy in furtherance of what the institution believes as a fiduciary to be in the best interests of their clients. In short, the institutional shareholder - not the proxy advisory firm - is making the ultimate voting decision."[60]

However, the voting record demonstrates a high correlation between the votes of institutions and the recommendations of the proxy advisory firms.

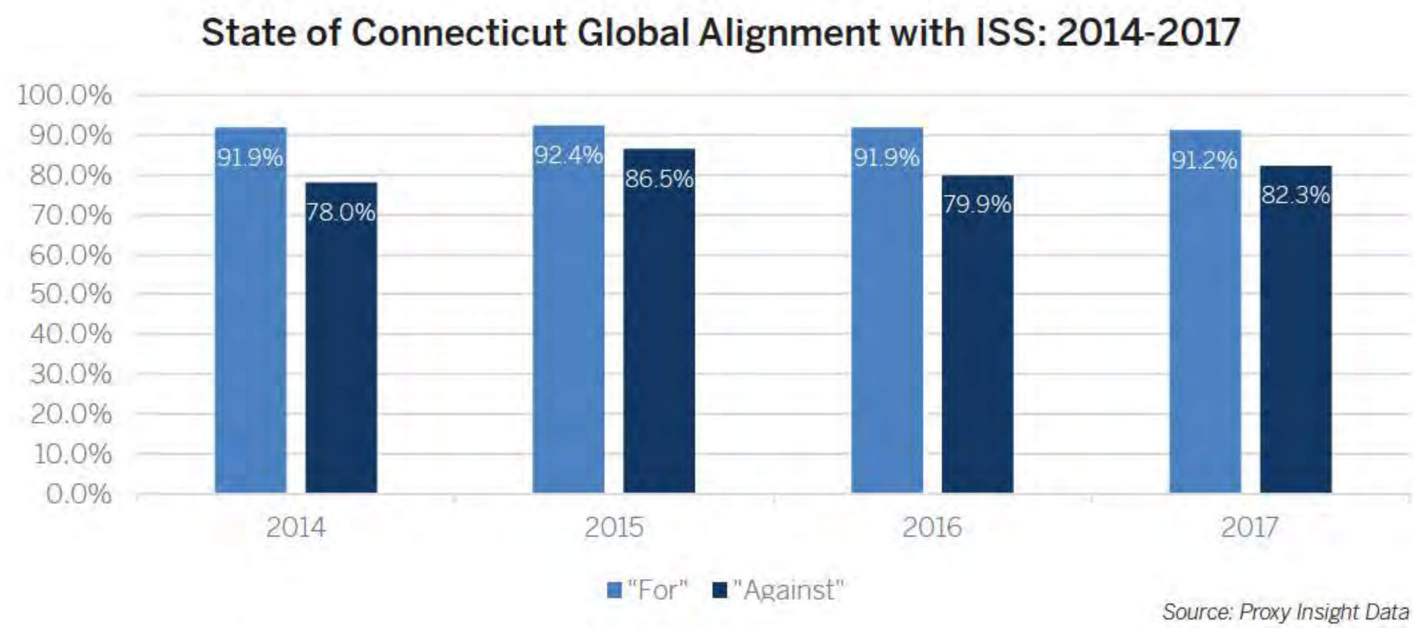
Of the three large mutual funds, State Street's voting has the highest correlation with ISS.

State Street Global Alignment with ISS: 2014-2017



Source: Proxy Insight Data

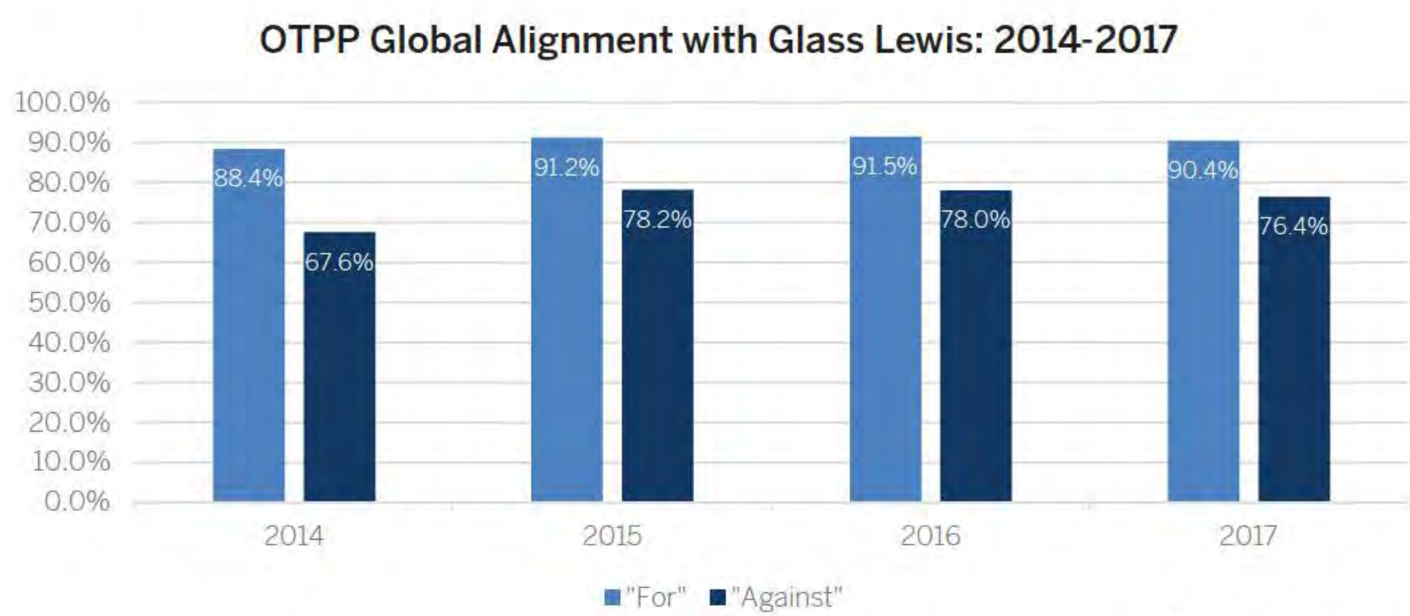
While less so than State Street, BlackRock and Vanguard still overwhelmingly vote in alignment with ISS, as do many large pension funds. Take for example the State of Connecticut Retirement Plans & Trust Funds:



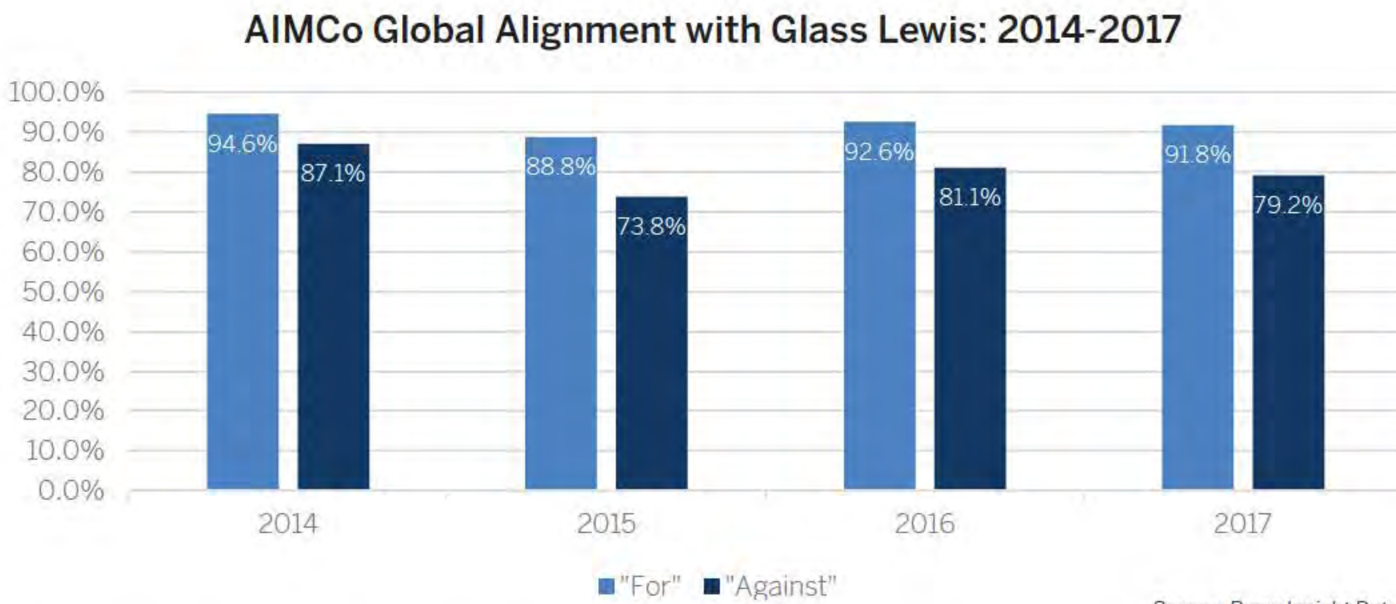
Source: Proxy Insight Data

The alignment with Glass Lewis is significantly lower at most institutions, in part due to ISS's leadership position in the space. That said, there are some notable exceptions. Foremost, as highlighted in the prior section, Glass Lewis is owned by two Canadian pension funds – the Ontario Teachers' Pension Plan ("OTPP") and Alberta Investment Management Corporation ("AIMCo"). They are overwhelmingly aligned with Glass Lewis.

Some of the resolutions where the two funds were aligned with Glass Lewis 100 percent in 2017 are simple and intuitive, for example approval of Board of Directors' reports. But some matters are more complex: both OTPP and AIMCo are completely aligned with Glass Lewis (and one another) on the approval of a capital increase to conduct a merger or acquisition, the renewal or amendment of takeover provisions, and the adoption or amendment of a Board Diversity Policy. OTPP presses this further and is fully aligned with Glass Lewis on overarching Diversity/EEO policies.



Source: Proxy Insight Data



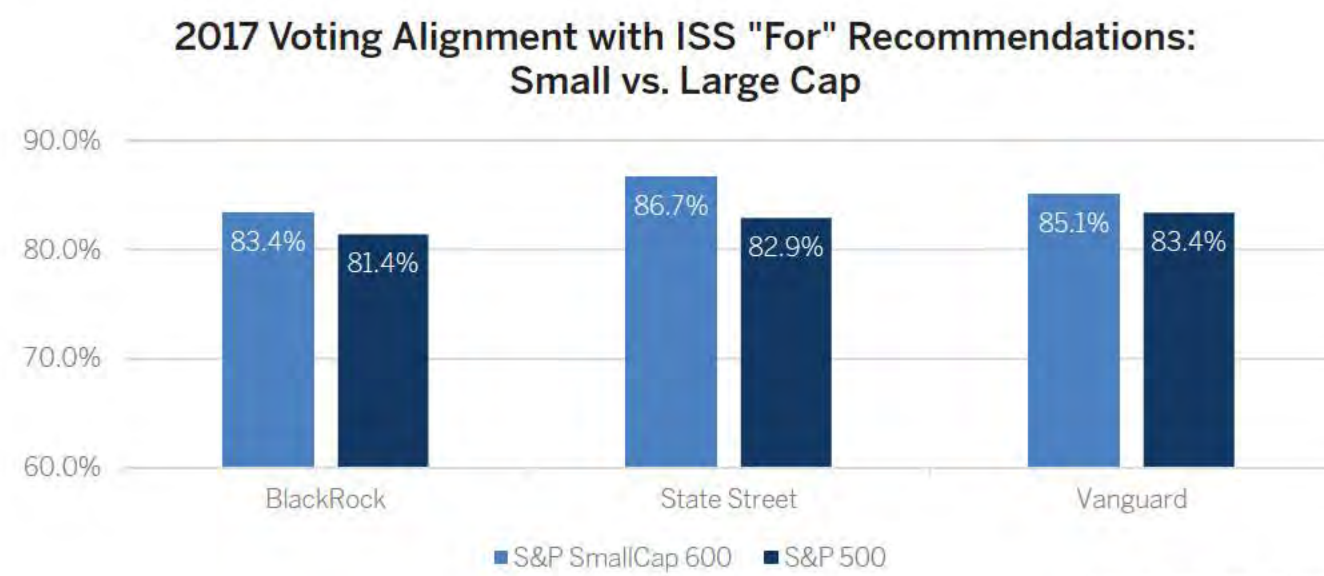
Source: Proxy Insight Data

In addition, many of the other pension funds examined are more aligned with Glass Lewis generally than their mutual fund peers. CalSTRS and the Illinois State Board of Investment are both more aligned with Glass Lewis than ISS – well over 80 percent of the time on both "for" and "against" recommendations.

IMPACT ON SMALL COMPANIES

The impact of institutions' close alignment with ISS and Glass Lewis has a disproportionate impact on small companies. Because the largest institutional holders own the majority of most small companies, the fact that they are stretched thin in their ability to evaluate them has significant implications from proxy season to proxy season. In fact, "88% of public companies count one of three large institutional investors -- State Street Global Advisors, Vanguard, and BlackRock -- as their largest investor."[61] And the large institutions are even less likely to deviate from proxy advisory recommendation when evaluating a smaller company.

Take, for example, the S&P 500 when compared to its smaller cap peer, the S&P SmallCap 600:



Source: Proxy Insight Data

At each of the three largest institutions, which hold the overwhelming majority of small companies, the smaller the company is, the more likely it is that they will follow the proxy advisory vote recommendation.

ROBO-VOTING

The issue of outsized voting influence by the proxy advisory firms was noticed not too long after the Dodd-Frank voting requirement was put into effect. Speaking on this issue in a speech at a meeting of the Society of Corporate Secretaries & Governance Professionals in July 2013 (after the agency's policy was tweaked), SEC Commissioner Daniel M. Gallagher, stated:

> "I also have grave concerns as to whether investment advisers are indeed truly fulfilling their fiduciary duties when they rely on and follow recommendations from proxy advisory firms. It is troubling to think that institutional investors, particularly investment advisers, are treating their responsibility akin to a compliance function carried out through **rote reliance on proxy advisory firm advice rather than actively researching the proposals before them and ensuring that their votes further their clients' interests.** The last thing we should want is for investment advisers to adopt a mindset that leads to them blindly casting their votes in-line with a proxy advisor's recommendations, especially given the fact that such recommendations are often not tailored to a fund's unique strategy or investment goals."[62]

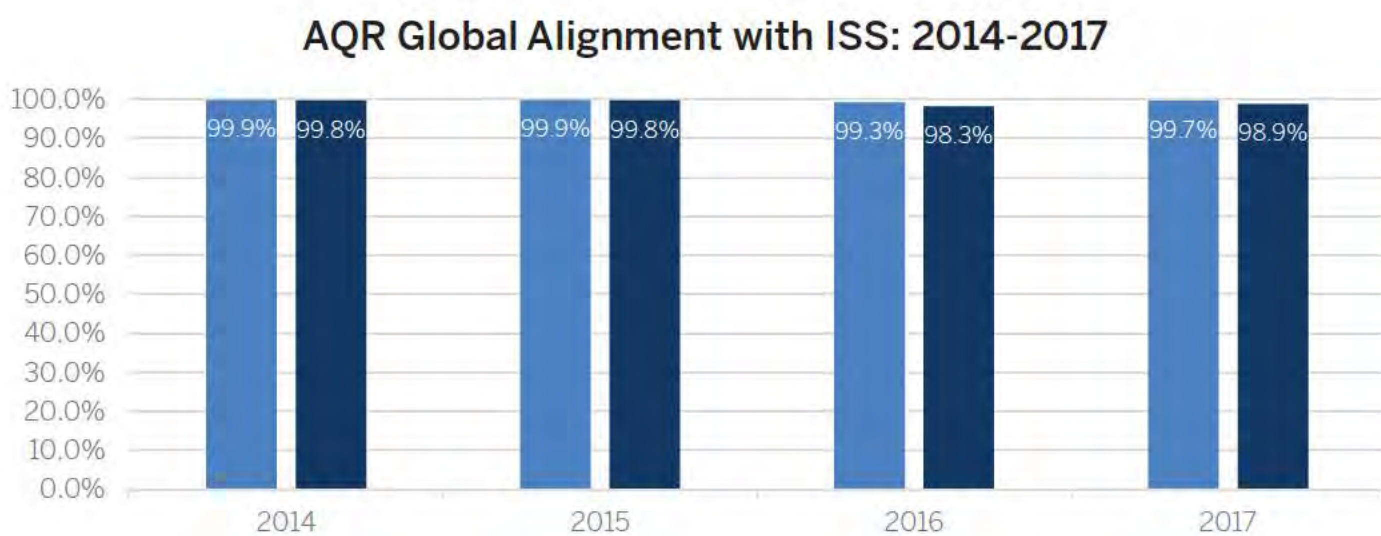
Commissioner Gallagher's concern is well-placed. Certainly not all institutions yield to the advice of proxy advisors, but many of them do – "particularly small and medium-size institutions that don't have their own corporate governance staffs."[63]

There is concerning evidence that "robo-voting" is even more prevalent amongst quant[a] and other hedge funds, and that the problem is even more widespread than data might indicate, since most of the funds that deploy these strategies are smaller hedge funds that are not required to disclose their voting history publicly by the SEC. Indeed, academic research indicates that "sensitivity to ISS recommendations is stronger for shareholders that are smaller and have higher turnover, consistent with these shareholders having weaker incentives to perform independent research."[64]

Take, for instance, quant fund AQR. While many institutional investors and funds correlate with ISS well over 80 percent of the time, AQR is nearly perfectly correlated with ISS on both "for" and "against" votes – and has been for the last several proxy seasons.

Because most quant funds are not mutual funds but hedge funds, the extent of this issue is deeper than the data can show. It is likely that a number of hedge funds (e.g. Bridgewater Associates, Renaissance Technologies, Two Sigma) have similar statistics around alignment to ISS.

a A "quant" or quantitative fund is an investment fund that chooses the securities in its portfolio using advanced analysis, models, software programs, and algorithms.



Source: Proxy Insight Data

Christiano Guerra, Head of ISS's Special Situations Research team, states himself that investors should look beyond ISS recommendations and conduct their own analysis: "It's important for our clients to read the report and understand how we got to where we got, as opposed to just saying, 'Well, it's just a one-liner for or against,' because these are never black-and-white situations…It's not a simplified argument."[65] However, any public company Investor Relations Officer is familiar with the sudden and significant influx of proxies voted in the 24 hours following an ISS opinion is issued. It is highly likely that both ISS and Glass Lewis are aware that their clients rely on their recommendations at face value.

THE IMPACT OF PROXY ADVISOR ACTIVISM

To quantify the impact of proxy advisors on voting more tangibly, consider the effects of just the ISS or Glass Lewis recommendation on a company's advisory vote on compensation, the "Say on Pay" proposal. The 2010 Dodd-Frank Act, required public companies to have an advisory vote on executive compensation practices at their annual general meetings at a frequency to be determined by another vote.

Since the inception of these "Say on Pay" votes, executive compensation consulting firm Semler Brossy has quantified the meaningful impact of the proxy advisors on these nascent proposals: In 2017, "shareholder support was 26 percent lower at companies that received an ISS 'Against' recommendation–the second smallest difference since voting began in 2011."[66] Semler Brossy has previously quantified that Glass Lewis's impact is closer to 10 percent.[67]

Academic studies using regression models find that a negative ISS recommendation can lead to a 25 percentage point decrease in voting support.[68] This is a strong influence on shareholder voting patterns, **essentially moving a quarter of all votes with a simple recommendation change.** And the impact may be even more pronounced than these numbers let on, since many companies will adapt to proxy advisor policy in advance of receiving said negative vote to avoid that very outcome. As explained in the often cited paper from Stanford Graduate School of Business Professor David F. Larcker and his colleagues, "Outsourcing Shareholder Voting to Proxy Advisory Firms":

> "We also find that many boards of directors change their compensation programs in the time period before the formal shareholder vote in a manner that better aligns compensation programs with the recommendation policies of proxy advisory firms. These changes appear to be an attempt to avoid a negative SOP recommendation by proxy advisory firms, and thereby increase the likelihood that the firm will not fail the vote (or will garner a sufficient level of positive votes)."[69]

In addition to "Say on Pay" voting, a key area of focus is the steady increase in the amount of proposals on Environmental and Social ("E&S") issues in recent years. Notably, since 2007 there have been 781 proposals relating to E&S issues with the number submitted in 2015, 2016, and 2017 well above past years' levels.[70] These proposals, which often come from pension funds, interest groups, and individuals, typically take the form of calling for increased disclosure, such as asking companies to create new reports (e.g. political/lobbying contribution reports, social reports, and GHG emission reports).

This clearly demonstrates the effect that ISS and Glass Lewis have had on the votes of institutions due to evolving policies. Over time the proxy voting guidelines of the proxy advisory firms have changed on these issues and, with these changes, the corresponding vote changes at the large passive investment firms can be observed. As James Copland of the Manhattan Institute wrote in a 2012 Wall Street Journal op-ed:

> "ISS receives a substantial amount of income from labor-union pension funds and socially responsible investing funds, which gives the company an incentive to favor proposals that are backed by these clients. As a result, the behaviors of proxy advisors deviate from concern over share value, [suggesting] that this process may be oriented toward influencing corporate behavior in a manner that generates private returns to a subset of investors while harming the average diversified investor."[71]

It is unclear which direction the influence runs in – is ISS driving changes (and thus, greater alignment with institutions) on environmental and social policies by altering its policies? Are the large passive institutions pressuring ISS through its non-public policy guideline comment period? Or are third party activists driving investors' shares to be voted more progressively?

Ultimately, because the comments and influence on ISS's policy guidelines are not public, it is unclear what is driving the change, but it is clear that a change is occurring.

For example, Glass Lewis's high-level policy on E&S issues has evolved from framing E&S issues as "challenges" to "risks," moving its language to correspond to the language typically included in the proxy proposals of these third parties. And, in 2017, Glass Lewis added key language to its voting policy:

> "When a substantial environmental or social risk has been ignored or inadequately addressed, we may recommend voting against responsible members of the risk committee or its equivalent (including an environmental or sustainability committee), or in favor of a shareholder proposal that addresses the company's failure to address such risks, **particularly around providing more disclosure and reporting regarding the risk and related mitigation initiatives.**"[72]

Language around enhanced disclosure has increasingly been pushed into both ISS and Glass Lewis voting guidelines – both generally and for specific policies, which is examined further in the pages that follow. The additional disclosure from companies that the proxy advisors are endorsing extends well above and beyond what is required by existing regulation or law, and coupled with the voting power the proxy advisory firms have, it solidifies their role as quasi-regulators.

While this paper can't assert for sure who is pressing ISS and Glass Lewis into this more activist direction (third parties, their customers, etc.), the changes in their overall E&S policies has brought them closer in line with large passive institutions. Take, for instance, the fact that Vanguard's alignment with both proxy advisors' recommendations has increased dramatically and steadily over the past four years.

This coincides with policies that many see as more politically progressive than at Vanguard – whether influenced by the proxy advisors or otherwise. Commenting on the recent voting changes, Vanguard's Investment Stewardship Officer, Glen Booraem stated:

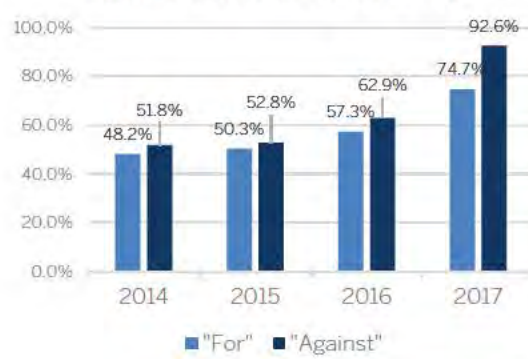
> "The updates to our voting guidelines on environmental and social issues are intended to better articulate the types of proposals we will consider supporting...For a number of years, we have abstained on most of the environmental and social proposals that we didn't support, though we'd vote against proposals in places where abstentions weren't counted in the vote results. To simplify our process while effecting the same voting outcomes, we've decided to eliminate our use of abstentions for this purpose. Going forward, we will simply vote either 'for' or 'against' each proposal based on our guidelines."[73]

As outlined above, there is clear evidence that both proxy advisors have an impact on how these institutions vote on a wide array of policies. Also worth considering, it is possible that these institutions are heavily and directly influencing the proxy advisors in turn. Large pension funds and institutional investors in particular, whose votes represent a key profit source for the proxy advisors, may leverage the non-public policy guideline comment process to weigh in and press the institutions to be more progressive. The pages that follow outline some of the E&S changes that proxy advisors have adopted in recent years. And while these changes may be influenced by just a few, they have vast implications for the wide array of voters who wholly or largely vote in line with ISS and Glass Lewis policy.

Vanguard Global Alignment with ISS on Environmental and Social Issues: 2014-2017

Source: Proxy Insight Data

Vanguard Global Alignment with Glass Lewis on Environmental and Social Issues: 2014-2017



Source: Proxy Insight Data

Furthermore, by consistently moving in a more activist direction, the advisors create a greater demand for their consulting services to aid companies in adapting to the "new normal," while simultaneously marketing environmental and social products to institutional customers and funds leveraging their data.

ENVIRONMENTAL POLICIES

Over the past decade, one of the greatest areas of change in the proxy advisors' voting policies is their response to climate change and greenhouse gas emissions proposals. Despite a lack of formal regulatory requirements in the category, ISS and Glass Lewis have created essential requirements for environmental disclosures from companies.

In its 2015 voting policy, ISS removed a number of factors it had previously considered in evaluating proposals:

- Overly prescriptive requests for the reduction in GHG emissions by specific amounts or within a specific time frame;
- The feasibility of reduction of GHGs given the company's product line and current technology; and
- Whether the company already provides meaningful disclosure on GHG emissions from its products and operations.[74]

In line with ISS's self-proclaimed view that management and the board generally know best about the day-to-day operations of the company, these now-deleted factors focused on the execution and autonomy of the company, rejecting notions of "overly prescriptive" proposals or those that might be infeasible. Instead, the 2015 policy factors in more prescriptive, disclosure-based considerations, which are in place unchanged in today's guidelines:

- Whether the company provides disclosure of year-over-year GHG emissions performance data;
- The company's actual GHG emissions performance; and
- The company's current GHG emission policies, oversight mechanisms, and related initiatives.[75]

The 2015 voting policy accepts a company's sharing of its data as fait accompli: if a shareholder is proposing a company create a report, ISS will evaluate the company's public emissions, policies, and performance data. Never mind that the very burden of compiling and reporting this unrequired and unaudited data might be why a management team would oppose a shareholder proposal to create such a report in the first place. This is a movement away from a focus on the impact such proposals might have on the company in favor of greater, more burdensome disclosure.

By 2018, the policy has fully evolved to the disclosure of not only risk, but also a company's *tactics* to respond to them. ISS will "generally vote for resolutions requesting that a company disclose information on the financial, physical, or regulatory risks it faces related to climate change on its operations and investments or on how the company identifies, measures, and manages such risks."[76] In the intervening period, as outlined above, ISS made a number of acquisitions in the environmental and socially responsible investing space.

Glass Lewis updated its guidelines in similar fashion around climate change and greenhouse gas emission disclosure, adding significant language in 2016:

> "On a case-by-case basis, we will consider supporting well-crafted proposals requesting that companies report their GHG emissions and adopt a reduction goal for these emissions. Particularly for companies operating in carbon- or energy- intensive industries, such as those in the basic materials, integrated oil and gas, iron and steel, transportation, utilities and construction industries, we believe that managing and mitigating carbon emissions are important to ensuring long-term financial and environmental sustainability."[77]

Both ISS and Glass Lewis have consistently maintained language about company management and board autonomy to make management and policy decisions. For instance: "Glass Lewis generally believes decisions regarding day-to-day management and policy decisions, including those related to social, environmental or political issues, are best left to management and the board as they in almost all cases have more and better information about company strategy and risk."[78]

However, the reality of their changing E&S policies tells a different story. The proxy advisors have increasingly moved to the left on environmental issues – while in some cases it may be warranted for investors to pressure companies for further disclosure (thus the case-by-case application), a blanket reliance on disclosure to decide whether a company ought to disclose creates a regime where such disclosures are essentially mandatory for companies, regardless of their costs or business implications.

GENDER PAY GAP & BOARDROOM DIVERSITY

Another social issue that has gotten attention from the proxy advisors with very real implications for their constituents is gender pay gap disclosures and boardroom diversity. In 2017, Glass Lewis added language to its voting policy around gender pay inequity for the first time, stating that "failing to address issues related to gender pay inequity can present legal and reputational risks for companies."[79] The language goes on to highlight those factors Glass Lewis will consider on a case-by-case basis evaluation of shareholder proposals around ensuring "pay parity":

- The company's industry;
- The company's current efforts and disclosure with regard to gender pay equity;
- Practices and disclosure provided by a company's peers concerning gender pay equity;
- Any legal and regulatory actions at the company.[80]

The alignment around this progressivism shows in the data – in 2017, when Glass Lewis made a recommendation on diversity proposals (e.g. adopting/amending a Board Diversity Policy, approving/amending a diversity or EEO policy, or creating a Board Diversity Report), BlackRock and Vanguard voted in alignment with the proxy advisor well over 90 percent of the time.[81] This is up from significantly lower alignment in prior years, with some proposals dropping to as low as 15 percent vote alignment. Interestingly, despite its advocacy, State Street was the least aligned with the proxy advisors, pulled down by a divergence on recommendation to create Board Diversity Reports – which State Street was less inclined to support with a "for" vote, even despite ISS or Glass Lewis recommendation in favor. It is notable that alignment with Glass Lewis on these proposals exceeded alignment with ISS, evidence perhaps of the former's policy shift toward acknowledging gender pay and boardroom diversity proposals.

In its 2018 voting policy, ISS also added language on Gender Pay Gap proposals for the first time. Its considerations on case-by-case recommendations for establishing reporting on company pay data by gender include:

- The company's current policies and disclosure related to both its diversity and inclusion policies and practices and its compensation philosophy and fair and equitable compensation practices;
- Whether the company has been the subject of recent controversy, litigation, or regulatory actions related to gender pay gap issues; and
- Whether the company's reporting regarding gender pay gap policies or initiatives is lagging its peers.

Again, drawing on existing reporting to decide if a company should report such information necessitates its collection and distribution. While laws on gender pay disclosure exist in few geographies, ISS and Glass Lewis have, through their activism, created an international regulatory scheme. While the importance of addressing diversity is beyond the scope of this paper, what is relevant is the influence proxy advisory firms have on these types of issues.

CORPORATE BURDEN

Not all disclosure-focused changes to the proxy voting guidelines have been as sharp or as noticeable as the environmental and gender-based policy changes. From 2013 to 2014 in ISS's policy guidelines, there was a marked shift away from an acknowledgment of the costs and administration implications of adopting certain environmental and social proposals, to a broader, less defined assertion of "burden." Looking at several of these policies side by side, a pattern emerges:

ISS Evolving Policy Guidelines on Cost vs. Burden

	2013	2014
Equality of Opportunity	Generally vote against proposals seeking information on the diversity efforts of suppliers and service providers. **Such requests may pose a significant cost and administration burden on the company.**	Generally vote against proposals seeking information on the diversity efforts of suppliers and service providers. **Such requests may pose a significant burden on the company.**
Gender Identity, Sexual Orientation, and Domestic Partner Benefits	Generally vote for proposals seeking to amend a company's EEO statement or diversity policies to prohibit discrimination based on sexual orientation and/or gender identity, **unless the change would result in excessive costs for the company.**	Generally vote for proposals seeking to amend a company's EEO statement or diversity policies to prohibit discrimination based on sexual orientation and/or gender identity, **unless the change would be unduly burdensome.**
Recycling	Vote case-by-case on proposals to report on an existing recycling program, or adopt a new recycling program, taking into account: [...] **"The timetable prescribed by the proposal and the costs and methods of program implementation."**	Vote case-by-case on proposals to report on an existing recycling program, or adopt a new recycling program, taking into account: [...] **"The timetable and methods of program implementation prescribed by the proposal."**

Source: ISS Policy Guidelines

The movement away from specific corporate considerations and real value implications of policy toward a broader-reaching policy has paved the way for broader activism and disclosure despite the costs to companies and their investors. This is at the core of the consistent cries of conflicts of interest from the proxy advisors' critics: ISS moves its policy ever-so slightly in the direction of greater disclosure at a cost to companies, perhaps due to the advocacy of anonymous third-party commenters or its customers themselves; then it counsels companies on how to react or disclose in order not to receive a negative vote.

POLITICAL CONTRIBUTIONS & LOBBYING

With the *Citizens United* ruling, political advocacy on a corporate level is more accessible than ever – but with the *de jure* reality comes the *de facto* rules of ISS and Glass Lewis. In 2014, ISS made significant changes, reshaping the whole section of its voting policy and adding more considerations, including:

- The company's current disclosure of relevant lobbying policies, and management and board oversight; and
- The company's disclosure regarding trade associations or other groups that it supports, or is a member of, that engage in lobbying activities.[82]

In 2015, ISS expanded further focusing attention on trade organizations and acknowledging the way in which corporate lobbying activities have shifted, adding consideration of "The company's disclosure regarding its support of, and participation in, trade associations or other groups that may make political contributions."[83]

Glass Lewis also added the concept of risk to its policy evaluation on lobbying disclosure, adding the query: "What is the risk to shareholders from the company's political activities?" and further added, "Glass Lewis will consider supporting a proposal seeking increased disclosure of corporate lobbying or political expenditure and contributions if the firm's current disclosure is insufficient, or if the firm's disclosure is significantly lacking compared to its peers, **or if the company faces significant risks as a result of its political activities."[84]**

The change in policy appears to align directly with special interests who favor increased disclosure from companies. The similarly timed changes to these ISS and Glass Lewis policies hardly seems like a coincidence. Was there a push from special interests or large institutional investors to increase political disclosures? Although outside the scope of this paper, it is hard to imagine the risks went up demonstrably in this period to such a degree that would result in a unified response.

ANIMAL WELFARE

Even a seemingly minute issue – like animal testing or welfare – has experienced an activist shift from the proxy advisors over the past few years. While this might not seem to have far-reaching implications for issuers, consumer products and healthcare companies may be heavily impacted by such changes.

In 2016, ISS made some seemingly innocuous changes to its voting policy on Animal Welfare Policies. Specifically it added language that gave it more flexibility to consider additional elements in favor of creating reports on animal welfare policies if a company faced "recent significant fines, litigation, **or controversies** related to the company's **and/or its suppliers'** treatment of animals."[85] The addition of a softer metric (controversies) and extension to suppliers' treatment, rather than just the company's behavior, gives ISS greater leeway to recommend for the creation of these reports where it previously might not have.

And the impact in the voting of the large institutional investors has been notable – both State Street and Vanguard were in much sharper alignment with ISS by 2017 – aligning on 100 percent of recommendations made around the creation of animal welfare policies (whether "for" or "against"), where in the years prior to the change, alignment had been as low as 30 percent.

This is not to say that large passive institutions are influencing these more progressive policies, though they certainly could be through the non-public comments on policy guidelines. But the reality remains – these environmental and social shifts are bringing the proxy advisors further in line with their clients, at a significant potential cost or burden to the companies they are evaluating.

REVISITING SMALL COMPANY BIAS

As this paper has outlined, these policy shifts have meaningful implications for companies. A movement toward increased disclosure is expensive and, in particular, builds bias in favor of large-cap companies. Big companies with extensive reporting functions and data collection capabilities are better equipped to furnish the data that goes into unaudited Corporate Social Responsibility ("CSR") or environmental reports. Small and mid-cap issuers are simply less likely to have these capabilities. As a recent Wall Street Journal piece notes, "because there is no such thing as universally good governance, the blind application of one-size-fits-all governance solutions across vastly different companies often has negative effects."[86]

Simultaneously, institutional investors are less likely to look at these same small companies on an issue-by-issue basis, instead voting in line with proxy advisor recommendations. Thus, the companies most impacted by the constantly shifting disclosure landscape have the least access to make their case to the institutions pressuring them to furnish the disclosures in the first place.

ISS ENVIRONMENTAL & SOCIAL QUALITYSCORE

Building increasingly environmental and socially-focused policy changes and investments, earlier this year, ISS announced the launch of a new product – a so-called "data-driven approach to measure the quality of corporate disclosure on environmental and social issues, including sustainability governance, and identify key disclosure omissions."[87]

The E&S QualityScore mimics ISS's popular Governance QuickScore, a single number that is often used as an "easy" way for investors to evaluate a company's governance. There have been many critiques of the ISS Governance Score, but the E&S QualityScore is new and less examined. Companies receive an overall E&S decile score from 1-10, which is underpinned by scores within eight broad categories: Management of Environmental Risks and Opportunities; Carbon & Climate; Waste & Toxicity; Natural Resources; Product Safety, Quality & Brand; Stakeholders & Society; Labor Health & Safety; and Human Rights. These factors are supported by over 380 distinct environmental or social factors (of which 240 apply to each industry group).

Instead of focusing on a company's management of environmental and/or social risks, the E&S QualityScore focuses solely on a company's disclosure. The data for the score is sourced from filings, Sustainability and CSR reports, integrated reports, publicly available company policies, and information on company websites.[88] It is notable here that the vast majority of these E&S metrics are unaudited, inconsistent across geographies, and rarely required by statute or regulation. The information from which these scores are drawn then is likely to be incomplete or inaccurate in many cases.

At launch, the product initially focused on just six industry groups that ISS self-proclaimed as being most exposed to E&S risks: Energy, Materials, Capital Goods, Transportation, Automobiles & Components, and Consumer Durables & Apparel. The company plans to add an additional 18 industry groups over the course of 2018, but its initial focus on energy and industrials companies was clear and politicized.

With this new offering, it appears that ISS is drawing on its influence with large institutions that vote in line with its recommendations. This would have the effect of creating another market for its E&S consulting services, for the same companies it is reviewing. In many cases the stringent stipulations of the E&S QualityScore actually conflict with, or are far stricter, than ISS's voting policies. Despite the fact that the Score will have **no impact on proxy voting recommendations,** the Score will be widely promulgated and directly associated with companies. The E&S Score will be widely available on ISS platforms and external sites – for anyone to see – without full understanding of the score's disclosure-based limitations and inaccuracies.

Why wouldn't a company then pay ISS or another advisory service for counsel on raising its scores or "improving" its disclosures? With the wide reach of the proxy advisors and the potential for a recommendation to shift as many as a quarter of votes,[89] it is essentially a requirement that companies take any policy or offering changes seriously or suffer the consequences. Additional products offered for profit only muddy the waters and create further need for ISS's consulting services.

CONCLUSION & RECOMMENDATIONS

> "To a large degree, corporate directors and executives are now subject to decision making on critical issues by organizations that have no direct stake in corporate performance and make poor decisions as a result. Conscientious shareholders, who do have such a stake, also suffer because their votes are usurped or overwhelmed by these same organizations. The SEC's proxy policy rules have led to results unimagined by their original advocates."[90]

The proxy advisory industry is immensely complex and interwoven. Its offerings and conflicts of interest are vague and unclear and yet the largest institutional investors, pensions, and hedge funds vote based on ISS and Glass Lewis recommendations. The reality of today's investment landscape and the role proxy advisors play in it is very different than their intended purpose.

1. **Proxy advisors have emerged as quasi-regulators.** Because of their influence on the votes of these large institutional customers, their push for increased disclosure across the board – and particularly in the areas of environmental and social policies – has grafted onto ISS and Glass Lewis the role of regulator. While limited legal disclosures are actually required, a proxy advisory recommendation drawn from an unaudited disclosure can in many cases create a new requirement for companies – one that has added cost and burden beyond existing securities disclosures.

2. **The investment community mistakenly perceives proxy advisors as neutral arbiters.** ISS and Glass Lewis are for-profit enterprises. Ultimately, the proxy advisors are not neutral arbiters of good policy or governance – they work for their customers who can influence their policy through anonymous comment periods and back-channels. They are incentivized to align with the comments of those who pay them the most and to move targets and change policy to create a better market for their company-side consulting services.

3. **Constant policy changes are burdensome and costly for companies.** As both quasi-regulators and for-profit businesses, ISS and Glass Lewis are constantly evaluating, updating, and changing policy, particularly on nascent and unregulated environmental and social issues. While seemingly innocuous, the cumulative changes have costly impacts for companies, who bear the burden to remain current. Unfortunately, the full cost of implementation of a proxy advisor policy change cannot be known since there is no requirement for this level of analysis. As a result, companies are often left scrambling to apply the proxy advisors' one-size-fits-all policies, which can destroy shareholder value in the process.

4. **Small and mid-cap companies are disproportionally affected by disclosure requirements.** Disclosure is expensive and creates a bias in favor of large-cap companies with robust reporting functions who are able to publish CSR reports or collect country-specific data on a variety of metrics. Small and mid-cap issuers, however, are less likely to have these functions while simultaneously being less able to get time to make their case on a proxy measure directly to the large institutions that hold them. The largest institutional holders own the majority of most small companies but are stretched quite thin in their ability to evaluate them effectively. Thus, small and mid-sized companies are in a bind: Investors are more likely to align with ISS or Glass Lewis recommendations, but these companies are less financially equipped to furnish the disclosures from which the proxy advisors may draw their recommendation.

5. **Robo-voting seriously undermines the fiduciary duty owed to investors.** While it is not the intention of SEC policy and may be a violation of fiduciary duties and ERISA, the reality of robo-voting is real. There are institutions, particularly in the quant and hedge fund space, that automatically and without evaluation rely on proxy firms' recommendations; they don't research the proposals before them or ensure the recommendation aligns with client interest. While this may not be troublesome on ordinary-course matters, it can have lasting implications for corporate policy, profits, and disclosures. This extends the power and impact of ISS and Glass Lewis policy recommendations and decreases the ability of companies to advocate for themselves or their businesses in the face of an adverse recommendation.

RECOMMENDATIONS

There are real actions that elected officials, investors, and companies alike can take to respond to the growing influence of these largely unregulated institutions, given the proxy advisors' immense impact on companies and their ability to generate shareholder value.

1. **Support congressional efforts to introduce basic oversight over proxy advisory firms.** Support for common-sense oversight of the proxy advisors and transparency around their conflicts of interest is an important first step in removing the quasi-regulatory hold these institutions have over publicly traded companies. One recent attempt to address these concerns is H.R. 4015, which is a bill seeking to level the playing field and decrease the burden proxy advisors can have on companies. Specifically, this includes a draft review requirement, which would help ensure that all companies are treated fairly and that investors receive more accurate proxy reports. The bill also provides for greater transparency around proxy firms' research practices and conflicts of interest.

2. **Demand much greater transparency about the formation of proxy advisory recommendations.** By allowing for anonymous comments to influence policy that has such direct implications for shareholder value, the proxy advisors are not being transparent with the companies they rate or the public. Proxy advisory firms should publish the comments to their policy changes, indicating who requested the change and why. This would better enable investors and companies alike to understand the underlying rationale and influence behind policy shifts.

3. **Require proxy advisors to disclose that much of the data they use are unaudited and incomplete.** The proxy advisory firms should be required to state the potential costs and limitations of implementation of increased disclosure upon a company. If this information is not available, then the proxy advisory firms should be required to either conduct a study to determine the cost before making recommendation or indicate what information is needed making a supportive recommendation. One-size-fits-all demands for increased disclosure have a proportionally higher cost impact on small- and mid-cap companies than on their larger competitors. And proxy advisory firms have failed to adequately disclose to their subscriber and the wider public that they rely heavily on unaudited and, potentially, incomplete or inaccurate disclosures from the companies they research to make recommendations on environmental and social disclosure-based policies. This fact should be disclosed in all circumstances where such unaudited information is relied upon in making a voting recommendation, particularly when that recommendation has a cost implication for the company.

Proxy advisory firms are wielding increasing influence and power in the public markets. Today this power is almost entirely unregulated and abuses could have severe consequences for companies and the shareholder value they generate for investors. With proxy advisory firms increasingly using their power to influence votes with limited correlation to company returns or profits, investors and stakeholders pay the price. This cost is particularly acute at small and mid-sized companies that provide the jobs and investment growth opportunities for retail shareholders. Investors need to be fully informed of the biases and conflicts inherent in their powerful vote recommendations. And proxy advisory firms need regulatory oversight to ensure they are providing the same disclosure and transparency they often call for in the companies they evaluate.

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ARE PROXY ADVISORS **REALLY A PROBLEM?**

RECENT DATA ANALYSIS AND SURVEY RESULTS DEMONSTRATE THE VALIDITY OF COMMON CONCERNS

October 2018

Frank M. Placenti
SQUIRE PATTON BOGGS

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FOREWORD

Proxy advisor recommendations are a key tool for institutional investors, particularly passive investors with hundreds, if not thousands, of proxy votes to submit each year. Unfortunately, as previous ACCF research has explored, there are institutions that automatically and without evaluation rely on proxy firms' recommendations. This phenomenon, called "robo-voting," has the potential to be a breach of fiduciary duty at the fund-level.

As explored in greater detail in this report, companies often complain that there is an immediate spike in voting after proxy advisors issue recommendations. This suggests that, at least in some cases, institutions do not take the time to fully vet proxy advisor reports to the potential detriment of shareholders at large. Some asset managers have separated themselves from this trend, increasing their investment in proxy due diligence and increasing the size of investment stewardship teams. Yet as more asset managers seek ways to cut costs in order to compete in the environment of low-expense fees, the concerning trend in robo-voting must be explored.

Further compounding this issue is the brief time companies have to respond to erroneous recommendations, leaving little room to correct proxy advisor mistakes before votes are cast. Since the voting spike happens within three days of the recommendation issuance, companies do not have the opportunity to adequately respond to the recommendation, even if it is factually incorrect.

When recommendations do contain errors, the main recourse a company has is to provide a supplemental proxy filing. As explored in this report, these voluntary filings provide written, public accounts of company disputes with ISS and Glass Lewis in a manner transparent to the SEC and help to quantify the universe of problems companies experience with proxy advisors each year. Unfortunately, many companies are unable to adequately respond to errors in these recommendations due to the reality that proxy advisors do not give prior notice and provide companies little time to respond to recommendations. Compounded with the prevalence of automatic voting, the deficiency in the process undermines an investor's right to accurate and timely information.

The American Council for Capital Formation (ACCF) has previously written on proxy advisors, noting that over reliance on their recommendations decreases the ability of companies to advocate for themselves or their businesses in the face of an adverse recommendation. The outsized power this places in the hands of proxy advisors has lasting implications for corporate policy, profits, and disclosures.

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Frank M. Placenti leads the U.S. governance practice at Squire Patton Boggs (US) LLC and currently serves as the Founding President of the American College of Governance Counsel and as Vice Chair of the American Bar Association Corporate Governance Committee. He is the Editor of The Directors Handbook, a Field Guide to 101 Situations Commonly Encountered in the Boardroom and has served on the boards of public and private companies. The views expressed herein are his, and do not represent the views of his law firm, its clients or any other organization with which he is affiliated, nor do they represent the views of the other law firms participating in the client survey discussed herein or of the companies who responded to that survey.

ACCF AMERICAN COUNCIL FOR CAPITAL FORMATION

ABOUT THE AMERICAN COUNCIL FOR CAPITAL FORMATION

For more than four decades, the American Council for Capital Formation (ACCF), a 501(c)(6) nonprofit, nonpartisan organization has advocated tax, energy, environmental, regulatory, trade and economic policies that encourage saving and investment, economic growth, and job creation. The ACCF is uniquely able to play this role because of its bipartisan credibility with Members of Congress and the White House, its highly respected research and analysis of legislative and regulatory initiatives, and the respect it has earned in the media.

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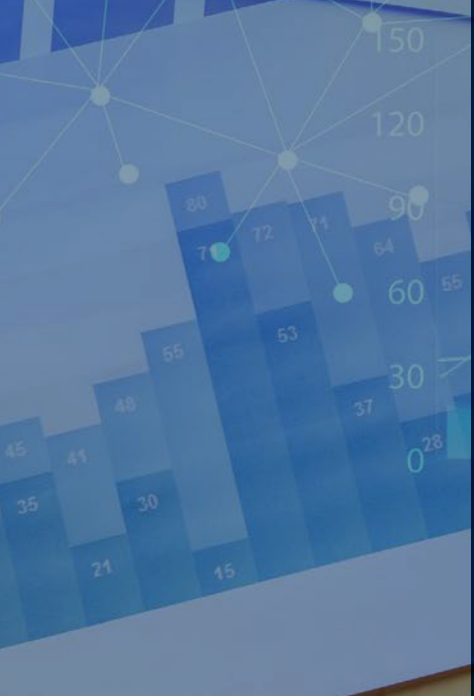

ARE PROXY ADVISORS REALLY A PROBLEM?

RECENT DATA ANALYSIS AND SURVEY RESULTS DEMONSTRATE THE VALIDITY OF COMMON CONCERNS

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ARE PROXY ADVISORS **REALLY A PROBLEM?**

RECENT DATA ANALYSIS AND SURVEY RESULTS DEMONSTRATE THE VALIDITY OF COMMON CONCERNS

BY FRANK M. PLACENTI

INTRODUCTION

Proxy advisory firms have been a feature of the corporate landscape for over 30 years. Throughout that time, their influence has increased, as has the controversy surrounding their role.

In BlackRock's July 2018 report on the *Investment Stewardship Ecosystem*[1], the country's largest asset manager noted that, while it expends significant resources[2] evaluating both management and shareholder proposals, many other investor managers instead rely "heavily" on the recommendations of proxy advisors to determine their votes, and that proxy advisors can have "significant influence over the outcome of both management and shareholder proposals."

That "significant influence" has been a source of discomfort for many public company boards and executives, as well as organizations like the American Council for Capital Formation, the Society for Corporate Governance and the Business Roundtable. They have charged that proxy advisors employ a "one-size-fits all" approach to governance that ignores the realities of differing businesses. Some have also complained that the advisors' reports are often factually or analytically flawed, and that their voting recommendations increasingly support a political and social agenda disconnected from shareholder value.

Academics have written that there is no empirical evidence that proxy advisors' benchmark governance policies promote shareholder value, effective governance or any meaningful advancement of the advisors' championed social causes. Indeed, a 2009 study by three Stanford economists concluded that, when boards altered course to implement the compensation policies preferred by proxy advisors, shareholder value was measurably damaged.[3] A second Stanford study reported that those charged with making investment decisions within an investment manager were involved in voting decisions only 10% of the time, suggesting a troubling de-coupling of voting decisions from any investment selection or the company performance that motivates that selection.[4]

While proxy advisors have had a raft of detractors, some institutional investor groups have defended the proxy advisors' role, asserting that the outsourcing service they provide is indispensable if institutional investors are to fulfill their perceived regulatory responsibility to vote on every issue presented for shareholder action at the hundreds of companies in which they hold positions.

For their part, proxy advisors contend that complaints about the quality of their analysis are overblown, that they make few material errors, and that disputes with companies most often represent mere "differences of opinion," as recently claimed in a May 30, 2018 letter from Institutional Shareholder Services (ISS) to six members of the Senate Banking, Housing, and Urban Affairs Committee.[5]

As in many such debates, where you stand depends on where you sit, and the absence of data has hindered an informed discussion.

1 Available at: https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-investment-stewardship-ecosystem-july-2018.pdf

2 BlackRock reports that it employs over 30 professionals dedicated to reviewing proxy proposals. The investment made by BlackRock and similar companies should serve as a model for the type activity needed for investment managers to exercise their fiduciary voting duties.

3 Rating the Ratings: How Good are Commercial Governance Ratings: Robert Daines, Ian D. Goe and David F. Larcker, Journal of Financial Economics, December 2010, Vol. 98. Issue 3, pages 439-461.

4 2015 Investor Survey: Deconstructing Proxy Statements — What Matters to Investors, David F. Larcker, Ronald Schneider, Brian Tayan, Aaron Boyd. Stanford University, RR Donnelley, and Equilar. February 2015.

5 Available at: https://www.issgovernance.com/file/duediligence/20180530-iss-letter-to-senate-banking-committee-members.pdf

CONCERNS ABOUT ELECTRONIC DEFAULT VOTING AND ITS IMPACT

For years, companies have anecdotally reported an almost immediate spike in voting after an advisor's recommendation is issued, with the vote demonstrating near lock-step adherence to the recommendation.

A few companies have been bold enough to contend that the immediacy of the vote reveals that institutional investors are not taking time to digest the information in the advisors' often-lengthy reports, only to experience the sting of investor backlash.

Moreover, many of these votes are cast through electronic ballots with default mechanisms that must be manually overridden for the investor to vote differently than the advisor recommends.[6] This practice allows no time for companies to digest the advisor's report and effectively communicate to their investors any objections they may have to it. The combination of default electronic voting and the speed with which votes are cast has been dubbed "robo-voting."

Public companies who do not receive the advisors' reports in advance are caught flat-footed by an adverse recommendation and are left to scramble to file supplemental proxy materials and otherwise struggle to communicate their message to investors. When those investors have already cast their vote by default electronic ballot, getting them to engage in a discussion of the issues, let alone reverse their vote, has proven to be practically impossible in most cases.[7]

IS ROBO-VOTING REAL?

Although many public companies and even proxy solicitation firms have anecdotally reported the existence of an immediate spike in voting in the wake of ISS and Glass Lewis recommendations, the size and prevalence of that spike has not been empirically examined in published reports.

In an effort to generate relevant data, four major U.S. law firms including Squire Patton Boggs recently collaborated on a survey of public companies seeking information about the existence, size and nature of the voting spike in the wake of an adverse proxy advisor recommendation. An adverse recommendation was defined as one urging a vote against a management proposal or in favor of a shareholder proposal opposed by the company's board of directors.

One hundred companies were asked about their experiences in the 2017 and 2016 proxy seasons. In particular, they were asked to report on the number of adverse recommendations they had received from proxy advisors in those years.

Thirty-five companies in 11 different industries reported an adverse proxy advisor recommendation during that period, totaling 93 separate instances. Responses ranged from one to 11 adverse recommendations in a single year. A hyperlink to a summary of the survey is available here.

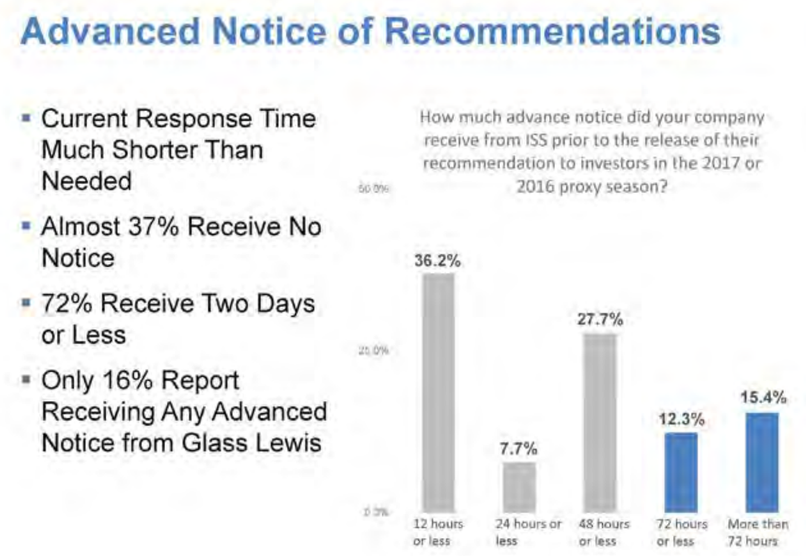
More specifically, companies were asked to quantify the amount of advance notice they received from the relevant proxy advisor regarding adverse recommendations. Almost 37% of companies reported that ISS did not provide them the opportunity to respond at all. Companies indicated that Glass Lewis was even worse – with 84% of respondents indicating they did not receive any notice from the advisor before an adverse recommendation.

When a company did receive notice, it was often not enough time to generate a response. Nearly 85% of companies that were given notice from ISS indicated they received less than 72 hours to respond to the

6 This robo-voting procedure was described in detail in the August 3, 2017 letter of the National Investor Relations Institute to SEC Chair Jay Clayton, available at: https://www.niri.org/NIRI/media/NIRI-Resources/NIRI-SEC-Letter-PA-Firms-August-2017.pdf

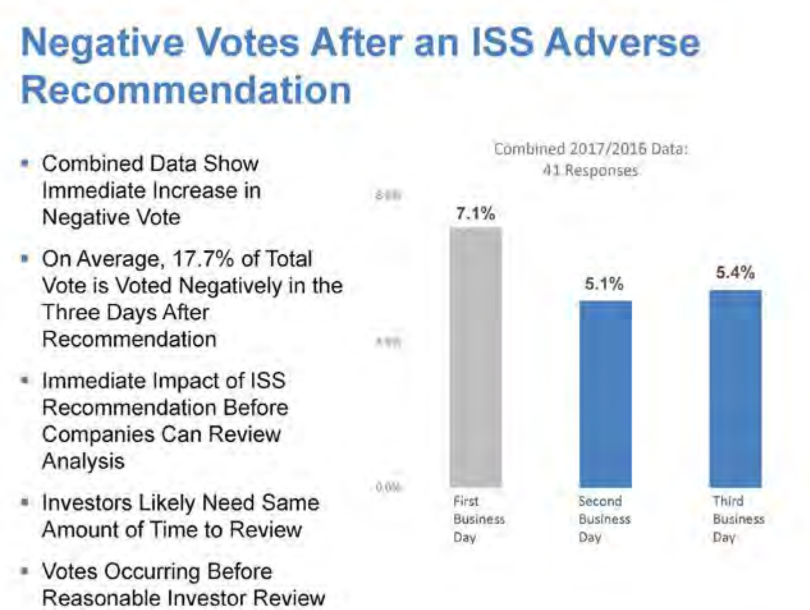
7 Testimony of Darla C. Stuckey, President & CEO, Society for Corporate Governance, Committee on Banking, Housing , and Urban Affairs Hearing on "Legislative Proposals to Examine Corporate Governance" (June 28,2018), U.S. Senate, available at: https://www.banking.senate.gov/imo/media/doc/Stuckey%20Testimony%206-28-18.pdf

adverse recommendation, with roughly 36% of these companies indicating they received less than 12 hours-notice from ISS.

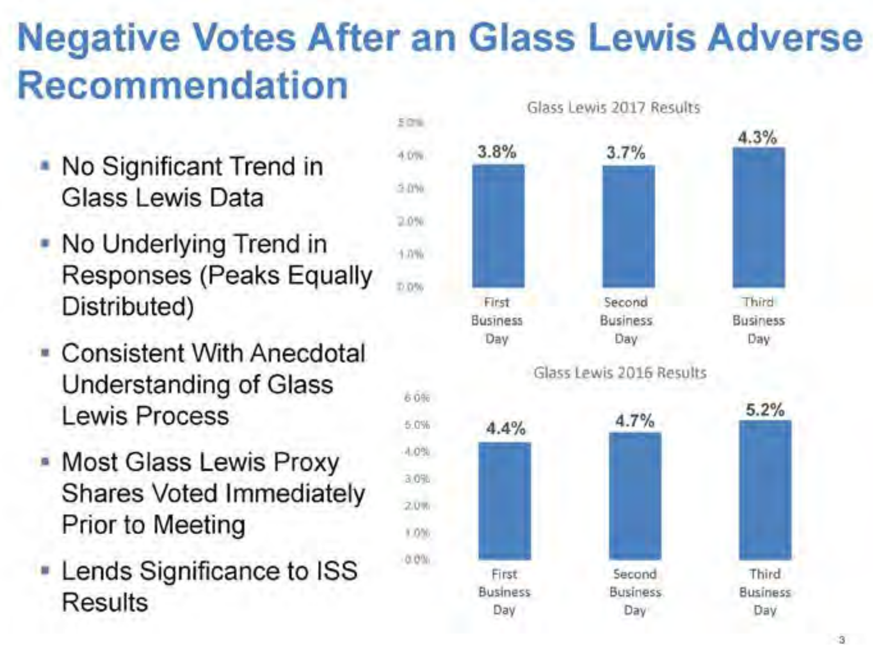


Companies were also asked to report the increase in shares voted within one, two and three business days of the publication of the advisors' adverse recommendation. Results varied depending on a variety of factors, including whether the recommendation in question was issued by ISS (which broadly employs electronic default voting) or Glass Lewis, or Glass Lewis (which seems to delay voting until much closer to the time of the annual meeting).

For the 2017 proxy season, the participating companies reported an average of 19.3% of the total vote is voted consistent with the adverse recommendations within three business days of an adverse ISS recommendation. For the 2016 proxy season, the companies reported an average 15.3% of the total vote being consistent with the adverse recommendations during the same three-day period.



Comparing the data for the voting spike for ISS and Glass Lewis recommendations provided an interesting contrast. Unlike ISS, Glass Lewis does not make extensive use of default electronic voting[8] and reports that it often delays casting votes until much closer to the annual meeting at the instruction of its clients.[9] While the average three-day spike for ISS was 17.7% for the 2017 proxy season, for Glass Lewis the comparable number was 11.8%.



Companies were also asked to state the time period they believed they would require to effectively communicate with shareholders to respond to an adverse recommendation. One hundred percent of companies stated they would need at least three business days while 68% stated they would need at least five business days to do so. This number must be viewed in the context that nearly 85% of respondents indicated that they received less than 3 days-notice of an adverse recommendation.

While the relatively small data set (and the non-random survey methodology) do not allow statistically significant conclusions to be drawn, the survey does provide empirical data to support the following conclusions:

- There is a discernible voting spike in the near aftermath of an adverse advisory recommendation that is consistent with the recommendation.
- The percentage of shares voted in the first three days represent a significant portion of the typical quorum for public company annual meetings.
- Companies need more time than they are being given to respond to adverse recommendations.

8 Glass Lewis Response To SEC Statement Regarding Staff Proxy Advisory Letters, (September 14, 2018), available at: http://www.glasslewis.com/glass-lewis-response-to-sec-statement-regarding-staff-proxy-advisory-letters/

9 Testimony of Katherine H. Rabin, CEO, Glass Lewis & Co, Subcommittee on Capital Markets and Government Sponsored Enterprises, U.S. House of Representatives, (May 17, 2016) available at: http://www.glasslewis.com/wp-content/uploads/2016/05/2016_0517_Glass-Lewis-HFSS-Testimony_FINAL.pdf.

Although this research makes clear that many institutional investors vote by default in a manner recommended by their proxy advisors, it is not true for all institutional investors. Several of the nation's largest funds like Vanguard, State Street, BlackRock and others have chosen to implement their own internal proxy voting analysis and increase the size of their internal corporate governance teams. The Financial Times has reported:

> "New York-based BlackRock now has the largest corporate governance team of any global asset manager, after hiring 11 analysts for its stewardship division over the past three years, bringing total headcount to 31. Vanguard, the Pennsylvania-based fund company that has grown quickly on the back of its low-cost mantra, has nearly doubled the size of its corporate governance team over the same period to 20 employees. State Street, the US bank, has almost tripled the size of the governance team in its asset management division to 11. Both Vanguard and State Street said their governance teams will continue to grow this year." [10]

These efforts are to be applauded as they reflect a commitment of significant resources to making informed and independent voting decisions. Moreover, in the experience of most practitioners, those funds that employ their own internal resources tend to show a greater willingness to engage in dialogue with companies who feel the need to express disagreement with their initial voting decisions.

IS LACK OF RESPONSE TIME A PROBLEM?

Should we care that so many shares are being voted before companies can effectively communicate their disagreements with a proxy advisors' recommendations?

There are two immediate answers to that question.

First, as noted in the July 2018 BlackRock report, many institutional investors rely "heavily" on those recommendations before voting. These institutional investors have fiduciary duties to their beneficiaries or retail investors to have all relevant information, including a company's response to a proxy advisor's recommendation, before voting. To exercise that obligation, it is not unreasonable to ask that they hear "both sides of the story" before they cast their vote. While a company's original proxy statement performs a portion of that function, it cannot respond (in advance) to errors or flaws in a proxy advisor's recommendation.

That leads to the second reason we should care about the lack of time to respond. Proxy advisor recommendations are not always right. Indeed, in some cases, they are demonstrably wrong.

HOW PREVALENT ARE ERRORS IN PROXY ADVISOR REPORTS?

As far back as 2010, the Securities and Exchange Commission (SEC) highlighted concerns that "proxy advisory firms may...fail to conduct adequate research and base [their] recommendations on erroneous or incomplete facts." [11]

In the years since that observation, public companies have continued to complain about errors in proxy advisor recommendations and have sometimes voiced those concerns in supplemental proxy filings with the SEC.

A review of supplemental proxy filings during 2016, 2017 and a partial 2018 proxy seasons (through September 30, 2018) provides some insight on the nature of this problem.

10 Marriage, Madison. "BlackRock, Vanguard and State Street bulk up governance staff," *Financial Times*, 28 Jan. 2017.

11 SEC Request for Comments, July 14, 2010, available at: https://www.sec.gov/news/press/2010/2010-122.htm

In conducting that review, we established four categories of filings in which companies challenged a proxy advisor's recommendation:

1. **No Serious Defects.** Filings specifying no serious defect in the report, but simply expressing a disagreement. Often, these filings sought to justify poor company performance by reference to external market or economic forces. (These filings were not further tabulated.)

2. **Factual Errors.** Filings claiming that the advisor's reports contained identified factual errors.

3. **Analytical Errors.** Filings claiming that the advisor's reports contained identified analytical errors, such as the use of incongruent compensation peer group data or the use of peer groups that inexplicably varied from year to year.

4. **Serious Disputes.** Filings that identified specific problems with the advisors' reports often stemming from the "one-size-fits-all" application of the proxy advisors' general policies. These included support for shareholder proposals seeking to implement bylaw changes that would be illegal under the issuer's state law of incorporation, inconsistent recommendations with respect to the same compensation plan in multiple years, and other serious disputes.

We contend that supplemental proxy filings should be regarded as a reliable source of data because, like all proxy filings, they are subject to potential liability under SEC Rule 14a-9 if they contain statements that are false or misleading, or if they omit a material fact. In short, if a company claims that an advisor's recommendation is factually or analytically wrong, it must be prepared to substantiate that claim.[12]

Moreover, it is probably fair to say that the number of supplemental proxy filings contesting proxy advisor recommendations represents the "tip of the iceberg" since many companies with objections to an advisor's recommendations decide not to make supplemental filings either because default electronic voting or other timing issues limit their impact on voting, or because they know they have to face the recommendations of the proxy advisor in future years.[13]

During the period examined, there were 107 filings from 94 different companies citing 139 significant problems including 90 factual or analytical errors in the three categories that we analyzed. There were 39 supplemental filings claiming that the advisors' reports contained factual errors, while 51 filings cite analytical errors of varying kinds. Serious disputes were expressed in 49 filings. Some filings expressed concerns in more than one category, with several expressing objections in all three categories. A hyperlink to the tabulated results is available here.

Perhaps the most ironic filing was made on June 1, 2017 by Willis Towers Watson.[14] The company took issue with an ISS report challenging the design of its executive compensation program. In short, Willis Towers Watson objected when ISS sought to substitute its judgment about compensation plan design for that of a company widely regarded as a leading expert on that very topic. The filing cited a litany of factual errors and laid bare the lack of depth in the ISS analysis perhaps suggesting that ISS had unwisely brought a knife to a gun fight.

Other filings were less entertaining but often no less troubling. Standing back and looking at the body of these supplemental filings leads to the conclusion that a meaningful number of public companies have been willing to go on the record identifying real problems in their proxy advisory reports.

12 This accountability stands in stark contrast to the fact that ISS and GL have experienced no regulatory consequences for issuing incorrect reports.

13 Picker, L & Lasky, A. "A congressman calls these Wall Street proxy advisory firms 'Vinny down the street' for their power to pressure companies," CNBC, 28 June 2018.

14 Willis Towers Watson Public Limited Company, Proxy Statement to the SEC, June 1, 2017 https://www.sec.gov/Archives/edgar/data/1140536/000119312517189751/d380806ddefa14a.htm

CONCLUSION

The two surveys discussed in this article strongly suggest that the concerns expressed by public companies and industry groups about proxy advisors should not be dismissed. Policy makers should explore and implement legislative or regulatory measures to assure that:

- Funds with fiduciary duties to their beneficiaries are not placing undue reliance on the recommendations of third parties;
- Institutional investors are making fully-informed voting decisions;
- Investors have more transparency into how their votes are to be cast on a default basis; and
- Public companies are allowed a reasonable opportunity to identify and respond to defects in the analysis of third-party proxy advisors.

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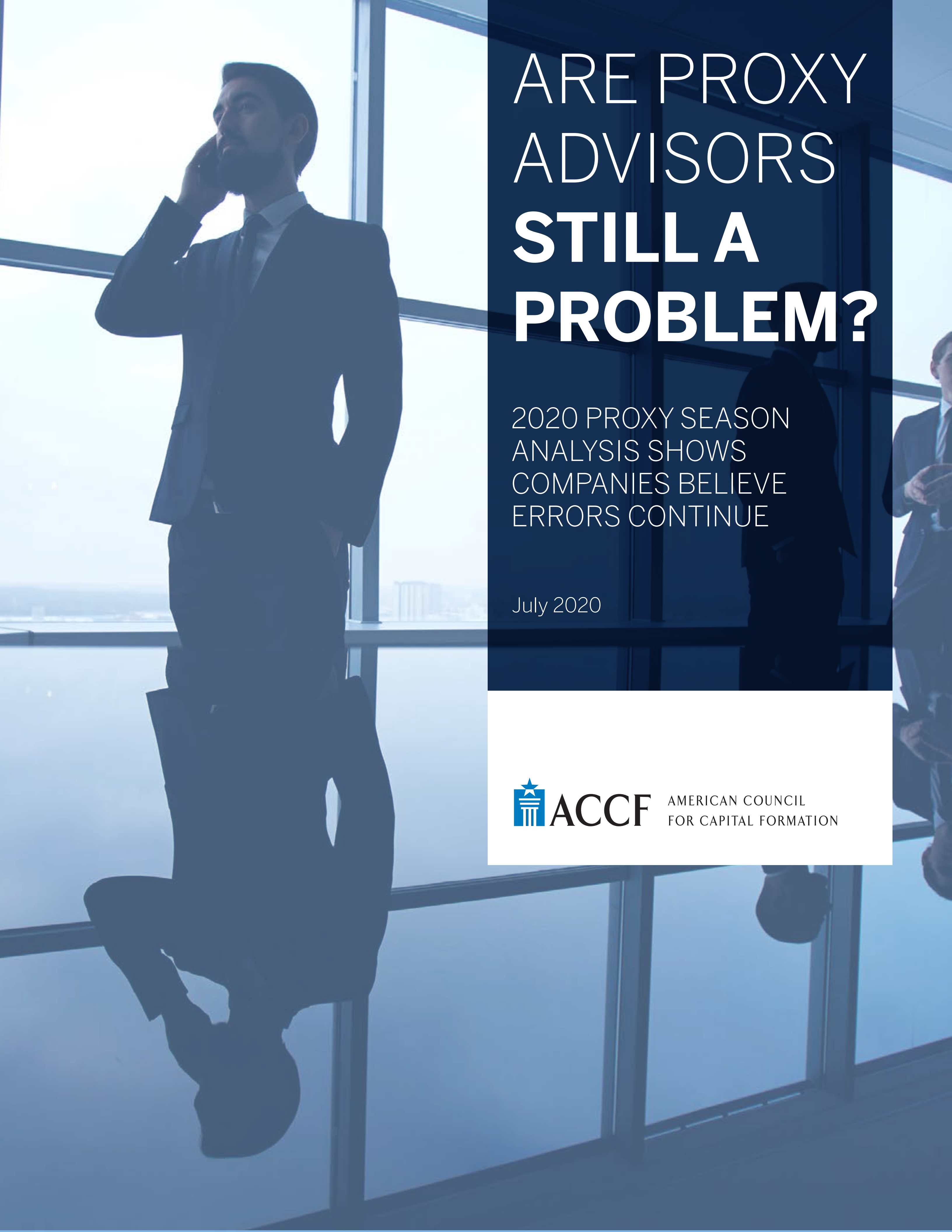

ARE PROXY ADVISORS **STILL A PROBLEM?**

2020 PROXY SEASON ANALYSIS SHOWS COMPANIES BELIEVE ERRORS CONTINUE

July 2020

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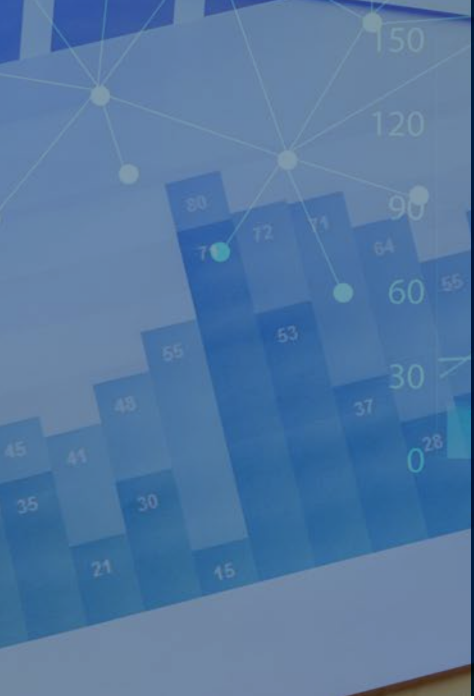


ARE PROXY ADVISORS STILL A PROBLEM?

2020 PROXY SEASON ANALYSIS SHOWS COMPANIES BELIEVE ERRORS CONTINUE

CONTENTS

ARE PROXY ADVISORS **STILL A PROBLEM?**

2020 PROXY SEASON ANALYSIS SHOWS COMPANIES BELIEVE ERRORS CONTINUE

INTRODUCTION

A new analysis of companies' supplemental filings to their proxy materials with the U.S. Securities and Exchange Commission (SEC) during the majority of the 2020 proxy season shows at least 42 instances where proxy advisors have formulated recommendations based on errors[1] or analysis disputed by the companies themselves.

For example, in one supplemental filing, a proxy advisor generated a recommendation using a disputed figure for a company's net income, a basic but critical number. Another highlighted how a proxy advisor based its recommendation on a peer group that did not include the company's actual competitors. Other filings showed instances where proxy advisors issued recommendations that appear to be contradictory with their stated policies.

These results are consistent with the prior analysis of supplemental filings we conducted into the 2016, 2017, and part of the 2018 proxy seasons, and which uncovered a total of 139 apparent errors.

The findings are significant as they show that disputes between companies and proxy firms have continued despite significant scrutiny from Congress, the SEC, and an array of impacted stakeholders. They suggest that these efforts have not fully had the intended effect and that further intervention is needed in order to ensure that investors have as accurate information as possible before voting their securities.

[1] In this report, any use of the term "errors" refer to cases where companies' supplemental filings plainly stated that a proxy firm's analysis contained either an outright factual mistake or fundamental errors or omissions in analysis when developing vote recommendations. Companies who submitted such filings are subject to antifraud provisions within SEC regulations and are legally liable for any misstatement of fact. A full accounting of the supplemental filings analyzed for the report is contained in the appendix.

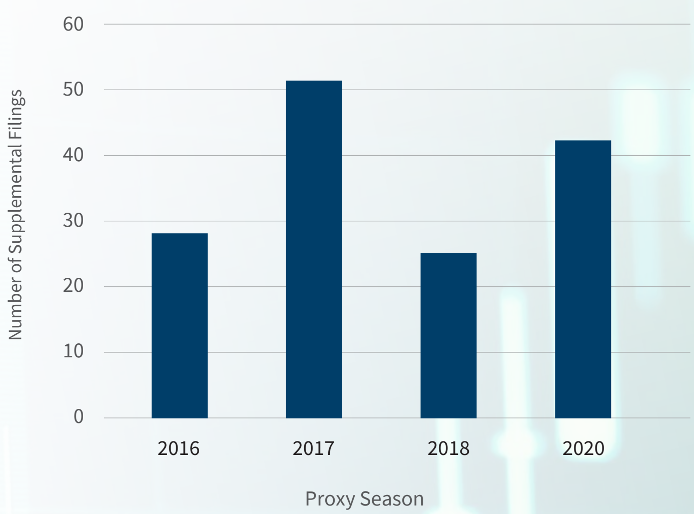
SUMMARY OF FINDINGS

A search of the SEC's EDGAR database through July 9, 2020 found 42 examples of public companies filing supplemental proxy materials this proxy season in order to correct the record regarding a proxy advisory firm vote recommendation. Because supplemental filings are subject to antifraud provisions of SEC regulations this study views them as accurate.

The companies that have made these filings cut across virtually every sector of our economy and most are small or mid-cap entities that do not have the significant legal and compliance resources of their larger counterparts.

These filings are consistent with our previous research into this topic, which showed 29 supplemental filings in 2016, 52 in 2017, and 26 during the period examined in 2018. They demonstrate that companies are still encountering proxy advisor recommendations that they argue are based on factual and analytical errors, as well as serious disputes, all of which should be considered by investors before casting their votes in corporate elections.

Company Supplemental Filings Per Year Analyzed



It is important to note that the number of supplemental filings highlighted in this and previous ACCF reports may well represent the "tip of the iceberg" and still undercount the overall instances of errors or other methodological flaws contained in proxy advisory firm recommendations.

Specifically, the data includes only those companies that have taken the extraordinary step of filing a supplemental proxy. Doing so not only entails voluntarily increasing the company's anti-fraud risk, but also requires diverting significant company resources to submit the filing in the limited window available. Anecdotal evidence suggests that many companies who face issues with proxy advisers are either unable or choose not to submit supplemental filings.

We would suggest that the current system of submitting supplemental filings does not represent the most efficient solution to correcting errors or disputed analysis in proxy advisors' recommendations. The process is both laborious and time consuming and perhaps most importantly imposes added demands on investors to identify necessary information before voting. As such, an update to the proxy voting process would certainly appear to be warranted.

CASE STUDIES

Factual Errors: Plains All American disputed the decisions by two proxy advisers to issue votes against the company's say on pay proposal, noting that one report was *"wrong and (is) based on a flawed and error-filled analysis."* The company claimed that amongst other errors, the pay for performance analysis in the proxy report was based on an erroneous net income figure that was off by $1.7 billion. This was the second year the proxy advisor based their analysis off a disputed figure, even though the company previously pointed out the issue to the advisor.

Analytical Errors: Five9 was puzzled when it found that a proxy adviser had issued a 'withhold' recommendation against one of its directors, due to her membership on four audit committees. The reason for the confusion was the proxy firms' own guidance, which states a director should not serve on more than three public audit committees, *"unless the audit committee member is a retired CPA, CFO, controller or has similar experience, in which case the limit shall be four committees."* The director who was subject to the 'withhold' recommendation is a retired finance professional and holds no operating positions with any company – clearly within the proxy firm's guidance on the subject.

Serious Disputes: Hecla Mining challenged a proxy adviser over its peer group selection for a say-on-pay recommendation. One of the oldest US incorporated mining companies, it stated that although the North American industry is dominated by Canadian businesses, a proxy adviser chose to use a peer group which only featured US incorporated companies, including those in the chemicals and agricultural products sectors.

ANALYSIS OF THE SEC'S PROPOSED RULEMAKING

It is important to recognize that proxy advisory firms perform a critical function in the U.S. capital markets. They provide institutional investors with research and vote recommendations regarding board of director elections, executive compensation, mergers and acquisitions, and other corporate governance matters at public companies. A well-functioning proxy advisory system can enhance the long-term value of businesses and ultimately benefit Main Street investors.

However, over the last decade, the practices of proxy advisory firms have come under increased scrutiny from market participants, Congress, academics, and the SEC. The quality of vote recommendations, a concern that proxy firms may issue "one size fits all" vote recommendations, and apparent conflicts of interest within the industry have led policymakers to propose reforms that would increase transparency and ensure proxy advisors provide high-quality voting advice that promotes the long-term best interests of investors.

Questions regarding the independence of proxy advisor firms have also been raised over the years. For example, proxy advisor "specialty reports" – provided to certain proxy firm clients based upon "socially responsible" or faith-based investment guidelines – are alleged to give preference to certain shareholder resolutions and have the potential to influence reports provided to other clients.

Companies typically have little insight into the content of such specialty reports and how it may affect the advice being provided to their shareholders.

These concerns have led the SEC to clarify the responsibilities of asset managers who hire proxy advisory firms. Asset managers owe a fiduciary duty to retail investors that put their savings into mutual funds, exchange-traded funds, or other managed investment vehicles. Asset managers must prioritize the economic interests of these shareholders when casting votes and take steps to affirm that any advice they rely on from proxy advisory firms is based upon factual and accurate information.

As the Commission explained through guidance issued in August 2019, a regular assessment by asset managers regarding, *"the extent to which potential factual errors, potential incompleteness, or potential methodological weaknesses in [a] proxy advisory firm's analysis...materially affected the proxy advisory firm's research or recommendations"* could assist them in fulfilling their fiduciary duty to shareholders. In other words, when asset managers rely on vote recommendations that contain errors or analytical weaknesses, it could ultimately harm retail investors.

In November 2019, the SEC proposed rules that would implement long-overdue reforms to the proxy advisor industry. The proposal is the culmination of a decades-long effort by the Commission to examine the practices of proxy advisory firms and those who rely on their recommendations, and has been informed by several SEC roundtables and solicitations for public comment, as well as Congressional hearings dating back to 2013. The proposal is properly calibrated to improve the overall quality of proxy advice received by institutional investors without imposing undue costs on market participants.

An important component of the SEC's proposed rule is a mechanism granting companies the ability to provide feedback on draft vote recommendations. This would provide companies the opportunity to correct any apparent errors or raise serious points of disagreement prior to a final report being issued. While nothing in the proposal grants companies any type of "veto" over a recommendation, a draft review process would ensure that recommendations are based on facts and that investors have both company and proxy adviser viewpoints available when making voting decisions. At a stroke, this will address not only factual disputes, but also the differences of opinion which proxy firms contend make up the majority of supplemental filings and other company complaints. Importantly, we see no reason as to why this would hinder proxy advisers' independence.

In a speech on the proxy advisor rule, SEC Commissioner Elad Roisman indicated that the proposal would likely be tweaked so that companies and institutional investors would both receive the proxy advisor reports at the same time and review them contemporaneously. If companies find errors or have serious disagreements with the recommendations, they could submit their response to proxy advisors and the advisors would then distribute the response to their institutional investor clients to consider before voting their shares. To ensure companies have time to submit their response before investors vote, Roisman indicated that the final rule would also likely include a "speed bump" or time period where proxy advisors would disable any mechanisms they have to "robo-vote" their clients' shares on their behalf.

If the final rule is updated to include this contemporaneous review period, it will represent a significant compromise by the business community. It removes companies' ability to review reports prior to publication and will not allow investors to assess both sides of the argument simultaneously. However, it will address concerns raised that the rule as proposed will slow down the voting process and give companies an opportunity to raise the concerns currently reflected in the often-overlooked supplemental filings highlighted in this report.

Currently, the largest proxy advisory firm permits only companies included in the S&P 500 the opportunity to review and comment on draft recommendations. Other proxy advisory firms have established subscription services for companies that wish to review draft reports. Both practices implicitly acknowledge the value of company feedback in the process. However, despite the importance of ensuring accurate information is included in final reports, there is no regulatory standard for providing companies with a way to correct errors and submit comments before a final vote recommendation is issued.

As noted by the SEC in the proposal, this lack of a standard has led to concerns that, "*there are not meaningful opportunities to engage with the proxy voting advice business and rectify potential factual errors or methodological weaknesses in the analysis underlying the proxy voting potential to improve the accuracy, transparency, and completeness of the information available to make those voting decisions.*" Ensuring that the clients of proxy advisor firms receive the most accurate and up to date information on critical proxy matters fits squarely within the SEC's mission and will promote the long-term best interests of investors.

CONCLUSION

The supplemental filings submitted by companies thus far in the 2020 proxy season provides a public glimpse of potential proxy firm errors and serious disputes they face each year.

These disputed data and analyses are critical pieces of information that must be evaluated by the institutional investors who vote on behalf of their clients in order to uphold their fiduciary duty. Left unevaluated, errors can cost companies instead of increasing their value as intended.

The factual disputes identified in this new report are consistent with previous years' findings, and demonstrate that recent efforts, including the SEC's August guidance, will not on their own be sufficient to resolve the problem. Further action is needed.

The SEC's proposed rule to regulate proxy advisors will address this critical issue by enhancing the information available to institutional investors without compromising the independence of proxy advisors. Once finalized, the rule will improve the workings of corporate governance by facilitating greater transparency and accountability amongst public companies and their investors.

APPENDIX

Company	Date of Supplemental Proxy Filing	Nature of Error	Summary of Error/Topic
Ares Capital	6/15/2020	Factual Error Analytical Error X Serious Dispute X	Company disputed proxy advisory firms' characterization of attendance by one board member, noting that the director had attended 100% of regularly scheduled meetings in 2019 and only missed meetings that were scheduled with limited notice.
United Therapeutics	6/15/2020	Factual Error Analytical Error Serious Dispute X	Company disputed several factors used in proxy advisory firm recommendations against say on pay and director nominees, stating interactions with the firms "were very productive, and we came away with the distinct belief that we had sufficiently addressed, through the compensation program adopted in March 2019, the concerns that gave rise to our 2019 Say-on-Pay vote. We also held calls with the proxy advisory firms in December 2019 to review our outreach efforts, the changes we were making in 2019 and to gather any additional feedback, and neither proxy advisory firm questioned our level of responsiveness to shareholders during those conversations."
Cowen Inc.	6/12/2020	Factual Error Analytical Error X Serious Dispute	Company received negative vote recommendations from proxy advisory firms regarding say on pay and incentive compensation plans. Explained a number of disagreements with recommendations, including: "Average and total 3-year CEO compensation for 2017-2019 includes payments and share vestings associated with the CEO transition and retirement of our former CEO in late 2017. This resulted in an increase in reported CEO compensation of more than $10 million in 2017, which inflates the 3-year compensation metrics utilized" by one of the proxy advisory firms.
Dave and Buster's Entertainment	6/9/2020	Factual Error Analytical Error X Serious Dispute X	Company was seeking to increase shares eligible under its omnibus incentive plan by 3,000,000 shares. Company disputed proxy advisory firm using a pre-COVID calculaiton of the share price when issuing a vote recommendation against the proposal.
Criteo S.A.	6/9/2020	Factual Error Analytical Error X Serious Dispute X	Company states its position that a proxy advisory firm is "mistaken" in its claim that the company failed to disclose minimum vesting periods for stock options. Company points to its proxy statement, which explicitly states that "any options granted under the 2016 Stock Option Plan will be subject to a vesting period of at least one year."
Providence Service Corporation	6/4/2020	Factual Error Analytical Error Serious Dispute X	Company disputes proxy advisory firm classification as current director as non-independent. Company explains that the director's relationship with and compensation from a law firm that the company had retained are immaterial and do not impact her independence.
Evercore	6/2/2020	Factual Error Analytical Error X Serious Dispute X	Company points out a number of flaws and omissions in proxy advisory firm recommendation against amendments to equity incentive plan, including 1) "The Report excludes from its quantitative burn-rate and dilution analyses the anti-dilutive impact of our share repurchase "; 2) "The Report compares our equity compensation practices to a peer group with materially different capital structures and business models"; and 3) "The Report provides no assessment of the significance of the qualitative rationale for our broad-based equity plan relative to its quantitative tests."
Activision Blizzard Inc	6/1/2020	Factual Error Analytical Error X Serious Dispute X	Company believes analysis underlying vote recommendation was faulty due to 1) A peer group selection that is irrelvant to the company and misrepresents who it competes against for talent; 2) Treating stock options as non-performance based compensation; 3) Failing to take into account the company's shareholder-favorable approach to granting equity; and 4) Placing inappropriate emphasis on disclosure of competitively sensitive and confidential strategic goals.
Trident Acquisition Corp	5/26/2020	Factual Error X Analytical Error Serious Dispute	Trident filed the supplemental to clarify that if shareholders approved the amendment to the company's articles of incorporation, insiders or their affiliates must depost $.15 for each share of common stock that had not been redeemed. The company sought the clarification as it had been made aware that a proxy advisory firm vote recommendation stated the amount deposited would be $500,000 in aggregate.
Mack-Cali Corporation	5/29/2020	Factual Error Analytical Error Serious Dispute X	Company disagrees with recommendations on director nominees put forward by Bow Street Opportunities Fund. Company claims that proxy advisory firms "failed to recognize the significant Board and governance enhancements that Mack-Cali has made over the last year" and claimed that the proxy advisors were "deceived" by Bow Street's "misleading commentary" regarding the Board.
Monolithic Power Systems	5/28/2020	Factual Error X Analytical Error Serious Dispute	Company provided detailed rebuttal to vote recommendation against company's 2014 equity plan. Stated that the characterization of the performance measurement period being two years was "simply incorrect" and that earnings per share had continued to grow despite an increase in outstanding shares, undercutting arguments that the equity plan was "cost excessive."
Neophotonics	5/22/2020	Factual Error Analytical Error X Serious Dispute X	Company received a negative vote recommendation for its 2020 equity incentive plan. The company notes that their three-year average adjusted and unadjusted burn rates are well below the benchmark used to inform the vote recommendation, and that 89% of their stock options are in the money, yet remain unexercised, reflecting a committed workforce.
Alexandria Real Estate Equities	5/21/2020	Factual Error Analytical Error Serious Dispute X	Company (a real estate investment trust governed under Maryland law) reiterates that its bylaws related to shareholder rights to amend bylaws are consistent with Maryland law; notes that the policy preference of one proxy advisory firm (which resulted in recommendation agaist board members) is contrary to longstanding Maryland law.

APPENDIX CONTINUED

Devon Energy Corp	5/22/2020	Factual Error Analytical Error X Serious Dispute X	Company took exception on several factors related to a negative vote recommendation for say on pay plan. As one example, negative vote recommendation stated that company had a "problematic practice" of granting executive age credits for the company pension plan. Devon explained that has not, and has no plans to, make granting age credits a practice.
Vocera Communications	5/18/2020	Factual Error Analytical Error Serious Dispute X	Company counters claims from proxy advisory firms that its equity compensation plan is "cost effective" and permits the liberal recycling of shares. Company notes that its burn rate is below proxy advisory firm benchmarks and that unvested shares are forfeited and returned to the equity pool.
GCP Applied Technologies	5/18/2020	Factual Error Analytical Error Serious Dispute X	Company disputes recommendation in favor of hedge fund Starboard's slate of nominees; says that recommendation resulted from taking Starboard's arguments at "face value" and disregarded facts underlying the company's slate of nominees.
Netgear	5/18/2020	Factual Error Analytical Error X Serious Dispute	Company argues that vote recommendation against equity incentive plan applies inflated burn rate and dilution calculations, and fails to factor in implications for shareholders if incentive plan is adopted.
Invacare	5/15/2020	Factual Error Analytical Error X Serious Dispute	Company disputes proxy advisory firm dilution analysis for executive compensation plan, and states that "[the firm's] evaluation of the plan's estimated cost, the plan features, and our equity grant practices have resulted in a score that would have otherwise led to a favorable recommendation." Company states that if counting existing shares available for the grant and new shares requested at one-half value based on the plan terms, dilution would have been 18% - well below the limit the proxy advisory firm used as basis for negative vote recommendation.
Tredegar	5/13/2020	Factual Error Analytical Error X Serious Dispute X	Serious dispute with vote recommendation regarding pay of CEO; amongst other concerns, company notes that: "In addition, the..Report notes that Tredegar's three-year CEO pay was among the lowest 5% of its peers, while its performance was above 50% of peers. Based on these quantitative results, it is shocking that [the firm] would have a "high concern level" regarding a potential "misalignment between CEO pay and Company performance." The...Report makes clear that Tredegar – specifically the Compensation Committee – has historically paid well below "market" CEO compensation for above average performance."
Hecla Mining Company	5/13/2020	Factual Error Analytical Error X Serious Dispute X	Dispute over say on pay recommendation, including over peer group selection. Company states that: "Notwithstanding that the North American mining industry is dominated by Canadian companies, the...peer group only includes companies that are incorporated in the United States, and from industries such as chemicals to agricultural products (with the exception of one mining company)."
Plains All American Pipeline	5/12/2020	Factual Error X Analytical Error Serious Dispute	Both proxy advisory firms issued recommendations against company say on pay proposal; company claims report from one firm "is wrong and is based on a flawed and error-filled analysis." Amongst other errors company explains that the pay for performance analysis in the report is based on an erroneous net income figured that is off by a factor of 6.2x.
Align Technology	5/8/2020	Factual Error X Analytical Error Serious Dispute	Company states that when formulating a vote recommendation against members of the compensation Committee, the proxy advisory firm misclassified the departure of the former chief legal officer as a "voluntary" retirement.
GEO Group	5/6/2020	Factual Error Analytical Error Serious Dispute X	Serious dispute over recommendation on board members and classification of certain members as "independent." Company states that majority of directors would be independent under NYSE rules as well as the proxy advisory firms own standards regarding independence.
Northrup Grumman	5/5/2020	Factual Error Analytical Error X Serious Dispute	Company disagreed with a proxy advisory firm regarding a say on pay vote, saying "With regard to [the] Pay-For-Performance analysis disclosed on page 7 of the report, we agree [the firm] has disclosed the GAAP measures correctly as reported by Northrop Grumman. However, we contend [the firm] should also have considered pension-adjusted metrics in their analysis of our performance. As noted in our proxy statement, management uses pension-adjusted metrics, such as pension-adjusted net income, as internal measures of financial performance and for performance-based compensation decisions. This has been our consistent practice for many years as it adjusts our earnings for the non-operational impact of pension income and expense. Also, during 2018, the company changed its accounting for pensions to the mark-to-market method, which is the preferable method under U.S. GAAP, but can result in significant volatility in GAAP earnings."
Southwestern Energy	5/5/2020	Factual Error Analytical Error X Serious Dispute X	Supplemental proxy includes letter from chairman of comp committee "setting the record straight" regarding company's executive compensation plan in light of a negative recommendation on say on pay. Company explained that CEO pay was 44% less in 2019 than targeted compensation, as the stock price fell by 29%.
Five9	5/5/2020	Factual Error Analytical Error X Serious Dispute X	Company states that a proxy advisory firm "issued a withhold recommendation against Kimberly Alexy in the election of directors due to her membership on four audit committees, despite [the firm's] own guidance that a director should not serve on more than three public audit committees "unless the audit committee member is a retired CPA, CFO, controller or has similar experience, in which case the limit shall be four committees." Given that Ms. Alexy is a retired finance professional and holds no operating positions with any company, we believe that she fits squarely into the exception set forth in [the firm's] guidance."
Tanger Outlets	5/4/2020	Factual Error X Analytical Error X Serious Dispute	Company explains that the actual amount of equity awards for the company's former President and COO was 54% of what was speculated in proxy advisory firm vote recommendation against say on pay plan.
XPO Logistics	5/4/2020	Factual Error Analytical Error Serious Dispute X	Company describes a number of disagreements with a proxy advisory firm recommendation against equity compensation plan and describes recent actions taken in response to shareholder feedback.

Stifel Corp	5/4/2020	Factual Error Analytical Error X Serious Dispute X	Company states that a proxy advisory firm's analysis and recommendation is "fundamentally wrong." States that the firm's "formulaic analysis would generate an "against" recommendation for our plan even if we were to ask for no additional share capacity because [the firm] ignores our controls that have successfully managed dilution.
AAON	4/29/2020	Factual Error Analytical Error Serious Dispute X	Regarding a vote recommendation against a proposal related to the company's 2016 long-term incentive plan, the company states that it "engaged in discussions with [the proxy advisory firm] and after such engagement, we believe [the firm] is interpreting language in the 2016 Incentive Plan in a manner which is inconsistent with the Company's intentions and administration of the 2016 Incentive Plan, specifically as it relates to the ten percent (10%) limitation on "Full-Value Awards" (as defined in the 2016 Incentive Plan)."
The Bancorp Inc	4/29/2020	Factual Error Analytical Error Serious Dispute X	Company notes that despite one of the company's directors meeting Nasdaq and SEC independence rules, a proxy advisory firm determined that the director did not meet its own independence guidelines.
Colony Capital	4/29/2020	Factual Error Analytical Error X Serious Dispute X	Company disputes vote recommendation against say on pay proposal, including clarifying that incentive fee allocations to CEO were one-time payments and not recurring, that the proxy advisory firm's report substantially inflates the value of the one-time CEO award, and that the recommendation failed to take into account meaningful changes to the executive compesnation program.
Commscope Holdings	4/28/2020	Factual Error Analytical Error Serious Dispute X	Company responds to recommendations against say on pay proposal, including criticisms from proxy advisory firms that forward-looking goals on long-term awards were not provided. Company notes that such forward-looking statements cause competitive harm and is consistent with market practices in not making such statements.
Discover Financial Services	4/28/2020	Factual Error Analytical Error Serious Dispute X	Company stated that a vote recommendation against the independent chairman of the board was based on a perception that the Board was unresponsive to the outcome of competing proposals from 2019 related to shareholders' right to call a special meeting. The company stated that prior to the recommendation, "the Company had not received any feedback to indicate that investors are dissatisfied with their 25% special meeting right."
Nielsen Holdings	4/27/2020	Factual Error X Analytical Error Serious Dispute	The company - a U.S.-based business that is incorporated in the United Kingdom - notes that a major proxy advisory firm "[applied] UK governance guidelines that do not apply to us because we are not listed in the UK."
CNO Financial Group	4/27/2020	Factual Error Analytical Error X Serious Dispute X	Proxy advisory firm issued a vote against say on pay based on assertion that company made discretionary payments to a former CEO after a voluntary separation. As company explains: "This additional material clarifies that Mr. Helding's separation was an involuntary termination by the Company without "Just Cause" (as such phrase is defined in his employment agreement), which triggered the payment of severance in accordance with the terms of his employment agreement. The payments made by the Company to Mr. Helding in connection with his separation from the Company were contractually required pursuant to the terms of his employment agreement. Mr. Helding did not receive any discretionary payments in connection with his separation."
RLI Corp	4/23/2020	Factual Error X Analytical Error X Serious Dispute	Company explained that a proxy advisory firm failed to take into account shares held by a wholly-owned insurance subsidiary of RLI when calculating the portion of company shares considered outstanding or reserved for issuance.
Arrow Electronics	4/23/2020	Factual Error Analytical Error Serious Dispute X	Company disputes proxy advisory firm recommendation regarding say on pay proposal, including a disagreement over the peer benchmark used to formulate voting recommendation.
Easterly	4/23/2020	Factual Error Analytical Error X Serious Dispute X	Company takes several issues with vote recommendation against incentive compensation program and points out that CEO pay has been well below thresholds for peer groups.
National Bank Holding Corp	4/22/2020	Factual Error Analytical Error X Serious Dispute X	"Company disagrees with vote recommendation on incentive plan citing, amongst other reasons, selection of peer group, stating the ""selected peer group is very different than the Company's peer group. We also note that the list of peers that [the firm] discloses for the Company is not updated from last year's peer group for the Company. The Company's new peer group for 2019 was revised by the Committee to address changes due to M&A activity, remove outsized peers and ensure the inclusion of smaller peers to ensure a proper mix. The Company believes that its peer group selected by the Committee reflects a group of peers that are reflective of the business model and service offerings of the Company, and is a better representation of the peer group."
Kaman Construction	3/23/3030	Factual Error Analytical Error X Serious Dispute X	Company lays out a number of arguments rebutting vote recommendation against say on pay proposal, including that a proxy advisory firm underestimated the company's free cash flow for 2019.
Panhandle Oil & Gas	2/24/2020	Factual Error Analytical Error X Serious Dispute X	Company disagrees with a proxy advisory firm analysis regarding amendment to restricted stock plan, including the firm's' assertion that the amendment contains liberal change-in-control provisions.

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For more than four decades, the American Council for Capital Formation (ACCF), a 501(c)(6) nonprofit, nonpartisan organization has advocated tax, energy, environmental, regulatory, trade and economic policies that encourage saving and investment, economic growth, and job creation. The ACCF is uniquely able to play this role because of its bipartisan credibility with Members of Congress and the White House, its highly respected research and analysis of legislative and regulatory initiatives, and the respect it has earned in the media.

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THE REALITIES OF **ROBO-VOTING**

November 2018

Timothy M. Doyle

Vice President of Policy & General Counsel

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Doyle holds a JD from Michigan State University as well as a BA with a dual major in Political Theory & Constitutional Democracy and Criminal Justice. During law school, he clerked for the Department of Justice in Washington D.C. at the U.S. Attorney's Office. He also worked his way through law school at the Senate Majority Policy Office in the Michigan Senate.

THE REALITIES OF ROBO-VOTING

CONTENTS

EXECUTIVE SUMMARY

by Timothy M. Doyle

New research from the American Council for Capital Formation identifies a troubling number of assets mangers that are automatically voting in alignment with proxy advisor recommendations, in a practice known as "robo-voting." This trend has helped facilitate a situation in which proxy firms are able to operate as quasi-regulators of America's public companies, despite lacking any statutory authority.

While some of the largest institutional investors expend significant resources to evaluate both management and shareholder proposals, many others fail to conduct proper oversight of their proxy voting decisions, instead outsourcing decisions to proxy advisors. We reviewed those asset managers that historically vote in line with the largest proxy firm, Institutional Shareholder Services (ISS), finding 175 entities, representing more than $5 trillion in assets under management, that follow the advisory firm over 95% of the time.

Proxy advisors regularly assert that their recommendations are only intended to be a supplemental tool used in voting decisions, yet too many asset managers fail to evaluate company specific considerations. Robo-voting is more concerning given recent concerns over the accuracy of advisor recommendations, the limited amount of time proxy advisors allow for company corrections, and the need for investment managers to align voting with fiduciary considerations, collectively highlighted in our previous study, Are Proxy Advisors Really A Problem?

This new report, "The Realities of Robo-Voting," quantifies the depth of influence that proxy advisory firms control over the market and identifies asset managers that strictly vote in alignment with advisor recommendations. Significantly, the research finds that outsourced voting is a problem across different types of asset managers, including pension funds, private equity, and diversified financials. Further, size of assets under management appears to have little impact, as both large and small investment firms display near-identical alignment with advisor recommendations.

The lack of oversight of proxy advisors, who dictate as much as 25% of proxy voting outcomes, is increasingly becoming a real issue for investors and it must be addressed. This report offers additional analysis of the asset manager voting landscape and reiterates important questions regarding the influence, impact, and conflicts of proxy advisory firms.

INTRODUCTION

By 2017, approximately 70% of the outstanding shares in corporations in the United States were owned by institutional investors such as mutual funds, index funds, pension funds and hedge funds. Institutional investors have significantly higher voting participation (91%) than retail investors (29%) and the proliferation of institutional ownership has given these entities a disproportionately large influence over voting outcomes at annual shareholder meetings. The growing increase in institutional ownership has correspondingly increased the power and influence of proxy advisors. These firms provide a number of services related to proxy voting, including voting recommendations.

The single biggest catalyst for the rise in influence of proxy advisors was the 2003 decision by the Securities and Exchange Commission (SEC)[1] to require every mutual fund and its investment adviser to disclose "the policies and procedures that [they use] to determine how to vote proxies"— and to disclose their votes annually. While the intention of the SEC was to spur greater engagement with the proxy voting process from mutual funds, the decision has had the opposite effect. While some institutional advisors have internal analysts to develop and implement the required "policies and procedures," many institutional investors have been disincentivized to carry out their own independent evaluations of proxy votes and governance practices, outsourcing their shareholder voting policies to a proxy advisor industry that relies on a "one size fits all" approach to assessing corporate governance. This issue may be best seen through the practice of 'robo-voting', whereby institutions automatically and without evaluation rely on proxy firms' recommendations, posing lasting implications for corporate policy, returns, and governance outcomes.

A GROWING INFLUENCE IN ROBO-VOTING

Originally explained in ACCF's prior paper *The Conflicted Role of Proxy Advisors*, robo-voting is the practice of institutions automatically relying on both proxy advisors' recommendations and in-house policies without evaluating the merits of the recommendations or the analysis underpinning them.

The influence of proxy advisors continues to grow as more and more institutional advisors follow their recommendations. In fact, academic studies continue to point to the influence of the two major proxy advisors – ISS and Glass Lewis – on voting outcomes. The level of influence of ISS is estimated as being between 6-11%[2] and up to 25%.[3]

ISS, aided by the lack of transparency over how its policies are formulated and how its recommendations are arrived at, denies the full scope of its influence, instead alluding to its role as an "independent provider of data." In a response to the Senate Banking Committee in May 2018, ISS claims:

> "We do, however, want to draw a distinction between our market leadership and your assertion that we influence 'shareholder voting practices.' ISS clients control both their voting policies and their vote decisions... In fact, ISS is relied upon by our clients to assist them in fulfilling their own fiduciary responsibilities regarding proxy voting and to

1. SEC, "Securities and Exchange Commission Requires Proxy Voting Policies, Disclosure by Investment Companies and Investment Advisers," press release, January 1, 2003, available at: http://www.sec.gov/news/press/2003-12.htm
2. Choi, Stephen; Fisch, Jill E.; and Kahan, Marcel, "The Power of Proxy Advisors: Myth or Reality?" (2010). *Faculty Scholarship*. 331
3. Nadya Malenko, Yao Shen; The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design, *The Review of Financial Studies,* Volume 29, Issue 12, 1 December 2016, Pages 3394–3427

> inform them as they make their proxy voting decisions. These clients understand that their duty to vote proxies in their clients' or beneficiaries' best interests cannot be waived or delegated to another party. Proxy advisors' research and vote recommendations are often just one source of information used in arriving at institutions' voting decisions… Said more simply, we are an independent provider of data, analytics and voting recommendations to support our clients in their own decision-making."
>
> -Institutional Shareholder Services, May 2018

Likewise, Glass Lewis offered an explanation for the "misperception" that it exerts influence on shareholders:

> "Glass Lewis does not exert undue influence on investors. This is clearly evidenced by the fact that during the 2017 proxy season Glass Lewis recommended voting FOR 92% of the proposals it analyzed from the U.S. issuer meetings it covers (the board and management of these companies recommended voting FOR 98% of the same) and yet, as noted by ACCF sponsor Ernst & Young, directors received majority FOR votes 99.9% of the time and say-on-pay proposals received majority FOR votes 99.1% of the time…The market is clearly working as shareholders are voting independently of both Glass Lewis and company management."
>
> -Glass Lewis, June 2018

Undoubtedly, certain large institutional investors use proxy advisor recommendations and analysis as an information tool, employing multiple advisors in addition to their own in-house research teams in an effort to ensure they have a balanced view of how best to vote on a particular proxy item. As previously highlighted in a report by Frank Placenti, chair of the Squire Patton Boggs' Corporate Governance & Securities Regulation Practice, BlackRock's July 2018 report on the Investment Stewardship Ecosystem states that while it expends significant resources evaluating both management and shareholder proposals, many other investor managers instead rely "heavily" on the recommendations of proxy advisors to determine their votes, and that proxy advisors can have "significant influence over the outcome of both management and shareholder proposals."[4]

In looking at asset managers more broadly, many entities have fewer resources to process the hundreds of proposals submitted each year, and in turn are left to not only utilize proxy advisory data, but automatically vote in line with their recommendations. ISS asserts they are not influential, stating they are instead an "independent provider of data, analytics and voting recommendations to support our clients in their own decision-making." The voting results, compared to their recommendations, are in direct conflict with ISS's public views on the role it plays in the proxy process.

Therefore, in stark contrast to the misinformation provided to the Senate Banking Committee by ISS, ACCF's new research demonstrates that ISS's role is much more than that of an information agent. The reality is clear: hundreds of firms representing trillions of assets under management are voting their shares almost exactly in line with proxy advisors' recommendations. Given the sheer numbers, the argument of independent data provider and mere coincidence on the actual voting is implausible.

HOW CAN WE BE SURE ROBO-VOTING HAPPENS AND WHICH TYPES OF INSTITUTIONAL INVESTORS ARE DOING IT?

ACCF conducted a detailed analysis of Proxy Insight data and evaluated those asset managers that historically voted in line with ISS recommendations. Specifically, the evaluation sought to identify those managers that aligned with ISS recommendations more than 95% of the time on both shareholder and management proposals. The analysis found that 175 asset managers with more than $5 trillion in assets under management have historically voted with ISS on both management and shareholder proposals more than 95% of the time.[5]

4. Available at: https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-investment-stewardship-ecosystem-july-2018.pdf
5. All Proxy Insight data was pulled from the platform as of October 13, 2018 and was filtered to include only those funds that had voted on more than 100 resolutions. ISS alignment data on the platform reflects all data available for each investor, which generally dates back as early as July 1, 2012 through the date it was pulled.

There may be those that say 95% is a justifiable alignment – after all, many matters on which institutions are asked to vote are matter-of-fact issues on ordinary course business operations. However, in the analysis we also assessed different robo-voting thresholds.

	Number of Asset Managers	Assets Under Management (AUM) ($mn)
95% Threshold	175	5,084,629
96% Threshold	151	3,553,453
97% Threshold	134	3,242,620
98% Threshold	115	2,084,612
99% Threshold	82	1,371,604

Upon increasing the threshold for robo-voting, the list of asset managers shrinks only marginally at each level. Of the 175 asset managers in the 95th percentile, nearly half are in the 99th percentile. That is, they are voting with ISS on both management and shareholder proposals more than 99% of the time. In sum, regardless of how one defines robo-voting – be it at 95% alignment or 99% – the data shows it is more than a coincidence that the practice is happening and equally important that it broadly represents a significant proportion of investment dollars.

WHICH INSTITUTIONS ARE IMPLEMENTING THIS STRATEGY?

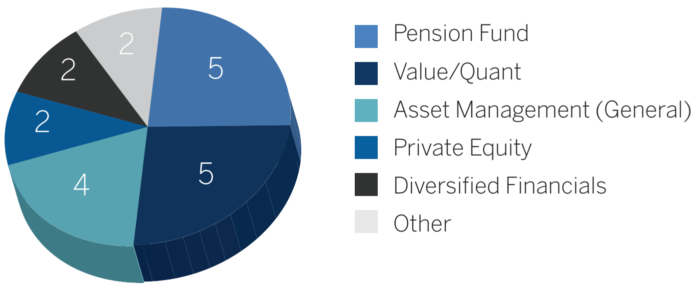
The list below identifies the top 20 robo-voters by AUM in the highest threshold category (99%).[6] Interestingly, previous assumptions were that this list would largely comprise quantitative hedge funds; however, the type of investor that almost never deviates from an ISS recommendation is far more diverse:

Asset Manager	AUM ($mn USD)	Management Proposals	Shareholder Proposals	Investor Type
Blackstone	368,000	100.0%	100.0%	Private Equity
AQR Capital Management LLC	224,000	99.9%	99.6%	Value/Quant
United Services Automobile Association	137,000	99.9%	99.5%	Diversified Financials
Arrowstreet Capital	69,952	100.0%	99.9%	Private Equity
Virginia Retirement System	67,804	99.9%	99.8%	Pension Fund
Los Angeles County Employees Retirement Association	56,000	99.7%	99.5%	Pension Fund
Baring Asset Management	40,000	99.9%	99.6%	Diversified Financials
Numeric Investors, LLC	39,800	100.0%	100.0%	Value/Quant
PanAgora Asset Management, Inc.	38,400	99.8%	99.5%	Value/Quant
First Trust Portfolios Canada	28,000	99.9%	99.3%	ETFs
ProShares	23,900	100.0%	99.6%	ETFs
Kentucky Teachers' Retirement System	16,576	99.7%	99.6%	Pension Fund
Stone Ridge Asset Management	16,285	100.0%	99.6%	Asset Mangement
Pensionskasse SBB	16,280	99.7%	99.5%	Pension Fund
Euclid Advisors LLC	13,500	99.6%	99.9%	Asset Mangement
Rafferty Asset Management, LLC	13,275	100.0%	100.0%	Asset Mangement
Driehaus Capital Management LLC	8,803	99.9%	99.7%	Value/Quant
Alameda County Employees' Retirement Association	6,966	99.9%	99.6%	Pension Fund
DSM Capital Partners LLC	6,500	99.6%	100.0%	Value/Quant
Weiss Multi-Strategy Advisers LLC	5,725	99.9%	99.8%	Asset Mangement

6. AUM data drawn from Proxy Insight reported data, except in a few select cases where Proxy Insight data was unavailable and was augmented by IPREO data as of August 1, 2018. Voting alignment percentages are rounded to the nearest tenth.

Indeed, when broken down by investor type, the picture of the entities who almost never deviate from an ISS recommendation is split across several categories and topped by pension funds and value and quant funds.

Investor Type



The reliance on proxy advisors is not just limited to investors where proxy voting may be viewed as a compliance function rather than an added value. Robo-voting is widespread: it is prevalent at a range of investor-types, and at large and small investors.

It is perhaps unsurprising that such significant levels of robo-voting occur in the proxy voting process. Both major proxy advisors derive the majority of their work not from their research, but from the provision of voting services, that is, providing the mechanics through which institutions vote their shares and comply with SEC regulations. As ACCF has explored previously, proxy advisory firms are, by design, incentivized to align with the comments of those who use their services the most. Moreover, many votes are cast through electronic ballots with default mechanisms that must be manually overridden for the investor to vote differently than the advisor recommends. [7]

While certain major institutions have the resources to put in place internal proxy voting processes, for the majority of institutions the requirement to vote represents a significant cost burden. For those entities, ISS and Glass Lewis provide a cost-efficient way of voting at thousands of meetings each year;[8] however, the negative externality is that some institutional investors do not have the capacity or the interest to review the research associated with the voting of their shares. Instead, they simply allow their shares to be voted through the proxy advisors' platforms and according to the proxy advisors' methodologies.

WHY DOES IT MATTER?

Fundamentally, in 2003, the SEC recognized proxy voting was an important aspect of the effective functioning of capital markets. However, under the current system, corporate directors and executives are subject to decision making on critical issues by entities that have no direct stake in the performance of their companies; have no fiduciary duty to ultimate beneficial owners of the clients they represent; and provide no insight into whether their decisions are materially related to shareholder value creation. Informed shareholders, who have such a stake and carry out their own independent research, suffer due to the prevalence of robo-voting, because their votes are overwhelmed by these same organizations.

The practice of robo-voting can also have lasting implications for capital allocation decisions and has resulted in ISS and Glass Lewis playing the role of quasi-regulator, whereby boards feel compelled to make decisions in line with proxy advisors' policies due to their impact on voting. While limited legal disclosures are actually required, a proxy advisory recommendation drawn from an unaudited disclosure can in many cases create a new requirement for companies – one that adds cost and burden beyond existing securities disclosures.

In addition, a recent ACCF commissioned report, 'Are Proxy Advisers Really a Problem?', led by Squire Patton Boggs' Placenti, discusses the pertinence of factually or analytically flawed recommendations and the limited time provided to companies to respond to errors. Based on a survey by four major U.S. law firms of 100 companies' experiences in the 2016 and 2017 proxy seasons, respondents reported almost 20% of votes are cast within three days of an adverse recommendation, suggesting that many asset managers automatically follow proxy advisory firms. The report also includes an assessment of supplemental proxy filings, an issuer's main recourse to a faulty recommendation. Based on a review of filings from 94 different companies from 2016 through September 30, 2018, the paper identifies

7. This robo-voting procedure was described in detail in the August 3, 2017 letter of the National Investor Relations Institute to SEC Chair Jay Clayton, available at: https://www.niri.org/NIRI/media/NIRI-Resources/NIRI-SEC-Letter-PA-Firms-August-2017.pdf
8. ISS provides proxy voting to clients through its platform: ProxyExchange. Glass Lewis provides proxy voting through its platform: Viewpoint.

139 significant problems, including 49 that were classified as 'serious disputes.' In turn, errors in recommendations are magnified by the practice of automatic voting by select asset managers.

An error by a proxy advisor can have a material impact on voting as a host of proxy advisor clients will not review the research that contains the error, and will instead merely vote in line with the recommendations provided. As a result, when shareholders blindly follow an erroneous recommendation from a proxy advisor, their mistakes are perfectly correlated,[9] which can have real and damaging impacts on public companies.

Furthermore, institutions that do not research these proposals are negligently relying on proxy advisors to ensure their vote aligns with their clients' best interests. Yet proxy advisors have no fiduciary duty to the ultimate beneficiaries of mutual funds and have provided no evidence that their analysis and recommendations are linked to the protection or enhancement of shareholder value.[10] The fiduciary duty owed to investors has always been at the center of this debate. As former SEC Commissioner Daniel Gallagher indicated back in 2013:

> "I have grave concerns as to whether investment advisers are indeed truly fulfilling their fiduciary duties when they rely on and follow recommendations from proxy advisory firms. Rote reliance by investment advisers on advice by proxy advisory firms in lieu of performing their own due diligence with respect to proxy votes hardly seems like an effective way of fulfilling their fiduciary duties and furthering their clients' interests. The fiduciary duty…must demand more than that. The last thing we should want is for investment advisers to adopt a mindset that leads to them blindly cast their clients' votes in line with a proxy advisor's recommendations, especially given that such recommendations are often not tailored to a fund's unique strategy or investment goals." [11]

As explored in ACCF's previous report, "While it is not the intention of SEC policy and may be a violation of fiduciary duties and ERISA, the reality of robo-voting is real."[12] The result: enhanced power of proxy advisory firms with a potential for adverse recommendations and company outcomes, and limited ability for targeted companies to engage with their own diverse shareholder base. Regardless of whether one considers the role of proxy advisors to be positive or negative, it is clear the influence of ISS is not overstated.

9. Andrey Malenko and Nadya Malenko, The Economics of Selling Information to Voters, J. FIN. (forthcoming) (June 2018), available at: https://ssrn.com/abstract=2757597
10. In a number of papers, researchers have found that ISS's recommendations negatively impact shareholder value:David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, "The Economic Consequences of Proxy Advisor Say-on-Pay Voting Policy" (Rock Center for Corporate Governance at Stanford University Working Paper No. 119, Stanford, CA, 2012), available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id= 2101453. David Larcker, "Do ISS Voting Recommendations Create Shareholder Value?" (Rock Center for Corporate Governance at Stanford University, Closer Look Series: Topics, Issues and Controversies in Corporate Governance and Leadership No. CGRP-13, Stanford, CA, April 19, 2011): 2, available at: http://papers.ssrn .com/sol3/papers.cfm?abstract_id=1816543##.
11. Commissioner Daniel M Gallagher, Remarks at Georgetown University's Center for Financial Markets and Policy Event Securities and Exchange Commission Speech (2013), available at: https://www.sec.gov/news/speech/2013-spch103013dmg
12. Available at: http://cdn.accf.org/wp-content/uploads/2018/05/ACCF-The-Conflicted-Role-of-Proxy-Advisor-FINAL.pdf (page 24) (accessed October 12, 2018)

CONCLUSION

It seems out of sync with effectively functioning capital markets that proxy advisory firms remain unregulated, despite essentially representing trillions of assets at the annual shareholders meetings of U.S. corporations. By wielding the aggregated influence of those investors that blindly follow their recommendations, proxy advisors possess the ability to drive change in corporate behavior and practices, without being required to provide any meaningful transparency over how their decisions are made. Through the research on robo-voting, it's abundantly clear that proxy advisors have an indisputable influence over shareholder voting.

Robo-voting enhances the influence of proxy advisory firms, undermines the fiduciary duty owed to investors; and poses significant threats to both the day-to-day management and long-term strategic planning of public companies. In keeping with the regulation of mutual funds, who individually possess significantly less influence than proxy advisors, it seems natural that the proxy advisors would be subject to similar regulatory requirements and oversight. Greater exploration of the extent of this practice provides an opportunity to support the upcoming SEC Roundtable on the Proxy Process, where the commission will be looking for additional detail regarding the influence, impact, and bias of proxy advisory firms.

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