SKIN IN THE GAME FOR CREDIT RATING AGENCIES AND PROXY ADVISORS: REALITY MEETS THEORY

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Financial markets function most efficiently when all of the actors perform their functions scrupulously and through exerting optimal effort. However, human nature demonstrates that people will often underperform if they lack sufficient incentives. In the case of the individuals and entities acting as agents in the U.S. financial markets, if these players do not perform appropriately then everyone suffers. This fact was clearly demonstrated through the Enron and Worldcom scandals, as well as the recent financial crisis. One promising mechanism for motivating these entities is forcing them to have "skin in the game"—a direct financial interest in the companies affected by their actions. Skin in the game has become ubiquitous with regard to corporate "inside" agents—the managers and directors who act on the corporation's behalf—by providing them with stock options, bonuses, and other methods of pay-for-performance. So, if giving inside agents skin in the game tends to motivate them to act in the corporation's best interest, would such a mechanism be appropriate for the "outside" agents—entities that are not actually part of the corporation, but perform work on its behalf or on behalf of investors?

This Article fills a current void in the corporate scholarship by analyzing whether two particular kinds of outside agents—credit rating agencies and proxy advisory firms—should be given skin in the game. The "skin" would be a financial incentive tied to the success of the agent's service: rating agencies would be paid with the debt instruments they rate, and proxy advisors with share-based payment. The analysis is heavily based on principal-agent literature. The Article then applies theoretical insights derived from that literature and analyzes whether skin in the game would likely be beneficial with regard to proxy advisory firms and credit rating agencies. It concludes that the skin in the game approach would likely be beneficial when dealing with rating agencies, but should be employed cautiously *when dealing with proxy advisory firms.*

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INTRODUCTION

The literature on agency theory focuses largely on relationships in which one party, the principal, engages another party, the agent, to perform some service on the principal's behalf while delegating some decision-making authority to the agent. This literature explains that when the principal and the agent do not share the same interests, a conflict may arise—known as an "agency problem."[1] And, in the cases where the principal does not directly observe the agent's actions, a "moral hazard," or incentive problem, is likely to occur.

A natural remedy to this problem is to invest resources into *monitoring* the agent's actions, and using this information to impose contractual requirements and constraints upon the agent—an input-based contract. In many situations, however, comprehensive monitoring is not possible because full

[1] *See, e.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976). In fact, the notion of "agency theory" can be traced back to ADOLF BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) (concerning the separation of ownership and control), and in its most general, undeveloped form, to ADAM SMITH, THE WEALTH OF NATIONS 741 (1776) ("[B]eing the managers rather of other people's money than of their own, it cannot well be expected, that they will watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own.").

observation of agent's actions is either impossible or prohibitively costly. In such situations, the principal can structure the contractual relationship using incentives based on the agent's output—the end result of the agent's actions—to motivate the agent to perform well. Thus, the principal can essentially infer what the agent's unobservable actions and effort levels were when performing agency tasks.[2] These output-contingent contracts incentivize the agent to act in a manner that will maximize the payoff to both the principal and the agent—an output-based contract or incentive-based contract.

Traditionally, most corporate law scholarship has been focused on agency problems that occur in-house; that is, conflicts of interest between managers and dispersed shareholders, conflicts between controlling and noncontrolling shareholders, and between shareholders and creditors.[3] However, scant scholarly literature and very little theory, if any at all, exist regarding potential agency problems between a corporation's investors and outside agents of the corporation. This Article focuses on two such agency relationships: credit rating agencies, which act on behalf of creditors (potential and existing bondholders), and proxy advisory firms, which act on behalf of institutional investors (large institutions that manage and invest other people's money).

These outside agents play a crucial role in the U.S. capital markets today, and public companies' and their investors' increasing reliance on these agents has become a hotly debated topic in corporate governance. In particular, the endemic reliance on these agents, according to some commentators, results in significant agency problems arising when agents pursue personal interests at odds with investors' interests.[4] A major concern is that while investors possess an *actual* stake in public companies, the outside agents do not have such a vested interest in the success or failure of the company (except to the extent that the company represents to them a source of revenue), and so they largely do not bear the costs of their bad decisions.

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[2] Bengt Holmstrom, *Moral Hazard and Observability*, 10 BELL J. ECON. 74, 79 (1979); Joseph E. Stiglitz, *Principal and Agent*, *in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS 966–67 (John Eatwell, Murray Milgate, & Peter Newman eds., 1987).

[3] REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 35 (2d ed. 2009); *see also* Kathleen M. Eisenhardt, *Agency Theory: An Assessment and Review*, 14 ACAD. MGMT. REV. 57, 59 (1989) ("Also, positivist researchers have focused almost exclusively on the special case of the principal-agent relationship between owners and managers of large, public corporations."); Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 775 (2017) ("The subject of most corporate law scholarship is the conflict of interests between managers (broadly defined to include directors) and shareholders."). Recently, progress has been made by Ronald J. Gilson and Jeffrey N. Gordon, who have extended corporate discipline to include "a new agency problem that results from the gap between the interests of institutional record owners and beneficial owners." Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 865 (2013).

[4] *See infra* text accompanying notes 26–27 (regarding credit rating agencies); *infra* text accompanying note 36 (regarding proxy advisory firms).

Therefore, the argument goes, when agents' and investors' incentives are not aligned, the investors will be directly harmed by any loss in the value of their investment resulting from agents' bad decisions, while the agents will often suffer no corresponding ill-effects from a decline in a company's value. This discrepancy arguably results in a misalignment of interests between corporate investors and outside agents, creating a moral hazard. In other words, outside agents have been increasingly criticized for not having "*skin in the game*"—a device that is meant to incentivize agents to exert optimal levels of effort and to make decisions that are in the best interests of their principals. In this Article, skin in the game can be conceptualized as an *incentive (output-based)* device; a mechanism that connects the principals to the agents through contractual and property interests.

The skin in the game debate has been argued in reference to almost all of the outside agents in the U.S. capital markets. Credit rating agencies have been persistently criticized for offering ratings while having "only reputational capital at risk" based on their performance.[5] Proxy advisory firms have similarly been criticized for significantly influencing shareholder voting in companies by providing voting advice without "having an actual economic stake" in those companies and therefore no pecuniary interest in the actual outcome of a shareholder vote.[6] Similar arguments have been raised regarding "corporate gadflies"—equity shareholders who hold a relatively small number of shares for the purpose of gaining access to shareholder meetings and proxy materials in an effort to influence the corporation's activities;[7] external auditors;[8] mortgage originators (including S&Ls, commer-

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[5] Daniel Bergstresser, Randolph Cohen, & Siddharth Shenai, *Skin in the Game: The Performance of Insured and Uninsured Municipal Debt* 3 (Brandeis Univ. Dep't of Econ. & Int'l Bus. Sch., Working Paper No. 88, 2015), http://people.brandeis.edu/~dberg/skin_20101111.pdf; *see also* CFA INST., CREDIT RATING AGENCY SURVEY RESULTS 9, 15–17, 21 (2014), http://www.cfainstitute.org/Survey/credit_rating_agency_survey_ report.pdf (summarizing a survey taken by 20,379 CFA members and reflecting comments generally suggesting that rating agencies need to have skin in the game).

[6] Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42982, 43011 (proposed July 14, 2010) (to be codified at 17 C.F.R. pts. 240, 270, 274, 275); *see also Examining the Market Power and Impact of Proxy Advisory Firms: Hearing Before the Subcomm. on Capital Mkts. & Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 113th Cong. 9 (2013) [hereinafter *Hearing on Proxy Advisory Firms*] (statement of Timothy J. Bartl, President, Center on Executive Compensation) (quoting a company that stated, "[i]t feels like we are giving power over the board to a consultant without a horse in the race"); Stephen Choi, Jill E. Fisch, & Marcel Kahan, *Director Elections and the Role of Proxy Advisors*, 82 S. CAL. L. REV. 649, 650 (2009) ("Proxy advisors are depicted as powerful, yet unaccountable, institutions that can sway the outcome of corporate votes without any of their own money at stake.").

[7] *See* Daniel M. Gallagher, Comm'r, U.S. Sec. & Exch. Comm'n, Remarks at the 26th Annual Corporate Law Institute, Tulane University Law School: Federal Preemption of State Corporate Governance (Mar. 27, 2014), https://www.sec.gov/news/speech/2014-spch032714dmg.html ("Requiring a *sufficient* economic stake in the company could lead to proposals that focus on promoting shareholder value rather than those championed by gadflies with only a nominal stake in the company . . . . This could be an opportunity to address the practice of 'proposal by proxy' where the proponents of the resolution—typically one of the corporate gadflies—has no skin in the game, but rather receives permission to act 'on behalf' of a shareholder that meets the threshold. . . . Making adjustments along these lines will go a

cial banks, mortgage banks or unregulated brokers);[9] and even financial regulators.[10] In short, all of these outside agents are subject to criticism because they have no stake in the corporations that are affected by their actions; they have no skin in the game.[11]

This Article proposes that the debate over the "skin in the game" notion has suffered from the lack of a general theory describing when having skin in the game may be valuable to an agency relationship and when, in contrast, it may be worthless or even harmful. It seeks to help fill that void by attempting to answer the question: *When does requiring agents to have skin in the game have significant value?* Building upon agency theory foundations, combined with organizational and psychological perspectives and important theoretical extensions, this Article proposes a set of criteria which could be used to predict the value of giving agents skin in the game in any particular circumstance.

In brief summation, as this Article demonstrates, skin in the game is typically needed when two factors are present: First, the agent's behavior and the amount of effort that it exerts are unobservable by the principal, or when information about the agent's work is difficult and costly to obtain. Second, the agent's output—namely the agent's total contribution to the principal's objective[12]—is not difficult to define and measure. This Article demonstrates how these two factors are interrelated to several other factors which tend to indicate whether skin in the game would be beneficial. These additional factors include the agent's risk aversion; the operation of multiple agents at once—which makes measurement of each agent's output challenging and

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long way towards ensuring that the proposals that make it onto the proxy are brought by shareholders concerned first and foremost about the company—and the value of their investments in that company—not their pet projects." (emphasis added)); *see also* Steven Davidoff Solomon, *Grappling With the Cost of Corporate Gadflies*, N.Y. TIMES: DEALBOOK (Aug. 19, 2014, 8:02 PM), https://dealbook.nytimes.com/2014/08/19/grappling-with-the-cost-of-corporate-gadflies.

[8] *See* Sharon Hannes, *Compensating for Executive Compensation: The Case for Gatekeeper Incentive Pay*, 98 CAL. L. REV. 385, 390 (2010).

[9] *See* FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT 165 (2011), http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf [hereinafter: FCIC REPORT]; *see also* Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, Public Statement: Skin in the Game: Aligning the Interests of Sponsors and Investors (Oct. 22, 2014), http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370543250034#.VNH3p LocTmI (regarding asset-backed sponsors).

[10] *See generally* M. Todd Henderson & Frederick Tung, *Pay for Regulator Performance*, 85 S. CAL. L. REV. 1003 (2012) (suggesting a pay-for-performance approach for bank regulators in order to help reducing the incidence of future regulatory failures).

[11] With regard to most of those agents, it seems that the increasing interest in the notion of skin in the game has stemmed from the fact that they are, traditionally, shielded from liability. This point will be discussed *infra* regarding rating agencies and proxy advisors. *See infra* notes 130–132 and accompanying text.

[12] In fact, as noted elsewhere, "[t]he principal owns the output but contracts to share it with the agent by paying a wage . . . contingent on output." Robert Gibbons, *Incentives in Organizations*, 12 J. ECON. PERSPECTIVES 115, 116 (1998); *see also* PATRICK BOLTON & MATHIAS DEWATRIPONT, CONTRACT THEORY 135 (2005) (explaining how making an agent's wage contingent on output means "letting the agent 'buy' the output from the principal").

therefore makes skin in the game less beneficial; the reputational mechanism—which may serve as an incentive structure comparable to skin in the game, depending on the observability of an agent's input and output; and the risk that using skin in the game schemes can lead to several unintended negative consequences. The Article concludes that skin in the game would likely be beneficial when dealing with rating agencies, but should be employed cautiously when dealing with proxy advisory firms.

It is necessary to explain at the outset that, in general, skin in the game can be any type of *direct* economic interest of the agent in the company. It can be the agent's ownership of the shares or debt of a public company, the value or success of which may be affected by the agent's behavior and output;[13] or some kind of requirement that an agent must disgorge profits that the agent received in exchange for subpar services.[14] It is also important to note that in much of the economic literature, the notion of skin in the game may also include any potential *indirect* economic interests, such as reputational damage resulting from poor performance.[15] This is because such harm to an agent's indirect economic interests can cause the agent to suffer significant loss.[16]

This Article, however, eschews such a broad scope and restricts its definition of "skin in the game" to situations in which the agent has a direct financial interest in the value of the principal company. The definition is restricted in this manner to focus analysis on the most frequent criticism leveled at outside agents: that they are not accountable because they have no vested interest in their principal's value. The extent to which an outside agent's indirect economic interests will tend to keep it acting in the corporation's interests, and the relative effectiveness of such indirect interests in comparison to the direct interests discussed in this Article, are important topics for further research. But these topics are beyond the scope of the present inquiry except to the extent that the existence of indirect economic

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[13] Such an interest could be, for instance, ownership of shares in the principal corporation. In the case of a proxy advisory firm, for example, skin in the game could be ownership of shares in the company for which the firm provides voting advice. In the case of a credit rating agency, skin in the game could be ownership of debt securities issued by a company that the agency is rating. *See infra* Part I.

[14] *See, e.g.*, John Patrick Hunt, *Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, The Insufficiency of Reform, and a Proposal for Improvement*, 2009 COLUM. BUS. L. REV. 109, 112 (2009) (suggesting that credit rating agencies' incentive problem could be corrected by "requiring an agency to disgorge profits on ratings that are revealed to be of low quality by the performance of the product type over time, unless the agency discloses that the ratings are of low quality").

[15] *See, e.g.*, Jensen & Meckling, *supra* note 1, at 308 (referring to bonding costs as both "non-pecuniary as well as pecuniary" costs); Nassim N. Taleb & Constantine Sandis, *The Skin in the Game Heuristic for Protection Against Tail Events*, 1 REV. BEHAV. ECON. 1, 4 (2014) ("Note that our analysis includes costs of reputation as skin in the game . . . .").

[16] In fact, reputational damage—considered secondary to the primary risk—can be more costly than direct damage. *See, e.g.*, Jonathan M. Karpoff, D. Scott Lee, & Gerald S. Martin, *The Cost to Firms of Cooking the Books*, 43 J. FIN. & QUANT. ANALYSIS 581, 582 (2008).

interests may reduce the need to adopt a skin in the game compensation mechanism. This possibility is discussed later in this Article.[17]

This Article's analysis has wide-ranging implications for capital market regulation, research, and practice. It may also be applicable in any other regulatory context involving the prevalence of agency relationships. Furthermore, this Article also contributes to an ongoing debate regarding the operation of proxy advisors and the attempts of policymakers, practitioners, and scholars to reduce institutional investors' heavy reliance on advisors' services. This Article shows that it may be difficult to control proxy advisors' operation, even by giving them skin in the game; therefore, investors and policymakers should consider simply delegating less authority to proxy advisory firms.

This Article is organized as follows: Part I describes two major agents—credit rating agencies and proxy advisory firms—which operate in the U.S. capital markets and currently receive much criticism for not having skin in the game. Part II analyzes whether, and in what circumstances, skin in the game would improve agent performance and increase investors' welfare. This analysis is conducted through the lens of principal–agent models, combined with organizational perspectives and some theoretical extensions of those models and perspectives. In Part III, this Article discusses the potential negative effects of requiring outside agents to have skin in the game. Next, Part IV discusses the proper allocation of control between principal and agent. The insights from this discussion are relevant here because the skin in the game mechanism aims to control the agent and thus in circumstances where skin in the game will be less beneficial it will probably be more difficult for the principal to control the agent. In such situations, it may be optimal for the principal to retain more authority for itself and delegate less authority to the agent. Part V applies the analysis offered in Parts I–IV to the two outside agents described in Part I.

I. Outside Agents and Criticisms Directed Toward Them

This section describes two major agents operating in U.S. capital markets: credit rating agencies and proxy advisory firms. It highlights the agents' operation and goals, as well as their influence on the markets. This section also describes a major criticism lodged against them, which alleges that agents who do not have a vested interest in their principals' success are less effective because they are often subject to conflicts of interest and lack appropriate incentives in their compensation structure; they do not have skin in the game.

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[17] *See infra* Part II.C.

A. Credit Rating Agencies

Credit rating agencies are meant to provide investors with informed analyses of the risks associated with debt securities.[18] They determine the relative riskiness of investing in these securities by estimating the likelihood that the debt issuer—whether a corporation, banking entity, sovereign nation, or local government—will fail to make timely payments on the debt.[19] Riskiness is measured through solicited ratings, which are ratings of creditworthiness that are published with the request of the issuer and for a rating fee. Credit rating agencies will also sometimes publish unsolicited ratings, which are not requested by the issuer and are not compensated.[20] Within this Article's context, rating agencies are classified as agents that are supposed to act on behalf of investors—both potential bond investors who want to know the risks in buying a bond and existing investors who frequently review the ratings over the bond's lifetime. Therefore, the "output" of these agents is their contribution of trustworthy information for the protection of investors.

Three firms currently dominate the rating industry: Moody's, Standard & Poor's, and Fitch. The big three, which are designated as the Nationally Recognized Statistical Rating Organizations (NRSRO), hold a collective market share of roughly 95 percent, rendering the credit rating market extremely non-competitive.[21] This lack of competition has been strongly criticized.[22] Furthermore, this market's non-competitiveness is exacerbated by the "two-rating norm"—a standardized practice whereby entities seeking a credit rating are rated by two different agencies for each issue. This format assures that two out of the three agencies will not compete against each other for any given job.[23] This limited competition among credit rating agencies assures that the rating agencies have significant power in the U.S. financial markets.

Each of the big three rating agencies receives compensation for their solicited rating services directly from the issuers of the securities that they

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[18] These securities include government bonds, corporate bonds, certificates of deposit (CDs), municipal bonds, preferred stock, and collateralized securities, such as collateralized debt obligations (CDOs) and mortgage-backed securities.

[19] *See, e.g.*, Hunt, *supra* note 14, at 114; *see also Fast Answers: Credit Rating Agencies and Nationally Recognized Statistical Rating Organizations (NRSROs)*, U.S. SEC. & EXCH. COMM'N (May 31, 2013), http://www.sec.gov/answers/nrsro.htm.

[20] *See* Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 51 (2004).

[21] *See* Hunt, *supra* note 14, at 115, 131–38; *see also* STAFF OF THE OFFICE OF CREDIT RATINGS, U.S. SEC. & EXCH. COMM'N, REPORT TO CONGRESS: CREDIT RATING AGENCY INDEPENDENCE STUDY 7 (2013), https://www.sec.gov/news/studies/2013/credit-rating-agency-independence-study-2013.pdf (noting that the Securities and Exchange Commission has designated seven other firms as NRSROs, which play a much smaller role in the corporate market).

[22] *See, e.g.*, Robert J. Rhee, *On Duopoly and Compensation Games in The Credit Rating Industry*, 108 NW. U. L. REV. 85, 95 (2013) ("In a competitive market, reputation capital . . . does not incentivize performance well when two firms have cornered the market for a necessary service.").

[23] *See* Hill, *supra* note 20, at 59–62.

rate.[24] This "issuer-pay model," in which "the agencies are paid by the issuers or originator of the products they are rating,"[25] has been heavily criticized for causing serious conflicts of interest.[26] For example, while investors who consider buying a corporation's securities desire an accurate credit rating produced by a credit rating agency, the same is not always true regarding the issuing corporation. Rather, "firms whose securities are rated prefer favorable ratings as it directly lowers their cost of capital, and they do not necessarily prefer accurate ones."[27] Therefore, some incentives theoretically exist for rating agencies to prefer to please the issuers, which pay for their services, rather than maintain the precision of their credit ratings for investors. This situation thus creates a clear conflict of interest between the credit rating agencies and the investors they are supposed to inform and protect.

Furthermore, market observers have complained that credit rating agencies lack sufficient incentives to minimize errors and the Dodd-Frank Act sought to address some of those concerns.[28] Two potential solutions to this problem have been proposed: a disgorgement mechanism;[29] and a skin in the game mechanism—as originally suggested by Listokin and Taibleson—whereby credit rating agencies would receive a portion of the debt securities that it rates, parceled out slowly over time as the debt matures as payment for their services.[30] As explained below, Listokin and Taibleson's core proposal offers the added benefit of improved incentives not to overrate companies.[31]

To illustrate this skin in the game scheme, take the example proposed by Listokin and Taibleson,[32] according to which issuer D agreed to pay $500 to rating agency R. If R gives D an AAA rating, then each unit of D's debt is

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[24] *See* John (Xuefeng) Jiang, Mary Harris Stanford, & Yuan Xie, *Does It Matter Who Pays for Bond Rating? Historical Evidence*, 105 J. FIN. ECON. 607, 608 (2012) (noting that major rating agencies have uniformly applied the issuer-pay revenue model since S&P and Moody's first adopted the model in July 1974 and October 1970, respectively).

[25] Hunt, *supra* note 14, at 152. Rating agencies fees vary depending on the size and complexity of the issue. *See* Frank Partnoy, *How and Why Credit Rating Agencies are Not Like Other Gatekeepers*, *in* FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 59, 69 (Yasuyuki Fuchita & Robert E. Litan eds., 2006).

[26] Hunt, *supra* note 14, at 152; *see also* John C. Coffee, Jr., *Rating Reform: The Good, The Bad, and the Ugly*, 1 HARV. BUS. L. REV. 231, 254 (2011).

[27] Bo Becker & Todd Milbourn, *How Did Increased Competition Affect Credit Ratings?*, 101 J. FIN. ECON. 493, 494 (2011).

[28] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 939F, 15 U.S.C. § 78o–9 (2012) (recognizing the rating agencies' incentive problem and requires studies of "alternative means for compensating nationally recognized statistical rating organizations that would create incentives for accurate credit ratings").

[29] *See* Hunt, *supra* note 14, at 182.

[30] Yair Listokin & Benjamin Taibleson, *If You Misrate, Then You Lose: Improving Credit Rating Accuracy Through Incentive Compensation*, 27 YALE J. ON REG. 91, 94, 105–06 (2010).

[31] Indeed, rating agencies may be criticized by debt issuers who claim that they were injured by overly pessimistic ratings. However, this possibility is less likely to occur given that rating agencies are selected and paid by those issuers and "consistent underrating may destroy the business of a rating agency." *Id.* at 108.

[32] *Id.* at 105.

worth $0.90. Therefore, R should receive 555.56 units of debt ($500/$0.90) as its fee from D if R gives D an AAA rating. If R gives D a BBB rating, then each unit of D's debt is worth $0.80. Under that scenario, R should receive 625 units of debt ($500/$0.80) as its fee under a BBB rating. Suppose that the true default probability of D's debt is typically associated with a BBB rating. Furthermore, assume that business development incentives encourage R to give D a AAA rating, as this makes D more likely to choose ratings from R. With the skin in the game compensation scheme in place, however, R will pay a steep cost for overrating D. If it gives a AAA rating, then R will receive 555.56 units of debt. At market prices, this debt is only worth $444.40 (555.56 x $0.80). In other words, this fee structure gives R a monetary incentive not to overrate.[33]

B. Proxy Advisory Firms

Over the past decade, proxy advisory firms have played an increasingly crucial role in corporate ballot issues. These firms provide analysis and voting recommendations on matters appearing on proxy statements to investors, mainly institutional investors.[34] For the purposes of this Article, proxy advisors are defined as agents who are supposed to act on behalf of investors, mainly institutional investors. The proxy advisor's "output" is the value of their recommendations to investors who hold shares of corporations affected by the advisors' advice. This value is theoretically measured as the total contribution to the firm value, namely through the effect of good recommendations on the price of firm shares.[35]

The increasing use of proxy advisors has produced a wave of criticism, some of which is beyond the scope of this Article. Three main concerns are relevant here. First, there is a conflict of interests inherent in some proxy advisors' business models. For example, the leading proxy advisory firm, Institutional Shareholder Services, Inc., (ISS), provides both voting services to investors and consulting services to companies seeking assistance with the proposals on which the investors will vote.[36] The firm undertakes efforts to

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[33] *Id.*

[34] Proxy advisory firms also provide additional support services, such as executing votes in accordance with investor instructions, engaging in recordkeeping and in other administrative tasks associated with voting, and conducting corporate governance research. *See* Stephen Choi, Jill Fisch, & Marcel Kahan, *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. 869, 870 (2010).

[35] As explained in Part V.B, *infra*, the contribution of proxy advisors to the firm value is hardly measurable, if at all.

[36] *See* Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42982, 43011–12 (proposed July 14, 2010) (to be codified at 17 C.F.R. pts. 240, 270, 274, 275); *see also* Tamara C. Belinfanti, *The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control*, 14 STAN. J.L. BUS. & FIN. 384, 400–03 (2008); Sagiv Edelman, *Proxy Advisory Firms: A Guide for Regulatory Reform*, 62 EMORY L.J. 1369, 1383–84 (2013). The other dominant proxy advisory firm—Glass Lewis—does not offer corporate governance advice to public companies. Nevertheless, the firm is subject to a different conflict of interest:

represent the interests of both the shareholders and corporate management in proxy advising and proposals, two groups of people which do not always see eye to eye. Second, there is an overwhelming lack of competition in the proxy advisory industry. ISS and Glass Lewis currently enjoy a duopoly on providing these proxy advisory services; no other firm has a significant enough market share to be considered a serious competitor.[37] It is also worth noting that some institutional investors employ more than one proxy advisory firm, meaning that the market is completely uncompetitive, at least as far as those particular investors are concerned.[38] Third, and most relevant for the purposes of this Article, proxy advisors are subject to very little oversight and thus face little regulatory accountability. Proxy advisory firms provide institutional investors with a diverse range of services for a fixed fee,[39] but they do not have any financial stake in the companies for which they provide voting advice.[40] This situation has raised concerns about the quality and thoroughness of their work because they do not bear the costs of any bad advice that they may give.[41] These concerns have been exacerbated by the

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Glass Lewis is owned by an institutional investor who could conceivably recommend favorable votes on measures there is a potential bias based on a confliction of interest. *See Hearing on Proxy Advisory Firms*, *supra* note 6, at 27 (testimony of Jeffrey D. Morgan, President and Chief Executive Officer, National Investor Relations Institute) (indicating that because Glass Lewis is owned by the Ontario Teachers Fund there "absolutely" is a "huge potential conflict" of interest when a proxy advisor may be torn between responsibilities owed to their owner versus retail investors); *id.* at 31–32 (testimony of Hon. Harvey L. Pitt, Founder and Chief Executive Officer, Kalorama Partners, LLC, on behalf of the U.S. Chamber of Commerce) (suggesting that disclosure of conflicts from proxy advisory firms needs to happen "in real time," but "right now ISS and Glass Lewis have no interest in developing appropriate standards on conflicts.").

[37] *See Hearings on Proxy Advisory Firms*, *supra* note 6, at 70 (Appendix item CENTER ON EXEC. COMPENSATION, A CALL FOR CHANGE IN THE PROXY ADVISORY INDUSTRY STATUS QUO 15 (2011)) (discussing the background to centralization of the proxy advisory market). The proxy advisory market, like the credit rating market, is highly concentrated. Two firms currently dominate the US proxy advisory market: Institutional Shareholder Services, Inc, (ISS), which holds a market share of around 61%, and Glass, Lewis & Co, LLC, which holds a market share of around 36%. *See* JAMES K. GLASSMAN & J. W. VERRET, HOW TO FIX OUR BROKEN ADVISORY SYSTEM 8 (2013). The remaining three firms—Marco Consulting Group (MCG), Proxy Governance, Inc. (PGI), and Egan-Jones Proxy Services (Egan-Jones)—have much smaller client bases.

[38] *See* U.S. SEC. & EXCH. COMM'N, TRANSCRIPT OF SEC PROXY ADVISORY FIRMS ROUNDTABLE 56 (2013), https://www.sec.gov/spotlight/proxy-advisory-services/proxy-advisory-services-transcript.txt (statement of Karen Barr, General Counsel, Investment Adviser Association) [hereinafter SEC ROUNDTABLE]; *id.* at 105 (statement of Ann Sheehan, Director of Corporate Governance, CalSTRS).

[39] "Most services are offered on an annual subscription basis and paid for periodically in advance," though the ISS fee structure differs from this mainstream system. INSTITUTIONAL SHAREHOLDER SERVS., INC., BROCHURE 5 (2014), http://www.issgovernance.com/file/duediligence/iss-form-adv-part-2a-10-1-2014v1.pdf; *see also* RiskMetrics Group, Inc., Annual Report (Form 10-K) 36 (March 31, 2008). With regard to Egan-Jones, *see* Choi et al., *supra* note 6, at 654.

[40] Choi et al., *supra* note 6, at 650.

[41] *See, e.g.*, GLASSMAN & VERRET, *supra* note 37, at 19; Choi et al., *supra* note 34, at 872; Commissioner Daniel M. Gallagher, U.S. Sec. & Exch. Comm'n, *Outsized Power & Influence: The Role of Proxy Advisers* 8 (Wash. Legal Found., Working Paper No. 187, 2014), http://www.wlf.org/upload/legalstudies/workingpaper/GallagherWP8-14.pdf.

extreme influence that proxy advisors may wield over their clients (mainly institutional investors), as well as the significant sway the advisors may have over corporate vote outcomes.

In a nutshell, it has been said that the leading proxy advisory firms—ISS and Glass Lewis, which together dominate the proxy advisory business with 97 percent of the industry—are "de facto corporate governance regulators,"[42] or "de facto arbiters of U.S. corporate governance."[43] Their voting recommendations have been deemed "a strong predictor" of voting outcomes,[44] and "a milestone" for many crucial deals.[45] Similarly, the question of "'[w]hat will ISS say?' is regularly asked in the board rooms;"[46] and management dissidents and activist shareholders frequently admit that they "couldn't have won without ISS."[47] Empirical studies have revealed that proxy advisors' influence on shareholder votes can climb to as high as thirty percent.[48] Proxy advisors' influence may go even deeper than these empirical studies indicate, given that voting results do not fully capture the changes that companies may to their practices or corporate policies just to meet a

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[42] Letter from Wachtell, Lipton, Rosen & Katz, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 6 (Oct. 19, 2010), http://www.sec.gov/comments/s7-14-10/s71410-129.pdf [hereinafter Wachtell Letter].

[43] *Hearing on Proxy Advisory Firms*, *supra* note 6, at 7 (statement of Hon. Harvey L. Pitt, Founder and Chief Executive Officer, Kalorama Partners, LLC, on behalf of the U.S. Chamber of Commerce).

[44] SEC ROUNDTABLE, *supra* note 38, at 17 (statement of Comm'r Michael S. Piwowar, U.S. Sec. & Exch. Comm'n).

[45] In a 25-page report issued in March 2002, ISS supported the merits of the HP and Compaq merger. *See* Press Release, Compaq Computer Corp., Institutional Shareholder Services Recommends CPQ Shareholders Vote Yes For Merger (Mar. 7, 2002), http://www.prnewswire.com/news-releases/institutional-shareholder-services-recommends-compaq-shareholders-vote-yes-for-merger-76327507.html; *see also* Craig Zarley, *ISS: Long-Term Gains Justify Merger Support*, CRN (Mar. 5, 2002, 8:13 PM), http://www.crn.com/news/channel-programs/18819923/iss-long-term-gains-justify-merger-support.htm (referencing an email sent from Michael Capellas, Compaq Chairman and CEO, to Compaq Employees which stated that "another key milestone in the merger process is the recommendation of . . . ISS").

[46] *Hearing on Proxy Advisory Firms*, *supra* note 6, at 16 (statement of Darla C. Stuckey, Senior Vice President, Policy & Advocacy, Society of Corporate Secretaries & Governance Professionals).

[47] Shawn Tully, *Taking the Guesswork Out of Proxy Voting*, FORTUNE (Dec. 25, 2006), http://archive.fortune.com/magazines/fortune/fortune_archive/2006/12/25/8396763/index.htm.

[48] *See* Jie Cai, Jacqueline L. Garner, & Ralph A. Walking, *Electing Directors*, 64 J. FINANCE 2389, 2391 (1999) (citing studies that found that ISS's recommendations can sway between 13% and 30% of the votes concerning director elections); *see also* Jennifer E. Bethel & Stuart L. Gillan, *The Impact of the Institutional and Regulatory Environment on Shareholder Voting*, 31 FIN. MGMT. 29, 30, 46 (2002) (citing empirical studies that found that proxy advisors influence between 14-21% of the votes concerning management proposals); Choi et al., *supra* note 34, at 869–70; Yonca Ertimur et al., *Reputation Penalties for Poor Monitoring of Executive Pay: Evidence from Option Backdating*, 104 J. FIN. ECON. 118, 120, 129 (2012); Yonca Ertimur et al., *Shareholder Activism and CEO Pay*, 24 REV. FIN. STUD. 535, 565 (2011) (finding that proxy advisors influence around 25% of the votes concerning compensation-related shareholder proposals).

proxy advisory firm's standard.[49] Thus, concerns over advisory firms' degree of influence appear to be justified.

Before proceeding, it should be noted that unlike the case of rating agencies (as illustrated in the Listokin and Taibleson model), so far, no specific scheme of "skin in the game" has been suggested by academics, practitioners or policy-makers with regard to proxy advisory firms. In a related paper, I envision, together with a co-author, a novel framework for an equity-based incentive scheme for proxy advisory firms, concerning specific circumstances within the mergers and acquisitions context.[50] This Article, however, raises the conceptual question of skin in the game, without contemplating the properties of a possible incentivizing mechanism.

C. Summary

Part I has introduced two important corporate agents regarding the notion of "skin in the game." As explained, outside agents such as credit rating agencies and proxy advisory firms do not currently have systems in place giving them significant skin in the game to tie their compensation to the value of their output. However, at various times, there have been calls to give these agents more skin in the game to correct deficiencies and inefficiencies that currently exist with regard to these agents' operations. The next section will more thoroughly explain the concept of "skin in the game" itself, and outline the concerns relevant to this concept.

II. Going Forward

This section of this Article explores the factors that should be taken into account when considering the notion of having "skin in the game," and when it would be wise to provide agents with a significant stake in the companies which their actions affect. It should be noted in advance that at least some of the factors explored below are interconnected and influence each other. To determine when and why having skin in the game would be beneficial, decisions should be made based on consideration of all these factors in

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[49] *Hearing on Proxy Advisory Firms*, *supra* note 6, at 42 (written testimony of Timothy J. Bartl, President, Center on Executive Compensation) (noting for example that in a 2010 survey conducted by the Center on Executive Compensation and the HR Policy Association, 54% of respondents said they had changed or adopted a compensation plan or practice in the past three years primarily to meet the standard of a proxy advisory firm); *see also* SEC Roundtable, *supra* note 38, at 140 (statement of Michael Ryan, Vice President, Business Roundtable); *id.* at 138 (statement of Hoil Kim, Vice President, Chief Administrative Officer, and General Counsel, GT Advanced Technologies); David F. Larcker, Allan L. McCall, & Gaizka Ormazabal, *Outsourcing Shareholder Voting to Proxy Advisory Firms*, 58 J.L. & Econ. 173, 203 (2015) (finding that a substantial number of firms change their compensation programs in the time period before the formal shareholder vote in a manner consistent with the features known to be favored by proxy advisory firms in an effort to avoid a negative voting recommendation).

[50] Asaf Eckstein & Sharon Hannes, Long/Short Incentive Scheme for Proxy Advisory Firms (2016) (unpublished manuscript) (on file with author).

the aggregate. An example of such an analysis will be demonstrated in Part V of this Article with regard to two of the outside agents that were discussed above—credit rating agencies and proxy advisory firms.

A. Observability of Input, Measurability of Output, and Risk Aversion

At the heart of principal-agent theory is the trade-off between the cost of monitoring an agent's behavior and the cost of providing the agent incentives to act in the principal's best interest.[51] The starting point and most critical component in analyzing that trade-off, as described in the classic agency literature, is that when an agent's input (behavior and effort level) is relatively *observable*, a monitoring mechanism is typically the best way to control the agent's actions.[52]

Observability, of course, depends greatly on the nature of the agent's work. When an agent's operation is more transparent (for example, easily observable), it will likely make more sense for the principal to use a monitoring device to control the agent's operation.[53] Similarly, monitoring will likely be beneficial when an agent's tasks are relatively pre-programmed,[54] involve only an insignificant amount of discretion on the agent's part, and are not complex.[55] Lastly, the existence of a long-term relationship between the principal and the agent increases the principal's ability to observe and monitor the agent's behavior effectively.[56] This insight is extremely important in the U.S. corporate context where contracts between public firms and agents are repeated, and new information about an agent's behavior may become available during the course of a relationship.

In contrast, when information about the agent's work is difficult to interpret or costly to obtain, the agent's input is hidden from the principal and

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[51] *See* Eisenhardt, *supra* note 3, at 61.

[52] *See* Holmstrom, *supra* note 2, at 76 (explaining that if the principal could observe the agent's action, "a forcing contract could be used to guarantee that the agent selects a proper action . . . . The latter we will refer to as the first-best solution, which entails optimal risk sharing" between the principal and the agent.); *see also* Stiglitz, *supra* note 2, at 967; Eisenhardt, *supra* note 3, at 61 ("Given that the principal is buying the agent's behavior, then a contract that is based on behavior is most efficient."). The agency literature usually thinks of the agent's action or behavior and the agent's effort interchangeably. *See* Holmstrom, *supra* note 2, at 76.

[53] Note, *Mechanisms of Secrecy*, 121 HARV. L. REV. 1556, 1557 (2008) (discussing the problem of secrecy and transparency from the perspective of the principal-agent relationship, and explaining that transparency may allow the principal to beneficially monitor the agent's behavior).

[54] *See* Eisenhardt, *supra* note 3, at 62.

[55] *Cf.* Canice Prendergast, *The Tenuous Trade-off Between Risk and Incentives*, 110 J. POL. ECON. 1071, 1074 (2002) (suggesting it is more difficult to monitor complex tasks because "optimal action is hard to pinpoint," and thus "complexity and incentive-based compensation go hand in hand.").

[56] *See generally* Roy Radner, *Monitoring Cooperative Agreements in a Repeated Principle-Agent Relationship*, 49 ECONOMETRICA 1127 (1981); *see also* Bengt Holmstrom, *Managerial Incentive Problems: A Dynamic Perspective*, 66 REV. ECON. STUD. 169, 170 (1999); Stiglitz, *supra* note 2, at 970.

a moral hazard problem arises.[57] Principals typically respond to such a moral hazard by using the agent's output (the agent's contribution to the principal's objective) to make inferences about the level of effort that the agent chose to exert,[58] and then by compensating the agent using an output-contingent compensation scheme. Such an arrangement incentivizes the agent to put forth additional effort and increases the likelihood of good output.[59] This Article focuses on whether giving an agency skin in the game will spur an agent's effort level and ultimate output quality. This would be accomplished by crafting an agency relationship wherein the agent's compensation or incentive is not based solely on the agent's actions and services rendered (e.g., a flat rate per job completed or billable hour), but rather a relationship giving the agent incentives that directly tie the agent's economic interests to the principal's objective.[60]

Finally, agency research traditionally cautions that when at least one of two major conditions exists, then it may be appropriate to reduce any outcome-contingent incentives, such as skin in the game.[61] The first condition is an agent's *risk-aversion* and any *uncertainty* regarding outcomes of the agent's action. Simply put, when agents are risk averse, they will seek stability and predictability.[62] Since an outcome-based incentive scheme links compensation to outcomes that are only partially under the control of the agent (because of some random factors related to market performance and other macroeconomic variables),[63] a risk-averse agent would usually demand an upward adjustment of pay to compensate the agent for the increase in risk.[64] This is especially true when risk-averse agents are operating in more uncer-

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[57] BOLTON & DEWATRIPONT, *supra* note 12, at 14–15.

[58] Stiglitz, *supra* note 2, at 967.

[59] BOLTON & DEWATRIPONT, *supra* note 12, at 129.

[60] *See* Eisenhardt, *supra* note 3, at 61; Stiglitz, *supra* note 2, at 967; Joseph E. Stiglitz, *Incentives, Risk, and Information: Notes Towards a Theory of Hierarchy*, 6 BELL J. ECON. 552, 570 (1975).

[61] Recall, in this Article's context, reducing skin in the game would mean tying the compensation of rating agencies less closely to the debt they rate, and tying the compensation of proxy advisors less closely to the value of the corporations regarding which they provide shareholder voting advice.

[62] Steven Shavell, *Risk Sharing and Incentives in the Principal and Agent Relationship*, 10 BELL J. ECON. 55, 64 (1979); *see also* Eisenhardt, *supra* note 3, at 61–62; Bengt Holmstrom & Paul Milgrom, *Aggregation and Linearity in the Provision of Intertemporal Incentives*, 55 ECONOMETRICA 303, 304 (1987) ("[W]hen agents are risk averse, optimal contracts will generally depend on all available information about the agent's action.").

[63] *See* George Baker, *Distortion and Risk in Optimal Incentive Contracts*, 37 J. HUM. RESOURCES 728, 731 (2002); *see also* BOLTON & DEWATRIPONT, *supra* note 12, at 137; Stiglitz, *supra* note 2, at 967.

[64] *See, e.g.*, Marianne Bertrand & Sendhil Mullainathan, *Are CEOs Rewarded for Luck? The Ones Without Principles Are*, 116 Q.J. ECONOMICS 901, 904 (2001); Prendergast, *supra* note 55, at 1071.

tain environments[65] since that sort of environment typically "adds observation error to performance measures."[66]

Consequently, giving risk-averse agents operating in uncertain environments skin in the game may not be in the principal's best interest, since the cost to the principal of such a system may outweigh the benefits of any increased effort on the agent's part. Within this Article's context, it is important to recall that the leading proxy advisory firms help many institutional investors determine how to vote their clients' shares on literally thousands of proxy questions posed each year, and credit rating agencies rate tens of thousands of securities. Such diversification takes away some of the risks related a single public firm. Still, however, this diversification does not alleviate the (systemic) risk related to the entire market.[67]

The second condition is the relative measurability of the agent's output. The more accurately a principal can measure an agent's success, the more effective a skin in the game mechanism will be. Therefore, whatever metric is chosen by the principal to serve this purpose should produce a measurement that strongly correlates with the agent's actual effort.[68] For purposes of this Article, that metric will be referred to as the "performance measure." The economic literature usually assumes that the performance measure will be affected not only by an agent's actions and effort but also by uncontrollable events unrelated to the agent's actions.[69] Therefore, in situations where the performance measure is based largely on the agent's actions and is relatively uninfluenced by uncontrollable events, the performance measure may be said to predict the agent's success accurately.[70]

Furthermore, the performance measure should encompass the value of all of the principal's objectives, and thus incentivizes the agent to enhance the total contribution to the principal. In some circumstances, however, some of the principal's objectives will not be tied to the market price of the company's stock, and will instead be more abstract and difficult to assess accurately. In these circumstances, the performance measure may omit important dimensions of the agent's total contribution, and thus may induce the agent to ignore these dimensions and produce incomplete incentives. This disconnect is typically termed the "multitasking" problem.[71]

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[65] Eisenhardt, *supra* note 3, at 61 ("Outcome uncertainty is positively related to behavior-based contracts and negatively related to outcome-based contracts.").

[66] Prendergast, *supra* note 55, at 1072.

[67] *See infra* note 175 and accompanying text (discussing rating agencies); note 177 and accompanying text (discussing proxy advisory firms). For a discussion on market risk and diversification, see WILLIAM W. BRATTON, CORPORATE FINANCE: CASES AND MATERIALS 95–96 (5th ed. 2003); RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, CORPORATE FINANCE 154–72 (8th ed. 2005).

[68] Stiglitz, *supra* note 2, at 967.

[69] *See supra* notes 63–66 and accompanying text.

[70] Baker, *supra* note 63, at 732–35.

[71] *See* Bengt Holmstrom & Paul Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design*, 7 J.L. ECON. & ORG. 24, 25–26 (1991).

The multitasking problem has been well illustrated by the controversy over the use of incentive pay for public servants. Many core public servants perform services that are hard or impossible to measure or produce outputs that are not market-priced. For example, critics of school and teacher evaluation schemes that are based on test scores have argued that teacher performance cannot be neatly summarized by relatively mechanical student test scores. According to those critics, such evaluative practices induce teachers to improve the *performance measure* (by "teaching to the test") but at the same time to ignore other *true objectives* (and almost certainly more important objectives) of the school system, such as educating students to be good citizens and successful members of society. Thus, an incentive program for schoolteachers that uses student test scores as the performance measure encourages tunnel vision, myopia, and measure fixation that contradict the overall goals of the teaching profession.[72]

In the specific context of this Article, which evaluates credit rating agencies and proxy advisory firms, the multitasking problem is probably not a significant concern. This is because both credit rating agencies and proxy advisory firms have one-dimensional tasks—to enhance investors' value. Rating agencies help investors determine a debt instrument's value by evaluating the riskiness of investing in such a security. Proxy advisors are expected to enhance investors' ability to positively influence the corporate governance of public companies and thus increase both the value of the companies and the corresponding value of the shareholders' securities.

Further complicating measurability, agents often operate in situations where a productive output is the result of the investment and effort of multiple agents. As discussed more thoroughly in Part II.B, when agents share the same agenda and agree with each other, distinguishing the output of an individual agent in such a situation can prove a very difficult, if not impossible, task.[73]

Basing significant incentives on non-measurable outputs may distort an agent's incentives and lead to an overall reduction of the agent's effort. In such situations, it is impossible to assess the value of the agent's output accurately, and consequently impossible to compensate the agent based on its output. This situation may also lead the agent to manipulate the incentive scheme by attempting to deceive the principal into believing that the agent's output was more effective than it actually was in order to maximize agent's benefit from the performance-based compensation scheme. Part III.A discusses this shortcoming in more detail.

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[72] *See, e.g.*, Richard J. Murnane & David K. Cohen, *Merit Pay and the Evaluation Problem: Why Most Merit Pay Plans Fail and Few Survive*, 56 HARV. EDUC. REV. 1, 3 (1986); Carol Propper & Deborah Wilson, *The Use and the Usefulness of Performance Measures in the Public Sector*, 19 OXFORD REV. ECON. POL'Y 250, 250–51 (2003).

[73] In contrast, situations involving competition among agents, where agents disagree with each other, allow for relative performance evaluation and therefore improve the measurability of each agent's output. *See infra* note 85 and accompanying text.

Based on the insights discussed above, we can make some conclusions regarding the effectiveness of skin in the game mechanisms concerning outside agents. Based on the agency theory foundations as discussed above, skin in the game will be needed more when the observability of the agent's behavior and effort is relatively low, and where the measurability of the agent's output is relatively high. Furthermore, the likelihood that skin in the game will be effective is negatively related to uncertainty regarding agents' output and their risk aversion.

B. Multiple Agents

The prior section applied several critical agency concepts with the unstated assumption that the hypothetical outside agent was acting on its own. However, outside agents do not operate in a vacuum; typically, they act in concert with other outside agents of the same kind, as well as various other agents whose operations impact one another. All of the considerations discussed above come into play when multiple agents are involved; however, the multiple agent situation makes the analysis regarding incentive structures more complex. It is even more difficult to measure each agent's individual contribution towards achieving a task in circumstances where multiple agents have been delegated to undertake that same task. As noted at the outset of this Article, most corporate law scholarship has been focused on agency problems occurring in-house. In particular, this scholarship has studied the effect of incentive-based compensation on the performance of managers and directors of public firms and the influence of compensation structures on firms' value and shareholders' welfare. This section of this Article argues that a more realistic perspective should take into account the operation of multiple, interdependent agents with regard to the same public firms; that is, the effect of the "team production dilemma."

In situations where multiple agents are involved and where each agent is independently capable of promoting corporate governance goals and enhancing firm value, there is considerable complexity added when it comes to designing effective incentives for the agents, including skin in the game mechanisms. It is interesting to see that scholarly literature has already studied similar complexities—regarding both organizations in general[74] as well as corporate governance in particular.[75] The focus of this literature, however, has typically been on shareholders and direct stakeholders, such as execu-

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[74] *See, e.g.*, Herbert A. Simon, *Organizations and Markets*, 5 J. ECON. PERSP. 25, 33 (1991) ("In general, the greater the interdependence among various members of the organization, the more difficult it is to measure their separate contributions to the achievement of the organizational goals.").

[75] *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 248–49 (1999); Bruno S. Frey & Margit Osterloh, *Yes, Managers Should Be Paid Like Bureaucrats*, 14 J. MGMT. INQUIRY 96, 99 (2005) (defining the team production approach of corporate governance as "the horizontal interaction among specialized team members").

tives and rank-and-file employees who "make essential contributions and have an interest in an enterprise's success."[76] The literature has not analyzed this complexity as applied to outside agents, such as proxy advisory firms and credit rating agencies.

Simply put, this complexity arises when a group of agents acts to enhance stakeholders' welfare, only their joint output is observable, and it is extremely difficult to separate the individual outcomes from one another. In such a case, largely basing agent compensation on the individual agent's output may lead to inefficiency because of the free-rider problem: underperforming agents will benefit from the success of other agents, removing the incentive to perform from the high-performing agents.[77] In the context of this Article, a multi-agent operation may result from the operation of *the same type of agents*. This occurs when public companies employ the services of more than one agent to perform the same or similar services, such as hiring multiple rating agencies[78] or proxy advisory firms.[79] Another challenge when evaluating an agent's outcome stems from multi-agent operations involving *different types of agents*. For example, the operations of proxy advisory firms quite often push in the same direction as credit rating agencies. These notions will be discussed in Part V.C.

In summary, when the operations of multiple agents are affecting a single outcome, this type of team production dilemma arises. This dilemma occurs any time that a principal is tasked with determining how any economic surpluses generated by team production should be divided. In the context of a corporation's outside agents, such a dilemma may occur in two situations: (1) when the corporation employs several agents of the same general type; or (2) when the corporation employs different types of agents, and the agents' operations overlap and produce a single, largely indivisible outcome. The bottom line that can be taken from the team production debate is that multiple agents' operation should lead practitioners, academics, and policymakers to be cautious when considering skin in the game for the outside agents. Further research is necessary to determine how best to allocate risks and profits through skin in the game incentives when multiple outside agents are involved.

C. Reputational Dynamics

Reputational mechanisms may emerge as viable alternatives or complements to traditional contractual solutions to agency problems such as moni-

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[76] Blair & Stout, *supra* note 75, at 250.

[77] *See* Armen A. Alchian & Harold Demsetz, *Production, Information Costs and Economic Organizations*, 62 AM. ECON. REV. 777, 780 (1972); Bengt Holmstrom, *Moral Hazard in Teams*, 13 BELL J. ECON. 324, 327 (1982).

[78] *See* Hill, *supra* note 20.

[79] *See* SEC ROUNDTABLE, *supra* note 38, at 56 (statement of Karen Barr, General Counsel, Investment Adviser Association).

toring and incentives. Put simply, an agent in a marketplace with an effective reputation system should expect that non-optimal behavior will result in a lower long-term payoff. Therefore, at least in theory, "there will be no need to resolve [an agent's] incentive problems using explicit contracts since markets already provide implicit incentive contracts."[80] This is extremely relevant in the capital markets context where many agents are in fact "reputational intermediaries" who are repeat players in the markets.[81]

Thus, reputation can work as a penalty or reward that influences agents' behavior. An agent's consumers can punish the agent by withholding business, and thus the expected discounted sum of the agent's future profits will serve to discipline the agent. Consumers may also negotiate a "flat" compensatory fee that takes into account the historical performance (reputation) of the agent, and adjust the fee upward or downward based on the agent's current reputation.[82] However, in theory, the effectiveness of reputation mechanisms for controlling an agent depends on the observability and verifiability of the quality of the agent's behavior or output.[83] As we learned from the financial collapse of 2008, regulatory and market mechanisms frequently do not have the capabilities or incentives to observe, verify and reveal the true performance of market participants.[84] Therefore, reputational mechanisms may not serve as an adequate alternative for skin in the game. Reputation will likely obviate any necessity for skin in the game only where the agent's behavior and output are readily observable (which once again emphasizes the importance of observability).

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[80] Holmstrom, *supra* note 56, at 170.

[81] *See, e.g.*, JONATHAN R. MACEY, THE DEATH OF CORPORATE REPUTATION: HOW INTEGRITY HAS BEEN DESTROYED ON WALL STREET 255 (2013); John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 308–11 (2004); Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 61, 94 (1986).

[82] For a recent interesting study applying this notion to rating agencies, see Anil Kashyap & Natalia Kovrijnykh, *Who Should Pay for Credit Rating and How*, 29 OXFORD REV. FIN. STUD. 420, 436 (2016) (explaining that "even if the fees are restricted to be paid upfront in each period, the CRA will be motivated to exert effort by the prospect of higher future profits—via higher future fees—that follow from developing a 'reputation' by correctly predicting the firms' performance").

[83] *See* Stiglitz, *supra* note 2, at 971. It should be explained that verifiability refers to the ability to prove variables of contract between the principal and the agent in front of an outside third party. *See id*.

[84] For a review of potential inherent deficiencies of market mechanisms that are expected to enforce reputational devices, see generally Asaf Eckstein, *Great Expectations: The Peril of an Expectations Gap in Proxy Advisory Firm Regulation*, 40 DEL. J. CORP. L. 77 (2015); *see also* Kraakman, *supra* note 81, at 98 (explaining why and how "difficulties in evaluating and predicting underwrite performance create reputational noise, which implies that investors will 'buy,' and the underwriters will 'sell,' less monitoring effort in aggregate than they would in a more informed market"); Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583, 1614 (2010) (stating that "information about past gatekeeper conduct may not be widely disseminated, and even where it is, it may not allow a reliable assessment of the gatekeepers' performance").

D. Agent's Market Power

Because financial agents do not operate in a vacuum, any skin in the game system must take into account the conditions of the relevant market, in particular, the market's level of competitiveness. To accomplish this, we must be able to answer a preliminary question: does a competitive environment reduce or increase the need for skin in the game? This question has relevance in this Article because although rating agencies and proxy advisors operate today in relatively non-competitive markets, some level of competition nonetheless exists and influences their behavior. This section of this Article examines that question through two separate—but interrelated—analyses. It concludes, however, that there is no straightforward answer. Although the market concentration almost certainly has an effect on the efficacy of skin in the game mechanisms, more research is needed to determine what, exactly, that effect might be. The answer to this question will also be largely influenced by the identity of the factor that selects and pays the agent.

The first analysis relies on economic and organizational research and shows that the relationship between competition and incentives has proved to be ambiguous; therefore, skin in the game could potentially be either valuable or detrimental. For example, in the agency context, some theoretical research suggests that competition increases incentives for agents to perform by providing information that allows a principal to evaluate an agent's performance better.[85] This means that competition reduces information asymmetry between a principal and the agent, and thereby makes direct monitoring of the agent more attractive and the skin in the game mechanism less needed.[86] Likewise, increased competition also raises the probability that a firm will falter or fail; that its competitors will outperform it and the firm will lose market share, potentially going out of business.[87] Therefore, increased competition has a positive effect on managerial effort; it is likely to induce managers of the agent to work harder in order to keep their jobs.[88] For the context of this Article, these analyses suggest that the relative level of competition and value of skin in the game are negatively correlated.

Finally, competition has traditionally been associated with a decrease in the incentives amongst competitors to innovate. This relationship between

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[85] *See, e.g.*, Christo Karuna, *Industry Product Market Competition and Managerial Incentives*, 43 J. ACCT. & ECON. 275, 276 (2007); *see also* BOLTON & DEWATRIPONT, *supra* note 12, at 637 (noting that "if a firm faces competitors, relative performance evaluation becomes possible"); Bengt R. Holmstrom & Jean Tirole, *The Theory of the Firm*, *in* HANDBOOK OF INDUSTRIAL ORGANIZATION 63, 96 (Richard Schmalensee & Robert D. Willig eds., 1989) (explaining how competition can "provide a richer information base on which to write contracts"); Oliver D. Hart, *The Market Mechanism as an Incentive Scheme*, 14 BELL J. ECON. 366, 381 (1983).

[86] *See* Karuna, *supra*, note 85, at 276.

[87] *See* BOLTON & DEWATRIPONT, *supra* note 12, at 637.

[88] *See id.*; *see also* Klaus M. Schmidt, *Managerial Incentives and Product Market Competition*, 64 REV. ECON. STUD. 191, 191–92 (1997).

competition, market structure, and innovation, traces back to Joseph Schumpeter's seminal research.[89] According to the Schumpeterian view, the monopoly deadweight loss is the price we have to pay in order to stimulate firms to invest in innovation. When a firm believes that it will be able to capture most or all of the profit from a particular innovation (as opposed to sharing the profits of that innovation with its competitors, who will simply copy it), it has the incentive to invest the time and effort into innovating. Put differently, traditional wisdom holds that increased competition leads to a lesser degree of innovation; therefore, external incentives to innovate may be needed. For the purposes of this Article, this means that the level of competition and the value of skin in the game are positively correlated.

However, Schumpeter's perspective has been "the subject of a voluminous theoretical and empirical literature, and the results often appeared contradictory,"[90] and it has become clear that incentives to innovate[91]—with regard to both product and process—"depend upon many factors, including the characteristics of the invention, the strength of intellectual property protection, the extent of competition before and after innovation, barriers to entry in production [and research and development], and the dynamics of [research and development]."[92] And, as a general conclusion, "economic theory does not offer a prediction about the effects of competition on innovation that is robust to all of these different market and technological conditions."[93] The concluding insight that can be taken for the skin in the game debate is that the effect of competition on the potential value of skin in the game is influenced by a wide variety of variables and is extremely difficult to predict.

The second analysis builds upon an analogy to the race-to-the-top/race-to-the-bottom dilemma, which is frequently raised in corporate law literature. This literature has long debated the effect of competition among states seeking to attract more business entities to incorporate in their state. All states have an interest in encouraging companies to incorporate within their borders and become subject to their laws; the question is: how do states tailor their laws to achieve this result, and what is the net impact of such laws? Scholars who subscribe to a "race-to-the-bottom" analytical paradigm argue that because managers typically control where a corporation chooses to incorporate, states seek to attract corporations by enacting laws appealing to managers' personal interests, rather than protecting the interests of the

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[89] JOSEPH A. SCHUMPETER, THE THEORY OF ECONOMIC DEVELOPMENT (1961); *see also* JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM, AND DEMOCRACY (1976).

[90] *See* Richard Gilbert, *Looking for Mr. Schumpeter: Where Are We in the Competition-Innovation Debate?*, *in* INNOVATION POLICY AND THE ECONOMY 159, 160 (Adam B. Jaffe et al. eds., 2006) (surveying the economic theory and the empirical evidence on the relationship between competition, market structure, and research and development).

[91] Defined as the "difference in profit that a firm can earn if it invests in R&D [research and development] compared to what it would earn if it did not invest." *Id.* at 162.

[92] *Id.*

[93] *Id.*

corporations or investors.[94] On the other side of the coin, scholars who subscribe to a "race-to-the-top" analytical paradigm argue that a company's decision regarding its state of incorporation is largely a rational one, driven by the company's determination that its value will be maximized by good corporate governance. Therefore, those who advocate for the race-to-the-top viewpoint believe that companies will tend to incorporate in states providing robust legal protections to shareholders.[95]

The same rationales can be borrowed and applied in the context of this Article. Competition among the same type of agents (for example, among credit rating agencies or proxy advisory firms) may have opposing effects on agents' incentives and performance. The answer to the question of whether competition will lead agents' operation to the top or to the bottom largely depends on the identity of the agent, and the identity of the actor that selects and pays the agent for its services. On the one hand, competition among rating agencies may lead to "shopping," where these agents weaken their standards in order to attract more public companies as customers. Under this logic, the rating agencies would appeal to the interests of the companies by offering to give them what they want—an artificially inflated credit score—even at the expense of investors.

On the other hand, competition may lead proxy advisory firms to improve standards—such as increasing their efforts to provide more accuracy when making recommendations—to attract business from investors who select and pay proxy advisors for their voting advice. Investors concerned with the long-term profitability of the company will tend to seek out reputable proxy advisors which have a track record of providing high-quality, accurate services that will foster confidence, predictability, and stable growth (although not always producing profitable results in the short-term). In such a scenario, the proxy advisors would compete to provide the most trustworthy advice and service, knowing that investors focused on the long run will value services protective of their interests.

Empirical literature supports this possible explanation regarding credit rating agencies and proxy advisory firms. With regard to credit rating agencies, Patrick Bolton and his co-authors found that increased competition among rating agencies led to ratings inflation (a decrease in the quality of ratings), as issuers were able to shop for ratings more easily.[96] Furthermore,

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[94] *See, e.g.*, Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1441 (1992). *See generally* William L. Cary, *Federalism and Corporate Law: Reflection upon Delaware*, 83 YALE L.J. 663 (1974).

[95] *See, e.g.*, John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 691–92 (1999); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 915 (1982); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 280–81 (1985).

[96] Patrick Bolton, Xavier Freixas & Joel Shapiro, *The Credit Ratings Game*, 67 J. FINANCE 85, 86 (2012).

Bo Becker and Todd Milbourn discovered that when Moody's and S&P experienced new competition from a third agency, Fitch (which only grew into a serious player in the credit rating market after 1997), the increased competition coincided with lower quality ratings from Moody's and S&P.[97] To explain these findings, Becker and Milbourn suggested that "ratings shopping" was taking place; issuers were shopping around for favorable ratings, and the ratings that the authors observed were those that were considered most positive by the issuers.[98] Similar research provided further evidence of ratings shopping and inflation.[99]

With regard to the proxy advisory industry, recent empirical research has suggested that increased competition causes the polar opposite result: agents providing higher quality services. This research has demonstrated that "increased competition [created by] Glass Lewis' entry into the proxy market has reduced ISS's favoritism to corporate managers."[100] That is, ISS is less likely to support the views of management in a proxy contest.

In conclusion, the effect of competition on the potential value of skin in the game mechanisms appears to be largely dependent upon the identity of the actor that selects and pays the agent. In circumstances where this actor is not the investor and stands to benefit from a lower quality service, as is the case in the market for credit ratings, competition tends to affect investor value negatively. Therefore, skin in the game may be beneficial. If, however, this actor is the investor, competition will tend to increase the quality of agent services, and skin in the game may not be necessary.

III. Potential Negative Effects of Skin in the Game

In the previous section, this Article explained the factors that should be taken into account when considering if and how to adopt a system giving outside agents skin in the game. In doing so, it implicitly assumed that a skin in the game system provides only varying levels of benefit, and does not involve negative, unintended consequences. The truth, however, is that a skin in the game compensation system can produce such negative consequences, and any decisions regarding whether to create skin in the game must consider the likelihood of such consequences and their potential impact

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[97] Becker & Milbourn, *supra* note 27, at 494.

[98] *Id.* at 498.

[99] *See, e.g.*, Francesco Sangiorgi, Jonathan Sokobin & Chester Spatt, Credit-Rating Shopping, Selection and the Equilibrium Structure of Ratings 2 (2008); Efraim Benmelech & Jennifer Dlugosz, *The Credit Rating Crisis*, *in* 24 NBER Macroeconomics Ann. 2009 161, 162 (Daron Acemoglu et al. eds., 2010); Jérôme Mathis, James McAndrews, & Jean-Charles Rochet, *Rating the Raters: Are Reputation Concerns Powerful Enough to Discipline Rating Agencies?* 56 J. Monetary Econ. 657, 657 (2009); Vasiliki Skreta & Laura Veldkamp, *Ratings Shopping and Asset Complexity: A Theory of Ratings Inflation*, 56 J. Monetary Econ. 678, 691 (2009).

[100] Tao Li, *Outsourcing Corporate Governance: Conflicts of Interest and Competition in the Proxy Advisory Industry*, Mgmt. Sci. (forthcoming) (draft published Dec. 2016) (manuscript at 4), https://doi.org/10.1287/mnsc.2016.2652.

on the agent's overall output. This section offers a non-exhaustive list of negative consequences likely to occur, at least to some extent, in cases where such a system is adopted. These potential negative consequences should be considered alongside the factors listed above when deciding whether to implement a skin in the game mechanism.

A. Manipulation

As noted at the outset, skin in the game is intended to deal with an agent's incentive problem, specifically, to incentivize the agent to invest its best effort for the sake of principal's welfare in situations where the agent's input is difficult to observe. However, the incentive problem is frequently multifaceted, and sometimes an attempt to solve an agent's incentive problem may unintentionally create a different incentive problem. Incentive schemes may cause an agent to artificially misrepresent their performance to the principal, negatively influencing the principal's value for the agent's own gain. This potential problem is the direct negative consequence of self-interest—the driving force behind the power of skin in the game to motivate agents.

The potential for this manipulation problem has been widely discussed with regard to managers' compensation, especially at the beginning of the millennium after the governance scandals at Enron and WorldCom.[101] A structure of incentive-based compensation (especially stock options) makes executive pay dependent on share prices. This fact gives managers incentive to *both* improve the firm's performance *and* to artificially misrepresent the firm's performance through earnings management,[102] the timing of disclosures,[103] or otherwise. It is sometimes very hard to decouple the good incentive to improve performance from the perverse incentive to artificially inflate and misrepresent performance; these are often two sides of the same coin. This argument has become common knowledge and has received empirical support.[104] The takeaway here is that when an agent has the power to

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[101] *See, e.g.*, John C. Coffee, Jr., *A Theory of Corporate Scandals: Why the USA and Europe Differ*, 21 OXFORD REV. ECON. POL'Y 198, 202 (2005) (analyzing the pivotal role of executive compensation in securities fraud); Jared Harris & Philip Bromiley, *Incentives to Cheat: The Influence of Executive Compensation and Firm Performance on Financial Misrepresentation*, 18 ORG. SCI. 350, 352–53 (2007); Michael C. Jensen, *Agency Cost of Overvalued Equity*, 34 FIN. MGMT. 5, 14 (2005) ("In fact, in the context of overvalued equity such equity-based incentives are like throwing gasoline on a fire.").

[102] *See* Michael Faulkender et al., *Executive Compensation: An Overview of Research on Corporate Practices and Proposed Reforms*, 22 J. APPLIED CORP. FIN. 107, 113–14 (2010).

[103] Some studies find that executives manage the timing of their voluntary disclosure around stock option awards by delaying disclosure of good news and accelerating bad news prior to option grants. *See, e.g.*, David Aboody & Ron Kasznik, *CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures*, 29 J. ACCT. & ECON. 73, 74 (2000); David Yermack, *Good Timing: CEO Stock Option Awards and Company News Announcements*, 52 J. FINANCE 449, 449–50 (1997).

[104] *See, e.g.*, Natasha Burns & Simi Kedia, *The Impact of Performance-Based Compensation on Misreporting*, 79 J. FIN. ECON. 35, 36–37 (2006) (finding a high positive relationship

misrepresent performance, an incentive scheme that is dependent on performance is a double-edged sword. Faced with the multidimensional incentive problem described above, it may be appropriate for a principal to respond with simpler incentive schemes that do not tie compensation to performance in a compelling manner.[105]

B. Circumvention of Skin in the Game

Skin in the game is also likely to be detrimental in cases where an entity other than the beneficiary of the agent's services knows more than the beneficiary about the true worth of the compensation scheme and designs the agent's compensation structure. In such cases, there is a significant danger that the agent's skin in the game would be designed in a manner that was not truly in the best interest of the party that is supposed to benefit from the agent's services. Interestingly, a similar concern has been discussed by Professors Bebchuk and Fried with regard to the "camouflage" of executive compensation.[106] Bebchuk and Fried's book illustrates how those who design directors' and managers' compensation schemes "can limit outside criticism and outrage [regarding compensation arrangements that favor directors and managers] by dressing, packaging, or hiding—in short, camouflaging—rent extraction."[107] They explain that "the more reasonable and defensible a package appears, the more rents managers can enjoy without facing significant outrage."[108] Given *managers' power and ability to influence* the design of their compensation packages, managers may prefer compensation practices that obscure the real amount of compensation, and which "appear to be more performance based than they actually are."[109]

"Camouflaging" comes in many forms. Camouflaging practices may include supplemental retirement plans, lifetime health benefits, free use of company assets such as planes, cars, or apartments, security systems, large loans, and many other possible benefits, the costs of which are not reflected in the level of executive compensation that the company publicly discloses.[110] Camouflaging may occur whenever the designers of a compensa-

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between the sensitivity of the CEO's option portfolio to stock price and the propensity to misreport).

[105] *See* BOLTON & DEWATRIPONT, *supra* note 12, at 23 (suggesting "both less 'high powered' and simpler incentive schemes" in such cases).

[106] LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 67–68 (2006).

[107] *Id.* at 67.

[108] *Id.*

[109] *Id.*; *see also* Erik Lie, *On the Timing of CEO Stock Options Awards*, 51 MGMT. SCI. 802, 810–11 (2005) (illustrating how the true value of option pay may be distorted by widespread practices of option backdating and option re-pricing); M.P Narayanan & H. Nejat Seyhun, *The Dating Game: Do Managers Designate Grant Dates to Increase Their Compensation*, 21 REV. FIN. STUD. 1907, 1907–08 (2008) (making a similar point).

[110] *See* Michael S. Weisbach, *Optimal Executive Compensation Versus Managerial Power: A Review of Lucian Bebchuk and Jesse Fried's* Pay without Performance: The Unfulfilled Promise of Executive Compensation, 45 J. ECON. LITERATURE 419, 425–26 (2007).

tion structure (for instance, public companies designing compensation structures for rating agencies), know better than investors (such as debt holders) the total true value of the compensation—which, for the purposes of this Article, is the true value of any skin in the game.

The danger is that camouflaging the true value of skin in the game may create an "expectations gap."[111] Agents may then benefit from unwarranted increases in their reputation, and enjoy an undeserved level of trust in their work. Those aware of the agents' operation may believe that the agent is more trustworthy than it actually is because they think the agent is better incentivized than it actually is. Through such overestimation, skin in the game may unintendedly exempt certain agents from a large amount of "undesirable" marketplace attention, and lower the volume of necessary monitoring. Furthermore, skin in the game may alleviate criticism of the agents in cases of governance failure or scandal, by signaling (perhaps inaccurately) that the agent had given its best efforts, and that the failure was not the agent's fault.[112]

C. Psychological Factors

The rationale underlying any skin in the game mechanism—that compensating an agent based on the results of its performance—relies on two assumptions. First, that paying an agent more based on the agent's results will actually cause the agent to try harder. And second, that when an agent tries harder, this increased effort will actually translate into better results. Academic literature generally accepts both assumptions. However, there are two important caveats which deserve brief discussion.

Concerning the first assumption, it is well established in economic and psychological literature that external intervention via monetary incentives or punishments may undermine intrinsic, pre-existing motivations. This dynamic is commonly known as the crowding-out theory. Laboratory studies by both economists and psychologists, as well as field research by economists, have validated this theory regarding many areas of the economy and society.[113] Although there have been many significant developments over the last two decades concerning the *crowding-out effect*, no research—theoretical or empirical—has been conducted on any crowding out that takes places in relationships between firms and their outside agents. Despite this fact, theoretical rationales and their empirical support from the aforementioned studies on crowding out can be borrowed and applied in the context of this Article.

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[111] Eckstein, *supra* note 84.

[112] *See id*. at 78.

[113] *See, e.g.*, Bruno S. Frey, *A Constitution for Knaves Crowds Out Civic Virtues*, 107 Econ. J. 1043, 1046 (1997); Bruno S. Frey & Reto Jegen, *Motivation Crowding Theory*, 15 J. Econ. Surv. 589 (2001).

According to the major rationale of the crowding-out theory, two psychological processes account for this negative effect. First, when individuals perceive an influence—such as a skin in the game incentive structure—to be "controlling;" that is, to significantly reduce the extent to which they can determine the consequences of their actions, that controlling factor becomes a substitute for their pre-existing intrinsic motivation. In other words, the source of their motivation shifts from sources within themselves to the new, external sources.[114] Second, an external motivating factor may carry with it a signal to the actor that the actor's intrinsic motivation was not sufficient. The actor is implicitly told that it could not be trusted to sufficiently motivate itself, and any intrinsic motivation is undermined.[115] Furthermore, examination of the crowding out phenomenon could answer another question relevant to this Article's topic: in situations in which a governance device must be employed to control an agent's behavior, which type of device is preferable to ensure minimal harm to the agent's intrinsic motivation—incentives or monitoring? To the best of the author's knowledge, the crowding-out literature has not yet tackled this question, which merits further research.

Regarding the second assumption—that an increase in motivation and effort will result in improved performance—caution is warranted here as well. Research by psychologists, as well as common anecdotal wisdom, demonstrates that significantly increasing a person's motivation—in other words, imbuing them with a strong desire to perform well—can actually lead to a decrease in performance—a phenomenon known as "choking under pressure."[116] Psychological research has identified several mechanisms that can produce performance pressure. A significant mechanism is the level of performance-contingent monetary incentives.[117] Therefore, as suggested by Professor Dan Ariely and his co-authors: "[B]eyond some threshold level, it appears, raising incentives may increase motivation to supra-optimal levels and result in perverse effects on performance."[118]

D. Concluding Thoughts

Part III of this Article does not suggest, by any means, that skin in the game is ill-advised. Instead, it suggests that incorporating skin in the game into an agent's operation requires caution when designing a skin in the game scheme, as well continuous, periodic observation to ensure that the scheme is fulfilling its goals. In this respect, it is worth noting that the SEC continu-

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[114] Frey, *A Constitution for Knaves Crowds Out Civic Virtues*, *supra* note 113, at 1045.

[115] *See id.*

[116] *See* Roy F. Baumeister, *Choking Under Pressure: Self-Consciousness and Paradoxical Effects of Incentives on Skillful Performance*, 46 J. PERSONALITY & SOC. PSYCHOL. 610 (1984).

[117] *See* Dan Ariely, Uri Gneezy, George Loewenstein, & Nina Mazar, *Large Stakes and Big Mistakes*, 76 REV. ECON. STUD. 451, 452–54 (2009) (providing a brief survey of scholarship).

[118] *Id.* at 467–68.

ously updates and overhauls the format and content of mandatory compensation disclosures regarding incentive-based compensation schemes employed to incentivize corporate managers. Just recently, the SEC acted to modernize its executive compensation rules by proposing amendments on pay versus performance. These amendments attempt to make it easier for shareholders to understand the relationship between executive pay and company performance through increased transparency into the executive compensation scheme.[119] In other words, the SEC has recognized that the current skin in the game compensation structure designed for officers and directors remains imperfect, and that caution is warranted when implementing devices that give these inside agents skin in the game. Similar caution is warranted regarding any skin in the game mechanisms employed in the context of outside agents.

IV. Division of Control Between the Principal and the Agent

So far, this Article has focused on the tradeoff between monitoring an agent and incentivizing the agent's behavior by giving it skin in the game. While doing so, this Article has presumed that the principal delegates a *certain, static amount* of authority to the agent, and that the principal's main goal is to induce the agent to maximize the principal's welfare by striking an effective balance between monitoring and incentives. However, in some circumstances, especially when an agent's behavior is not observable, and its output is also not measurable, it may be more efficient simply to delegate less authority to the agent if any at all.

Agency costs are the sum of "monitoring costs," "bonding costs," and "residual loss." The phrase "monitoring costs" refers to any efforts exerted by the principal to track the agent's behavior and ensure that the agent is acting in the principal's interests. "Bonding costs," are the costs that a principal incurs when it places contractual restrictions on an agent's activities or provides additional, contingent benefits to incentivize an agent's behavior.[120] The cost to the principal of a skin in the game compensation scheme would be an example of a bonding cost. The skin in the game "bonds" the agent to the principal's ultimate success or failure. "Residual loss," reflects the costs

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[119] *See* Pay Versus Performance, 80 Fed. Reg. 26329, 26311 (proposed May 7, 2015) (to be codified at 17 C.F.R. pts. 229, 240); Public Statement by Comm'r Luis A. Aguilar, U.S. Sec. & Exch. Comm'n, Statement at an Open Meeting on Pay Versus Performance Disclosures (Apr. 29, 2015), http://www.sec.gov/news/statement/improving-transparency-for-executive-pay-practices.html.

[120] In contrast to monitoring, described above, these bonding costs associated with tracking the agents' behavior are borne by the agents themselves through self-monitoring. Agents will typically bear these costs, since effective self-monitoring creates confidence on behalf of principals that the agents will not act inappropriately. *See* Jensen & Meckling, *supra* note 1, at 308.

of the agency relationship incurred by the principal that monitoring and bonding fail to prevent.[121]

On the opposite end of the spectrum are "principal costs." As demonstrated by Professors Goshen and Squire, principal costs represent the costs that the principal would incur if it simply acted on its own behalf, whereas agency costs represent the costs that will be created if the principal delegates authority to an agent.[122] The analysis in which this Article has thus far engaged focuses on agency costs and the balance between monitoring and bonding mechanisms, with skin in the game representing the bonding side of the equation. However, another balance should be analyzed too—the balance between agency costs and principal costs.

As Goshen and Squire illustrate, in an agency relationship where investors are the principals and the managers are the agents, "control rights in a business firm are a fixed pie: more control rights for managers necessarily means less for investors. As investors delegate more control to managers, potential principal costs fall while potential agency costs rise. This tradeoff exists because investor control and managerial control are substitutes."[123] However, as Goshen and Squire explain, investor control and managerial control are not perfect substitutes. Within a discernable range of "control delegation," as more control is delegated to managers, expected principal costs fall more quickly than expected agency costs rise. In that range, delegating more control to managers is efficient. When the amount of delegated control moves outside that range, the opposite is true and expected agency costs rise more quickly than expected principal costs fall; therefore, delegating less control becomes more efficient.[124]

To translate the aforementioned discussion into the context of this Article, a principal has a wide spectrum within which it can choose how much control to delegate to the agent. At one end of the spectrum, the agent can have complete control. Such a structure minimizes potential principal costs but maximizes potential agency costs. At the opposite extreme, the principal retains full control over the matter and decides not to delegate any authority to an agent. There are no agency costs, but the principal's costs are maximized. As Goshen and Squire put it, the challenge is therefore to identify the point where the expected sum of agency costs and principal costs is minimized.[125] That point location depends on the nature of the agent, the principal, and to a large extent on specific factors that relate to the principal-agent

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[121] *See id.*

[122] *See generally* Goshen & Squire, *supra* note 3. According to Goshen and Squire, who have examined the principal-agent relationship between investors (principals) and managers (agents) of the publicly-held firms, principal costs can result from conflicts of interest among investors, investors' collective-action problems, and mistaken decisions caused by investors' lack of information or expertise. *See id.* at 772–73 (internal citations omitted).

[123] *Id.* at 5.

[124] *Id.*

[125] *Id.*

relationship. The relevance to this article is that in circumstances where skin in the game is costly to apply, overall agency costs are likely to increase. This fact may lead to a decision to delegate less control to the agent and accordingly leave more control at the hands of the principal.

V. Skin in the Game Regarding Credit Rating Agencies and Proxy Advisory Firms

So far, this Article has explained the difference between monitoring and incentives mechanisms as used to ensure that agents perform at a satisfactory level and act in the principal's best interests. It has highlighted the concept of giving agents skin in the game as an incentive device and has elaborated on the factors that will influence whether giving a particular agent skin in the game will achieve the desired results. It has described potential unintended, negative consequences of giving agents skin in the game. This Article also introduced two specific kinds of outside agents which currently attract massive attention with regard to the skin in the game notion: credit rating agencies and proxy advisory firms. This section of this Article analyzes whether, and to what extent, skin in the game would be beneficial with regard to these agents. The analysis employs the factors and concerns highlighted in earlier portions of this Article, and concludes that in the cases of credit rating agencies it would likely be beneficial to give these outside agents skin in the game; however, skin in the game is likely to be less beneficial in the case of proxy advisory firms, but should still be adopted in a cautious manner.

As a starting point, skin in the game is likely to be beneficial to both rating agencies and proxy advisory firms in the sense that it will enhance their effort levels and proactivity.[126] Conventional wisdom among many scholars today holds that rating agencies display a tendency toward responding reactively to financial crises, instead of anticipating them. They have been criticized for not being proactive. For example, as noted by Professor Steven L. Schwarcz, rating agencies have been accused of being "conservatively biased against innovation."[127] Similarly, Professor Frank Partnoy argued that rating agencies "have become reactive rather than proactive, and some evidence indicates they have maintained accurate credit ratings (*i.e.*, ratings correlated with actual default experience) due more to after-the-fact

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[126] Organizational research defines proactive behavior as "anticipatory action that employees take to impact themselves and/or their environments." *See, e.g.*, Adam M. Grant & Susan J. Ashford, *The Dynamics of Proactivity at Work*, 28 Res. Org. Behav. 3, 4 (2008). According to the authors, proactive behavior differs from more general motivated behavior and more reactive, passive behavior in two major ways: first, proactive behavior is acting in advance before being instructed to do so, and second, it exhibits intent on the part of the agent to make a positive impact. *See id.* at 8–9. Proactivity "can be applied to any set of actions through anticipating, planning, and striving to have an impact." *Id.* at 9.

[127] Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. Ill. L. Rev. 1, 18 (2002).

corrections than to predictive power."[128] It, therefore, appears that, although credit rating agencies do not currently exhibit a high level of proactivity, their industry calls for it.

Similar concerns have been raised with regard to the "one-size-fits-all" approach of proxy advisory firms, according to which advisory firms do not provide their recommendations based on companies' unique characteristics, but rather on their own rigid approach to corporate governance and views on corporate "best practice[s]."[129] It would, therefore, appear that a higher level of proactivity is being demanded from credit rating agencies and proxy advisors, indicating that it may be beneficial to give them skin in the game. However, as explained in Parts II–IV, a multiple-step analysis is required before deciding whether and how to provide these agents skin in the game.

Moreover, skin in the game should be seriously considered given that both rating agencies and proxy advisors have historically been shielded from liability. Rating agencies have had a First Amendment defense that has protected them based on an analogy to journalists,[130] and "because their ratings touch upon matters of public concern."[131] Other defenses, such as unreasonable reliance of investors on the agencies rating, are available to rating agencies as well.[132] Even after The Dodd-Frank Wall Street Reform and

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[128] Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 Wash. U. L.Q. 619, 621 (1999); *see also* Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 Cornell L. Rev. 394, 405–06 (2004) (noting that "[n]either Standard & Poor's nor Moody's downgraded Enron's debt below investment grade status until November 28, 2001, four days before the firm's bankruptcy . . . . For Enron, the corporation's $250 million in rated senior unsecured debt had declined in value from ninety cents to thirty-five cents on the dollar in the month preceding its downgrade. In other words, the market rejected the investment grade rating on Enron's debt before the credit rating agencies exercised their power to downgrade it.").

[129] *See, e.g.*, *Hearing on Proxy Advisory Firms*, *supra* note 6, at 2 (statement of Hon. Scott Garrett, Chairman, Subcomm. on Capital Mkts. & Gov't Sponsored Enters.) ("[P]roxy advisory firms often make voting recommendations based on one-size-fits-all policies and checklists."); *id.* at 15 (statement of Darla C. Stuckey, Senior Vice President, Policy & Advocacy, Society of Corporate Secretaries & Governance Professionals); *id.* at 27, 30 (testimony of Hon. Harvey L. Pitt, Founder and Chief Executive Officer, Kalorama Partners, LLC, on behalf of the U.S. Chamber of Commerce) ("ISS and Glass Lewis adopted a one-size-fits-all position and have effectively been able to mandate that all corporations do [a say-on-pay vote] on a yearly basis. This is expensive and it doesn't produce any value for shareholders, and there are studies that say it actually has acted to the detriment of shareholders."); SEC Roundtable, *supra* note 38, at 137 (testimony of Darla Stuckey, Senior Vice President of Policy and Advocacy, Society of Corporate Secretaries).

[130] Theresa Nagy, *Credit Rating Agencies and the First Amendment: Applying Constitutional Journalistic Protections to Subprime Mortgage Litigation*, 94 Minn. L. Rev. 140, 148 (2009); *see also* Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 Cardozo L. Rev. 1553, 1687–93 (2008).

[131] Caleb Deats, *Talk That Isn't Cheap: Does the First Amendment Protect Credit Rating Agencies' Faulty Methodologies from Regulation?*, 110 Colum. L. Rev. 1818, 1821 & n.16 (2010) (referring to Abu Dhabi Commercial Bank v. Morgan Stanley & Co., 651 F. Supp. 2d 155, 175 (S.D.N.Y. 2009)).

[132] John C. Coffee, Jr., Gatekeepers: The Professions and Corporate Governance 302–03 (2006).

Consumer Protection Act of 2010,[133] which, among other things, addressed rating agency accountability, increased liability for these agencies has remained complex and impractical.[134] Proxy advisors often rely upon exemptions to federal proxy rules. Indeed, they remain covered by Exchange Rule 14a-9,[135] the SEC's general anti-fraud that prohibits false and misleading statements.[136] However, the burden to show a materially false or misleading statement in a recommendation might be very difficult and impractical. Based on the insights discussed above, a serious consideration of skin in the game for rating agencies and proxy advisors is necessary.

A. Observability of Input

Given that skin in the game is an incentive device, it is important to determine the appropriate balance between monitoring and incentives. As explained in Part II.A above, this balance is primarily determined by the principal's ability to observe the agent's behavior and effort level. When an agent's operation is more transparent—that is, more easily observable by the principal—then the principal is more likely to use a monitoring device to control agent's operation.

The decisionmaking processes of credit rating agencies seem to be more transparent than those of proxy advisory firms, due in large part to regulatory reforms which took place during the last decade. In the case of rating agencies, concerns were raised over the then-existing lack of transparency concerning rating agencies' methodology, which resulted in the market's inability to understand the bases of ratings.[137] These concerns led to regulatory efforts to increase transparency, beginning with the Credit Rating Agency Reform Act of 2006,[138] followed by the Dodd-Frank Act and subsequent SEC regulations which aim to enhance, among other things, the transparency of rating agencies' methodology and performance.[139] It is important

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[133] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S. Code) (commonly referred to as the Dodd-Frank Act).

[134] *See* Stephen Harper, *Credit Rating Agencies Deserve Credit for the 2007-2008 Financial Crisis: An Analysis of CRA Liability Following the Enactment of the Dodd-Frank Act*, 68 WASH. & LEE L. REV. 1925, 1964–68 (2011).

[135] 17 C.F.R. § 240.14a–9 (2017).

[136] *See* Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42982, 43009–10 (proposed July 14, 2010) (to be codified at 17 C.F.R. pts. 240, 270, 274, 275).

[137] *See* Hunt, *supra* note 14, at 138–42; *see also* SEC. INDUS. & FIN. MKTS. ASS'N, RECOMMENDATIONS OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION CREDIT RATING AGENCY TASK FORCE 3 (2008), http://www.sifma.org/issues/item.aspx?id=21391.

[138] Pub. L. No. 109-291, 120 Stat. 1327 (codified in scattered sections of 15 U.S.C.). This Act established a registration and oversight program for NRSROs through self-executing provisions added to the Securities Exchange Act of 1934 and the implementation of rules adopted by the Commission. *Id.* at § 15E, 15 U.S.C. § 780-7 (2012).

[139] *See e.g.*, Nationally Recognized Statistical Rating Organizations, 79 Fed. Reg. 55078, 55078–80 (Nov. 14, 2014) (codified at C.F.R. pts. 232, 240, 249, & 249b); *see also* Lynn Bai, *Performance Disclosure of Credit Rating Agencies: Are They Effective Reputational Sanc-*

to note, however, that although transparency generally helps to promote observability, it does not ensure it. In many instances, it is very difficult for observers to process and understand the information that is being disclosed. This is especially true with rating agencies.[140] This is due in part because it is commonly believed that solicited ratings—which are requested and paid for by the issuers of the debt that is being rated[141]—are typically based on private information that is not available to other market participants.[142] This fact makes it much more difficult to observe credit rating agencies' input.

Similar concerns have been raised over a lack of transparency with proxy advisory firms as well. In particular, some argue that it is unclear how ISS implements its proxy voting policies.[143] This fact, as noted elsewhere, "hampers any attempt by mutual funds or the market to monitor ISS' methodologies and resulting advice."[144] After a significant wave of criticism regarding proxy advisors' operation, followed by discussions held by the U.S. Congress and the SEC, the Investment Management and Corporate Finance Divisions of the SEC issued a bulletin outlining the responsibilities of proxy advisors and institutional investors when casting proxy votes on June 30, 2014.[145] The bulletin only deals with transparency regarding advisors' potential conflicts of interests, and it does not devote any effort toward enhancing transparency with regard to proxy advisors' methodology or performance.

Furthermore, in May 2016, the Proxy Advisory Reform Act of 2016 was introduced in the House of Representatives.[146] This bill seeks to improve proxy advisors' operation by requiring them to register with the SEC. As part of the registration process, advisory firms would be required to provide information regarding, among other things, their procedures and methodologies. The advisory firms would need to disclose any potential or actual

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tions?, 7 N.Y.U. J.L. & Bus. 47, 54–63 (2010) (providing a review of previous SEC regulations).

[140] *See, e.g.*, Bai, *supra* note 139, at 68–70; Jeffrey Manns, *Downgrading Ratings Agency Reform*, 81 Geo. Wash. L. Rev. 749, 761 (2013).

[141] *See* Hill, *supra* note 20 and Part I.A.

[142] *See* Paolo Fulghieri, Gunter Strobl, & Han Xia, *The Economics of Solicited and Unsolicited Credit Ratings*, 27 Rev. Fin. Stud. 484, 492 (2013) (noting that "when soliciting a rating, firms make their books available for inspection by the rating agency and hence disclose private information to the agency that is not available to other market participants."); *cf.* Partnoy, *supra* note 128, at 663–64, n.206 ("The likelihood that credit ratings are able to generate, over several decades, substantial private information not already reflected by other market participants is also lowered, because the credit information that credit ratings discover and disseminate has the characteristics of a public good, and therefore is immediately available to all market participants at zero cost.").

[143] *See* Belifanti, *supra* note 36, at 418–20; *see also Hearing on Proxy Advisory Firms*, *supra* note 6, at 159–60 (written statement of Niels Holch, Executive Director of Shareholder Communications Coalition) (indicating that ISS provides draft copy of their reports only to S&P 500 companies, while Glass-Lewis does not provide reports drafts to any public companies except those that pay for a subscription).

[144] Belifanti, *supra* note 36, at 420.

[145] SEC Staff Legal Bulletin No. 20 (June 30, 2014), https://www.sec.gov/interps/ legal/cfslb20.htm.

[146] H.R. 5311, 114th Cong. (2016) (as reported H. Comm. on Fin. Servs., Sept. 28, 2016).

conflicts of interest created by their ownership structure and the services they provide to clients, including whether they engage in consulting services for companies, who their largest clients are (which can be disclosed confidentially to the SEC), and which policies and procedures are in place to manage conflicts that may arise in this context. Finally, the bill would give corporations a better chance to review and comment on a proposed recommendation by a proxy advisory firm before the recommendation is provided to investors.

Although the proposed Act would represent a significant step toward much-needed oversight of proxy advisors,[147] it does not guarantee a perfect control for proxy advisors operation in general nor address the acute need transparency regarding their operations. This is because proxy advisors still have broad discretion over the extent to which they should disclose their methodologies, and how they might deal with potential conflict of interests, including whether they would even disclose potential or actual conflict of interests and how they manage those conflicts. Until there is more transparency in this area, no one can really know how effective proxy advisors are at managing such conflict and what happens behind the scenes.[148]

Overall, despite recent efforts, both credit rating agencies and proxy advisory firms lack the level of transparency sufficient to warrant a thorough *consideration* of an incentive device, such as giving the agents skin in the game.

Beyond the level of transparency regarding an agent's operation, the relative complexity of an agent's tasks serves as a strong indicator of whether offering the agent incentives through a skin in the game device would be effective. The more complex the agent's tasks become, the less observable the agent's behavior will be, making skin in the game more desirable.[149] Both credit rating agencies and proxy advisory firms provide complex services and operate within uncertain environments; thus, their behavior is relatively unobservable. As noted by Frank Partnoy, "credit rating agencies increasingly focus on structured finance and new complex debt prod-

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[147] According to the bill, proxy advisory firms that would apply for registration would be required to disclose "(ii) the procedures and methodologies that the applicant uses in developing proxy voting recommendations, including whether and how the applicant considers the size of a company when making proxy voting recommendations; . . . (v) any potential or actual conflict of interest relating to the ownership structure of the applicant or the provision of proxy advisory services by the applicant . . . ; (vi) the policies and procedures in place to manage conflicts of interest . . . ." Corporate Governance Reform and Transparency Act of 2016, H.R. 5311, 114th Cong. § 3(a) (2016) (proposing to amend The Securities Exchange Act of 1934, Pub. L. 73–291, 48 Stat. 881 (1934) (codified in scattered section of 15 U.S.C.) by adding a new §15H).

[148] In this regard, some have argued that despite claims of a firewall, examples reinforce how ISS Consulting uses its relationship with ISS Research to sell business. *See, e.g.*, *Legislative Proposals to Enhance Capital Formation, Transparency, and Regulatory Accountability: Hearing Before the Subcomm. on Capital Mkts. & Gov't Sponsored Enters.*, 114th Cong. 7–8 (2016) (written testimony of Timothy J. Bartl, CEO & President, Center on Executive Compensation).

[149] *See* Prendergast, *supra* note 55 and accompanying text.

ucts, particularly credit derivatives."[150] Similar complexity characterizes proxy advisory firms' analyses and recommendations when it comes to executive pay plans;[151] mergers, and sales of assets and other reorganizations and restructurings (which require complex analyses concerning both value creation and alternative courses of action),[152] and contested director elections.[153] It appears, then, that the complexity of the operations of both proxy advisory firms and credit rating agencies tends to indicate that they would be good candidates for a skin in the game device.

Before concluding the analysis of the observability of input for rating agencies and proxy advisory firms, we should take into account that both agents are repeated players in the market. This consideration pushes towards better observability of agents' input,[154] and in turn, tilts the scale somewhat towards using more monitoring and fewer incentive structures. However, repeat engagement with these agents still does not guarantee full observability because of the complex nature of the services that rating agencies and proxy advisor firms provide.

Under the preceding analysis focusing on the observability of rating agencies and proxy advisors' *behavior (input)*, and taking into account the relatively low transparency and the high level of complexity inherent in their work, a conclusion militates in favor of using a skin in the game scheme for these agents. However, as explained in Part II.A, such analysis should not be limited just to agents' behavior (inputs). Rather, both their behavior *and* their outputs (their contribution to the principal's objectives) must be examined.

B. Measurability of Output and Risk Aversion

Recall that when outputs are difficult to measure, skin in the game becomes less attractive. In the context of this Article's analysis, credit rating agencies' output—reflected by the accurate information provided to investors regards the creditworthiness of a borrower—can be observed in a fairly

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[150] Partnoy, *supra* note 25, at 60; *see also* Michel G. Crouhy, Robert A. Jarrow & Stuart M. Turnbull, The Subprime Credit Crisis of 07 9 (July 9, 2008) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1112467 (examining the different factors that contributed to the subprime crisis and noting that "[i]nvestors in complex credit products had considerably less information at their disposal to assess the underlying credit quality of the assets they held in their portfolio," and therefore they "often came to rely heavily on the risk assessments of rating agencies").

[151] *See* Yonca Ertimur, Fabrizio Ferri, & David Oesch, *Shareholder Votes and Proxy Advisors: Evidence from Say on Pay*, 51 J. ACCT. RES. 951, 967 (2013) (noting that Say-on-Pay recommendations require "the analysis of thousands of complex and idiosyncratic compensation plans."); *id.* at 956–57 (explaining how ISS and Glass Lewis organize their analysis on Say-on-Pay along multiple dimensions); *see also* Charles M. Nathan, Latham & Watkins LLP, *Proxy Advisory Business: Apotheosis or Apogee*, HARVARD L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Mar. 23, 2011), http://corpgov.law.harvard.edu/2011/03/23/proxy-advisory-business-apotheosis-or-apogee.

[152] Nathan, *supra* note 151.

[153] *Id.*

[154] *See supra* note 56 and accompanying text.

exact manner. By contrast, proxy advisors' output—reflected by the merit of their recommendations to investors regarding how to vote—remains relatively unobservable. A credit rating agency's performance can generally be defined as its success or failure in predicting the debtor's ability to pay back the debt and the probability of default. In hindsight, whether the rating agency was correct can typically be answered with a simple, unqualified "yes" or no." Rating agencies' performance is also measured based upon other secondary parameters. In particular, ratings should have some level of stability, and should allow investors to "keep their portfolio rebalancing as low as possible."[155]

These default and stability parameters can be accurately measured retrospectively. Thus, it is not surprising to find that rating agencies provide the statistics on the accuracy of ratings complied by themselves,[156] by governmental authorities,[157] and by academics.[158] In fact, NRSROs are required by regulation to disclose extensive information about their performance,[159] including the default ratio,[160] the "fallen angels" ratio,[161] and the rating change ratio.[162] Therefore, it is typically quite easy for a principal to observe the ultimate success or failure of a credit rating agency's performance.[163]

By contrast, proxy advisory firms' output—performing advisory services on behalf of institutional investors—is far less measurable, if at all. First and foremost, there is a difficulty in defining what is considered to be a good advice.[164] There is no consensus among market observers and academ-

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[155] Edward I. Altman & Herbert A. Rijken, *A Point-in-Time Perspective on Through-the-Cycle Ratings*, 62 FIN. ANALYSTS J. 54 (2006).

[156] *See, e.g.*, MOODY'S INVESTOR SERVS., MEASURING THE PERFORMANCE OF CORPORATE BOND RATINGS 19 (2003), http://papers.ssrn.com/sol3/papers.cfm?abstract_id =996025 (reporting 82.6% accuracy for Moody's).

[157] The Financial Crisis Inquiry Commission, which studied the root causes of the financial crisis, attributed many of the failures in financial markets to rating agencies. *See* FCIC REPORT, *supra* note 9, at 118–22.

[158] *See, e.g.*, Paulo V. Carvalho, Paul A. Laux & João P. Pereira, The Stability and Accuracy of Credit Ratings 14 (Oct. 4, 2014) (unpublished manuscript), https://ssrn.com/abstract =2504972 (reporting 71% accuracy for Moody's ratings between the years 1994–2011, and 73% accuracy for S&P in the same years).

[159] Bai, *supra* note 139, at 59–63.

[160] The default ratio is the ratio of the total number of defaults to the total number of ratings that a rating agency has assigned during a specified time period.

[161] This ratio is the total number of ratings that were of investment grade at the start of the period but migrated to a non-investment grade or a default rating by the end of the period, divided by the total number of investment grade ratings that the rating agency has assigned during the period.

[162] The rating change ratio is the total number of rating changes divided by the total number of ratings assigned during a specified period.

[163] It must be acknowledged that the success or the failure of a rating agency cannot be perfectly measured because investors are not able to completely distinguish cases of "good [or bad] luck" from cases of "good [or bad] ratings." *See* Fulghieri et al., *supra* note 142, at 3. However, still, default rates are nonetheless a very good indicator of the quality of credit rating agencies' input.

[164] *See, e.g.*, Ertimur et al., *supra* note 151, at 955 (noting that whether proxy advisors' recommendations create or destroy shareholder value "is a difficult question because, in contrast to other intermediaries, such as analysts and credit rating agencies, where ex post realiza-

ics regarding the correct manner in which to resolve some of the most significant corporate governance issues, including which proxy advisory firms give voting recommendations.[165] Thus, for instance, whereas proxy advisory firms typically focus on the downsides of staggered (classified) boards of directors and recommend that shareholders oppose this structure,[166] there is a large body of research indicating that staggered boards are likely to be beneficial for shareholders.[167] Given the lack of consensus regards the merit of advisors' recommendations, it is unsurprising to find that it is quite difficult to predict whether institutional investors will follow the voting recommendations of proxy advisory firms.[168]

Additionally, the performance of a proxy advisor is influenced by many outside factors. An assessment of a proxy advisor's performance must capture the extent to which the advisor's recommendations affected voting, and in turn, whether the vote added to or detracted from shareholder value. However, despite significant academic effort to determine the true impact of voting recommendations on voting outcomes, this impact has remained woefully unclear. Although some literature has identified a positive correlation between proxy advisor recommendations and voting outcomes,[169] this correlation is not necessarily causal. Put simply, scholars cannot demonstrate that investors tend to vote in line with proxy advisors' recommendations as a result of those recommendations.

Thus, for instance, a correlation between voting outcomes and proxy advice may exist merely because investors and proxy advisors share a "common cultural approach . . . and a similar conception of best governance practices shared by investors and proxy advisors,"[170] or because of the existence of only three possible alternatives for voting proposals ("For," "Withhold," and "Against" votes).[171] Furthermore, even assuming that proxy advisors' recommendations *do* affect votes outcomes, it is not clear what "the source

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tion of earnings and default rates can be used to assess the quality of the outputs, we do not have direct ex post measures of quality of compensation plans.").

[165] Martin Lipton, Wachtell, Lipton, Rosen & Katz, *Disintermediating the Proxy Advisory Firms*, HARVARD L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Jan. 21, 2012), https://corpgov.law.harvard.edu/2012/01/21/disintermediating-the-proxy-advisory-firms ("Unfortunately the voting policies of the proxy advisory firms are usually derived from unsupported notions of what constitutes 'good governance' . . . .").

[166] *See infra* note 188 and accompanying text. When a board of directors is staggered, only a fraction of the seats will be up for re-election at any given annual meeting.

[167] *See, e.g.*, Daniel M. Gallagher & Joseph Grundfest, *Did Harvard Violate Federal Securities Law? The Campaign Against Classified Boards of Directors* (Rock Ctr. for Corp. Governance, Working Paper No. 199, 2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2536586.

[168] *See, e.g.*, Choi et al., *supra* note 34, at 869, 906; Stephen Choi, Jill Fisch, & Marcel Kahan, *Who Calls the Shots? How Mutual Funds Vote on Director Elections*, 3 HARV. BUS. L. REV. 35, 39 (2013).

[169] *See supra* note 48 and accompanying text.

[170] EUR. SEC. & MKTS. AUTH., FINAL REPORT: FEEDBACK STATEMENT ON THE CONSULTATION REGARDING THE ROLE OF THE PROXY ADVISORY INDUSTRY 12 (2013), http://perma.cc/VW43-8URB.

[171] *See id.*

of their influence" is; specifically, whether they influence shareholders because they "convey new information to investors, or [rather] because they play a certification role, protecting institutions from potential criticism" for their voting practices.[172]

Any disagreements among proxy advisory firms would increase the likelihood of detecting erroneous recommendations made by proxy advisors.[173] In other words, such disagreements would enhance the measurability of advisors' output. As explained in Part I.B, however, such disagreements among proxy advisors are extremely uncommon. While splits, when they do occur, enhance measurability, such splits are so few and far between that they do not provide any meaningful enhancement to the transparency and observability of proxy advisory firms. Finally, as the next subsection will demonstrate, proxy advisory firms are not the sole voice on proxy issues. Other factors frequently push votes in the same direction as proxy advisors' recommendations. In sum, it is quite difficult to measure proxy advisors' output, namely, to determine their contribution to the value of corporations about which they recommend.

Considering the aforementioned points regarding the measurability of credit rating agencies' and proxy advisory firms' *outputs*, that factor would militate in favor of adopting a skin in the game scheme with regard to credit rating agencies. But, it would also require us to adopt such a scheme in a cautious manner for proxy advisory firms (in other words, giving the agents a relatively small stake in the principal corporations or limiting the applicability of the incentive scheme to very specific contexts).[174] Because the success or failure of a credit rating agency's performance is relatively easy to determine, it makes sense to compensate the agency based, in part, on that success or failure. Recall also that when considering skin in the game for an agent, the agent's relative risk aversion must be considered alongside the observability of its output. The more risk-averse the agent, the less attractive a skin in the game scheme will be. Given that rating agencies act on behalf of a large set of issuers,[175] they are immune from some of the risk related to their output. That is, the agency does not experience a great deal of risk with regard to a single rating job. Recall, however, that diversification does not provide protection from market (systematic) risk,[176] and therefore, risk aver-

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[172] Nadya Malenko & Yao Shen, The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design 2 (April 2015) (unpublished manuscript), https://fisher.osu.edu/supplements/10/15459/Malenko,Shen%20(2015).pdf.

[173] *See supra* note 85 and accompanying text.

[174] It means to limit the incentive-based scheme to voting that its outcome is relatively measurable, such as mergers and acquisitions voting. *See* Eckstein & Hannes, *supra* note 50 ("Our proposed model is designed to deal with cases where shareholders reject the bid. Then, we use the market value of the shares of the target company as a performance measure.").

[175] In 2009, Moody's, Standard & Poor's, and Fitch each had slightly more than 1,000 analysts to rate about 400,000, 1,400,000, and 700,000 bond issues, respectively. *See* Lawrence J. White, *Markets: The Credit Rating Agencies*, 24 J. ECON. PERSP. 211, 217 (2010).

[176] *See supra* note 67 and accompanying text.

sion should play a role here. Taken together, these several considerations strongly indicate that skin in the game will be beneficial for credit rating agencies.

Unlike rating agencies, proxy advisory firms do not exhibit similar measurability with regard to the success or failure of their efforts. In most contexts, giving them skin in the game would likely have less value because it would be difficult to determine whether that compensation device had any impact on their effectiveness. With regard to the risk-aversion consideration, the risk involved in their work relative to a single public firm is well-diversified because many institutional investors hire proxy advisory firms to provide analysis and voting recommendations regarding thousands of public firms.[177] However, as in the case of rating agencies, market risk cannot be diversified away, and therefore risk aversion may have some impact on proxy advisory firms.

C. Multiple Agents

The multiple agents issue discussed earlier in Part II.B is relevant to both rating agencies and proxy advisors because public companies and their investors are often influenced by more than one agent. As explained earlier in this Article, a multi-agent operation may result from the operation of *the same type of agent*. This will occur when public companies hire the services of more than one agent to perform the same or similar services, such as hiring multiple rating agencies or proxy advisory firms. Although proxy advisors may differ from each other in the methodologies that they employ,[178] proxy advisors frequently make the same recommendations with regard to specific voting proposals. For example, a recent study conducted by The Conference Board, NASDAQ, and the Rock Center for Corporate Governance at Stanford University found that ISS and Glass Lewis made the same recommendation regarding say-on-pay votes[179] seventy-five percent of the time.[180] Similar results were found in studies by Ertimur, Ferri, and Oesch,[181]

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[177] *See* U.S. Gov't Accountability Office, GAO-07-765, Corporate Shareholder Meetings: Issues Relating to Firms That Advise Institutional Investors on Proxy Voting 13 (2007), http://www.gao.gov/new.items/d07765.pdf (reporting that as of 2007, ISS and Glass Lewis had 1,700 and 300 clients, respectively); RiskMetrics Grp., Inc., Annual Report (Form 10-K) 3 (Feb. 24, 2010) (reporting that at the end of 2009, ISS had 2,970 clients).

[178] *See* Choi et al., *supra* note 6, at 649 (providing evidence showing that the four proxy advisory firms—ISS, Glass-Lewis, Proxy Governance, and Egan-Jones Proxy—"differ substantially from each other in their willingness to issue a withhold recommendation, in the factors that affect their recommendations, and in the relative weight of those factors.").

[179] "The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) requires that public companies allow shareholders the opportunity to cast an advisory vote on executive compensation—a process known as say on pay (SOP)." David F. Larcker et al., The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions 1 (2012), https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-survey-2012-proxy-voting_0.pdf.

[180] *See id.* at 2.

[181] *See* Yonca Ertimur et al., *supra* note 151, at 959.

as well as by Tao Li.[182] A similarly high correlation exists between the ratings of different rating agencies. Split ratings—a situation in which two or more rating agencies give different ratings to the same issue—occurs around only twenty percent of the time.[183]

Another challenge when evaluating an agent's outcome stems from multi-agent operations involving *different types of agents*. This may occur, for example, in situations where proxy advisory firms operate alongside credit rating agencies. For core issues of corporate governance both agents share the same views and goals. For instance, credit rating agencies view corporate governance as a risk factor. In particular, they view a lack of board effectiveness and "true" independence as a significant governance problem.[184] Accordingly, a high credit rating is positively associated with board independence.[185] Relatedly, the independence of the board is also considered to have great importance to proxy advisory firms, who tend to believe that a board can best protect and enhance the interests of shareholders if it is sufficiently independent.[186] Similar views regarding other corporate governance issues, such as board declassifications,[187] are common also to proxy advisory

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[182] *See* Li, *supra* note 100, at 4 (finding a convergence in recommendations between ISS and Glass Lewis as the market share of Glass Lewis has increased).

[183] *See* Donald P. Morgan, *Rating Banks: Risk and Uncertainty in an Opaque Industry*, 92 Am. Econ. Rev. 874, 876 (2002) (investigating the disagreements between Moody's and S&P over a sample of 7,862 new bonds issued between January 1983 and July 1993 and finding a relatively high correlation between ratings over all sectors, especially with regard to banking and insurance); *see also* Michael Bowe & Waseem Larik, *Split Ratings and Differences in Corporate Credit Rating Policy Between Moody's and Standard & Poor's*, 49 Fin. Rev. 713, 714 (2014); Jeff Jewell & Miles Livingston, *Split Ratings, Bond Yields, and Underwriter Spreads for Industrial Bonds*, 21 J. Fin. Res. 185, 185 (1998) (examining 1,277 public industrial bond issues and finding 221 split ratings, issued from 1980 through mid-1993); Stefano Lugo, Annalisa Croce, & Robert Faff, *Herding Behavior and Rating Convergence Among Credit Rating Agencies: Evidence from the Subprime Crisis*, 19 Rev. Fin. 1703, 1714 (2015) (investigating herding behavior and rating convergence among CRAs during the recent subprime crisis).

[184] *See, e.g.*, Moody's Investor Servs., Lesson Learned in Moody's Experience in Evaluating Corporate Governance at Major North American Issuers 1 (2006), https://www.moodys.com/sites/products/AboutMoodysRatings Attachments/2005500000428570.pdf (highlighting the frequency with which the structure of corporate governance influences credit ratings driver); Press Release, Standard & Poor's, S&P's Governance Services Launches New GAMMA Score (Apr. 28, 2008), http://www.kase.kz/news/show/1046642.

[185] *See* Ronald C. Anderson, Sattar A. Mansi, & David M. Reeb, *Board Characteristics, Accounting Report Integrity, and the Cost of Debt*, 37 J. Acct. & Econ. 315, 315 (2004) (finding that the cost of debt is inversely related to board independence); Hollis Ashbaugh-Skaife, Daniel W. Collins, & Ryan LaFond, *The Effects of Corporate Governance on Firms' Credit Ratings*, 42 J. Acct. & Econ. 203, 203 (2006).

[186] *See* Glass, Lewis & Co., Proxy Paper Guidelines: 2015 Proxy Season 3 (2015), http://www.glasslewis.com/assets/uploads/2013/12/2015_GUIDELINES_United_States.pdf (discussing Glass Lewis's approach to proxy advice); RiskMetrics Grp., 2010 SRI U.S. Proxy Voting Guidelines 9, 11 (2010), https://www.issgovernance.com/file/files/RMG_2010_SRI_US.pdf (discussing ISS's proxy voting guidelines).

[187] Declassification is the removal of rules requiring directors to serve for staggered terms. When a board of directors is staggered, only a fraction of the seats will be up for re-election at any given annual meeting.

firms and shareholder activists (who operate as another dominant player in the US capital markets).[188]

The analysis above demonstrates how a multi-agent operation makes it difficult to measure each agent's output, and accordingly suggests some potential difficulties with adopting skin in the game compensation structures in those circumstances.

D. Reputational Dynamics

This Article also briefly discussed the possibility that an agent's reputation will serve as a sufficient motivating factor, obviating the need for further incentives such as skin in the game. Indeed, both rating agencies and proxy advisors are repeat players, and therefore reputation can become a key determinant of their behavior. However, reputation is only effective if the agent's behavior and output are readily observable.[189] It is difficult to observe the behavior of both rating agencies and proxy advisors, and it is also difficult to observe the quality of output of proxy advisors output. This difficulty derives mainly from the complexity, novelty, and opacity of products that the agents deal with,[190] and also from the fact that credit rating agencies and proxy advisory firms frequently agree with their competitors, described in Part V.C above.[191] Finally, for credit rating agencies, the disciplining effect of reputation is also limited because these agencies can issue unfavorable unsolicited ratings (ratings being conducted free of charge, without a requirement from the issuer) in order to increase their reputation by "demonstrating to investors that they resist the temptation to issue inflated ratings."[192] Reputation will, therefore, have a limited effect on both agents, and it cannot serve as a substitute for additional incentives such as skin in the game.

E. Market Power

Besides considering the relative observability of both the input and the output of credit rating agencies and proxy advisory firms, another related

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[188] During the past few years' proposals advocating for board declassification have been presented by shareholder activists. *See* George W. Dent, Jr., *A Defense of Proxy Advisors*, MICH. ST. L. REV. 1287, 1302–03 (2014). The subject of board declassification has been frequently addressed by proxy advisors, who typically recommend that shareholders support declassification and opposed staggered boards of directors. *See* GLASS, LEWIS & CO., *supra* note 186, at 20–21; RISKMETRICS GRP., *supra* note 186, at 15.

[189] *See supra* Part II.C.

[190] *See supra* notes 149–153 and accompanying text.

[191] *See* Stéphane Rousseau, *Enhancing the Accountability of Credit Rating Agencies: The Case for a Disclosure-Based Approach*, 51 MCGILL L.J. 617, 639 (2006) (noting that reputation may not work effectively in periods of crisis because "rating agencies can intensify their mutual observations, thus producing similar ratings in order to avoid being the only one wrong").

[192] Fulghieri et al., *supra* note 142, at 1.

factor must also be contemplated: the market power of the agents. As explained in Part I, both rating agencies and proxy advisors enjoy enormous market power. Both types of firms operate in oligopolistic markets (and rating agencies, in particular, have benefitted from a regulatory oligopoly due to licensing requirements placed on the debt instruments that they rate).[193] Still, some level of competition does exist. As explained in Part II.D, such competition may have opposing effects on the behavior of rating agencies and advisory firms. Specifically, competition may incentivize services of either superior quality or poorer quality. Whether competition will have a positive or negative effect on the agents' services will depend, in large part, on the identities of the actors that select the agents and pay for their services.[194]

For credit rating agencies, the managers of the corporation (and not the investors) select the rating agency and pay for its services. Therefore, as evidenced by the recent financial collapse, rating agencies may be pressured to give higher rating than are warranted to please the managers and win further business from them.[195] Furthermore, rating agencies typically have very open lines of communication with the debt issuers.[196] However, the same cannot be said regarding rating agencies' relationships with investors.[197] Therefore, it is likely that in the case of rating agencies both a conflict of interest and information asymmetry between the rating agency (the agent) and the investors (the principals) will be created and sustained. This situation may lead to excessive agency costs and may require the investors to use the skin in the game device with regard to credit rating agencies.

In the case of proxy advisors, the investors select and compensate the agents. Given that investors subscribe to those advisors that best match their assessment of which votes maximize the value of their shares, advisors are supposed to be incentivized, at least in part, by competition.[198] Further, investors have direct communication with the proxy advisors.[199] Therefore, it

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[193] *See* THE FINANCIAL CRISIS INQUIRY COMMISSION, *supra* note 9, at 439; Partnoy, *supra* note 128, at 623, 684.

[194] *See supra* Part II.D.

[195] *See* Becker & Milbourn, *supra* note 27, at 494, 499; Coffee, *supra* note 26, at 254.

[196] *See, e.g.*, U.S. SEC. & EXCH. COMM'N, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKET 21–22 (2003), https://www.sec.gov/news/studies/credratingreport0103.pdf.

[197] It is not to say that rating agencies and institutional investors, especially the largest investors, do not have any connection; in fact, they do. However, this is not the kind of direct relationship that exists between rating agencies and issuers or proxy advisors and investors which is at issue here.

[198] As explained earlier, investors do not have a good understanding of the basis for voting recommendations of the various proxy advisors. Therefore, it is commonly believed that proxy advisors are badly incentivized.

[199] *See, e.g.*, SEC ROUNDTABLE, *supra* note 38, at 154 (testimony of Anne Sheehan, Director of Corporate Governance at CalSTRS) ("I think what it is is the customers have to talk to these two firms [ISS and Glass Lewis] about what we want and what we need, and that's what we do, and we do it on an annual basis."); *id.* at 103 (statement of Mr. Trevor Norwitz, Partner, Wachtell, Lipton, Rosen & Katz) ("Right now these are for-profit businesses, and you know, when they are, you have to listen very closely to what your customers tell you").

is less likely that information asymmetry between the advisor (the agent) and the investors (the principals) will be created. And, as opposed to rating agencies, there is less indication that skin in the game is merited for proxy advisory firms. However, there remain potential conflicts of interest; as noted in Part I.B, one of the two leading proxy advisors—ISS—provides services to both institutional investors and corporate clients.[200] Therefore, it may be that with regard to the ISS, skin in the game may be required. To identify the exact effect of ISS's conflict of interest has on its operations and the value of skin in the game, further research is required.

F. Potential Negative Effects

Finally, the potential negative, unintended effects of a skin in the game mechanism must also be considered. They are examined in detail below. Although some of them are likely to exist in the case of both credit rating agencies and proxy advisory firms, it seems unlikely that any effects will be detrimental enough to obviate the expected gains from a skin in the game mechanism.

First, we must examine the risk that skin in the game will cause the outside agents to inflate the value of their performance artificially. This concern is largely relevant only to credit rating agencies. Recall that under the proposed structure of a skin in the game mechanism for credit rating agencies discussed earlier in this Article, credit rating agencies should be compensated (at least in part) by the debt that they rate. While this compensation method provides beneficial incentives against overrating when the debt is issued, it creates the risk that the rating agency will manipulate their future ratings of the same debt.[201] This possibility is especially troubling given that solicited ratings are based, to a large extent, on private information that is not available to other market participants.[202]

The possibility of manipulation has been acknowledged by Listokin and Taibleson who suggested that particular form of skin in the game for rating agencies.[203] To deal with this risk, they suggested keeping the rating agency tied to the debt instrument until it matures by paying the agency incrementally over the life of the instrument, instead of all at once. Thus, the

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[200] In fact, a significant portion of ISS's revenue comes from corporate clients. *See, e.g.*, *Hearing on Proxy Advisory Firms*, *supra* note 6, at 87 (Appendix item CENTER ON EXEC. COMPENSATION, A CALL FOR CHANGE IN THE PROXY ADVISORY INDUSTRY STATUS QUO 15 (2011)) (citing INSTITUTIONAL SHAREHOLDER SERVS., INC., DUE DILIGENCE COMPLIANCE PACKAGE 7 (2010), https://www.issgovernance.com/file/files/ISSDueDiligenceCompliancePackage.pdf for the proposition that "ISS has also disclosed on its website that approximately 17 percent of its total revenues are generated from its ICS subsidiary, which provides consulting services to corporations").

[201] Either because the rating agency is not required to hold debt until maturity or because the rating agency wishes to attract additional business by providing inflated incentives.

[202] *See supra* note 129 and accompanying text.

[203] *See* Listokin & Taibleson, *supra* note 30, at 104–06.

rating agency's incentives to artificially inflate the debt's rating to increase the value of its last payment will be counterbalanced by its interest in receiving the full value of its next compensation installment.[204] In contrast to rating agencies, it would be very difficult for proxy advisory firms to manipulate the value of their output, since their actions do not affect corporation's market value, at least not directly.

Second, a potential circumvention of the skin in the game scheme may exist with credit rating agencies. Recall that rating agencies are paid by corporations—debt issuers—to estimate the default probability of debts. Recall also that according to the proposed skin in the game scheme, rating agencies would be paid with debt they rate. Using the model explained in Part II.A, the issuer D would pay $500 to the rating agency R. If R gives D an AAA rating, then each unit of D's debt is worth $0.90 and R would receive 555.56 units of debt ($500/$0.90), and if R gives D a BBB rating, then each unit of D's debt is worth $0.80 and R should receive 625 units of debt ($500/$0.80). This model is supposed to give R an incentive not to overrate.[205]

However, given that both the issuer D and the rating agency R may be self-interested—D wants R to overrate its debt, and R wants D to consistently choose its services over the services of other credit rating agencies—collusion may arise, and the skin in the game scheme may be circumvented. An example given by Listokin and Taibleson illustrates this point.[206] Suppose again that the market rate of a rating service is $500. If R rated BBB debt as AAA, its fee would be $444.40 (555.56 units x $0.80 which is the true value of the BBB debt in the credit markets). However, if the issuer is confident that R will overrate its debt, it may be willing to pay more units of debt to better compensate R; thus, it may be willing to pay 625 units of debt, equivalent to rating fee of $500 (625 x $0.80).[207]

The upshot here is that implementing a skin in the game mechanism may create complacency and the illusion that a rating agency is highly motivated to act in the investors' best interest. An expectation gap can form between market participants' expectations that rating agencies will exercise a high level of fidelity and effort because they have skin in the game and the reality that perhaps agencies' other interests could trump the interest created by the skin-in-the-game mechanism. This situation could merely decrease the efficacy of other controlling devices, such as monitoring, without any real increase in the rating agency's incentive to work in the investors' interest.

Third and finally, we must consider the potentially negative psychological effects of skin in the game. As discussed in Part III.C, giving an agent skin in the game can "crowd out" other intrinsic motivations toward good

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[204] *See id.* at 106.
[205] *See supra* Part II.A.
[206] *See* Listokin & Taibleson, *supra* note 30, at 106–07.
[207] *See id.*

performance that the agents already had. If this occurs, then the skin in the game mechanism may not result in any significant increase in the agent's motivation level. Giving an agent skin in the game may also result in the agent feeling increased pressure to perform well, and the agent could falter under that pressure. Both psychological considerations are relevant to credit rating agencies and proxy advisory firms. However, insufficient data and discussion currently exist to determine the extent to which these two factors will negate the benefits of giving agents skin in the game. Instead, it is sufficient to point out that these considerations should be taken into account.

In an effort to simplify the foregoing discussion, this Article provides the following chart. It identifies all of the relevant considerations discussed above and derived from Parts II and III with regard to whether it would be advisable to adopt a skin in the game compensation system for outside agents. The chart then indicates whether the listed factors militate in favor of, or against, giving credit rating agencies and proxy advisory firms skin in the game.

Considerations	**Credit Rating Agencies**	**Proxy Advisory Firms**
Observability of Input	Supports giving skin	Supports giving skin
Observability of Output	Supports giving skin	Discourages giving skin
Risk-Aversion	Relatively discourages giving skin	Relatively discourages giving skin
Reputational Dynamics	Relatively supports giving skin	Relatively supports giving skin
Multiple Agents	Relatively discourages giving skin	Relatively discourages giving skin
Agent's market power	Relatively supports giving skin	Relatively discourages giving skin
Potential Negative Effect – Manipulation	Discourages giving skin	Not a relevant consideration
Potential Negative Effect – Circumvention of Skin in the Game	Discourages giving skin	Not a relevant consideration
Potential Negative Effect – Psychological Reasons	Unclear	Unclear

In light of the foregoing discussion, we can conclude that skin in the game will likely be beneficial with regard to both credit rating agencies and proxy advisory firms, but with regard to proxy advisory firms should be employed cautiously. Both agents engage in relatively complex tasks, and their behavior is relatively unobservable. It is therefore difficult for principals to monitor them, and principals would generally benefit if the agents were better motivated to exert sufficient effort on the principals' behalf. This is a much closer call for proxy advisors. In contrast to credit rating agencies, it is difficult for investors (principals) or other observers to

measure the effectiveness or value of the proxy advisor's output. This suggests that skin in the game will be less useful. Thus, while skin in the game is likely to be beneficial in both contexts, it will often be more beneficial when dealing with credit rating agencies.

Before concluding, it is worth mentioning that the foregoing analysis has highlighted a problem inherent in the current service model employed by proxy advisory firms. As demonstrated, these firms are not terribly amenable to a skin in the game mechanism. However, it is also quite difficult to monitor them as well. Because while some considerations—mainly the observability of the firms' output—suggest that skin in the game may not be sufficiently beneficial, it is still quite difficult to observe proxy advisors' behavior. This suggests that monitoring will not be effective, either. So perhaps there is a third possibility, apart from monitoring or skin in the game (incentives). As discussed in Part IV, when neither monitoring nor incentive mechanism is feasible, delegating less authority to the agent should be seriously considered. This means that heavy reliance of institutional investors on proxy advisory firms should be re-examined, based on the analysis offered in this Article.

Conclusion

The concept of skin in the game represents a powerful mechanism for motivating agents to perform at their best. It is an incentive-based compensation that ties agents' pay to their performance. In the wake of the financial crisis, market observers have begun clamoring for stricter controls on the behavior of the outside agents serving publicly-held companies and their investors. Until this point, however, no serious effort has been exerted by scholars or market participants to answer the questions of whether outside agents should be given skin in the game. In this author's view, such a lack of attention is a serious mistake. Just as skin in the game has been beneficial in the context of inside agents (directors and managers), so may it be put to use with certain outside agents for the benefit of investors. But before employing such a mechanism, corporations, investors and policy makers must understand the factors which will influence its effectiveness. This Article lays the groundwork for an analysis of when skin in the game may be beneficial with regard to any given outside agent.

There are a myriad of considerations which must be analyzed before deciding to give a particular agent skin in the game. The most important among those factors are the relative observability of the agent's input (the agent's behavior and level of effort) and output (the agent's contribution to the principal's goals and welfare). Numerous other factors beyond observability (some of which, however, are related to observability) will come to bear on the ultimate decision of whether to give an agent skin in the game. These factors include the agent's market power, the number and type of

agents simultaneously working for the same principal and goals, and potential negative effects of skin in the game.

This Article does not seek to establish a precise formula for weighing these factors; it merely seeks to highlight the considerations that a principal or a policymaker should undertake when making that decision. Whether skin in the game will be appropriate must be determined on a case-by-case basis, which will depend on the type of outside agent and application of the factors discussed in this Article. To better illuminate the kind of searching inquiry required, this Article applies the factors discussed herein and concludes that skin in the game will likely be beneficial in the case of credit rating agencies and less beneficial in the case of proxy advisory firms. Similar analyses will be necessary involving proposals to give different outside agents skin in the game.

The point here is that an incentive mechanism—skin in the game—used, more or less, with success in the context of inside agents should be strongly considered in the context of outside agents as well, especially considering the dangers that these agents pose to the global financial markets if their behavior is not sufficiently circumscribed. Although skin in the game may not always be appropriate in the context of particular outside agents, investors are best served when corporations and policy makers thoughtfully consider all of the tools at their disposal. Skin in the game holds much promise, and the device should be employed whenever the situation calls for it.