A LONG / SHORT INCENTIVE SCHEME FOR PROXY ADVISORY FIRMS

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ABSTRACT

Proxy advisory firms such as ISS or Glass Lewis play an important role in our capital markets. They advise institutional investors how to vote in shareholders' meetings and often have a dramatic influence on the outcome. Such immense power, however, has sparked concern and calls for regulation, given that proxy advisors have no "skin in the game". In this Article we propose a novel framework for an incentive pay scheme for proxy advisors within the highly important context of Mergers and Acquisitions, that would align their incentives properly. In short, instead of their current flat fee arrangements, part of the advisors' fees would be used to create the following incentive framework: if proxy advisors recommend their clients to vote against an acquisition, and shareholders accept their recommendation, proxy advisors should be placed in a "long" position on the stock of the target. The advisor would gain if share prices eventually pass the acquisition price and lose if they do not. However, if proxy advisors recommend shareholders to accept an acquisition and shareholders nevertheless reject the takeover bid and advice, the proxy advisor should be placed in a "short" position on the stock. They will lose if share prices eventually pass the acquisition price and gain if they do not. In the Article we discuss how to implement and promote this proposal.

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INTRODUCTION

Proxy advisory firms play a highly influential role in the capital markets all over the world. These firms help institutional investors determine how to vote their clients' shares on thousands of proxy questions companies pose each year.[1] Academic research has found, empirically, that proxy advisors have a strong impact on the voting outcome in many cases.[2] Furthermore, studies of proxy advisors' impact on voting results understates their influence on the market as a whole, given that companies try to meet the proxy advisors' standards and expectations in the first place.[3]

The leading proxy advisory firms – Institutional Shareholder Services ("ISS") and Glass, Lewis & Co. ("Glass Lewis"), which together account for 97 percent of the industry[4] – have been called "de facto corporate governance regulators,"[5] and "de facto arbiters of U.S. corporate governance."[6] Their voting

[1] *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. 2 (2013) [hereinafter: Hearing Before the House of Rep.], *available at* https://financialservices.house.gov/uploadedfiles/113-27.pdf (introducing the subject of public shareholder proxy advising).

[2] *See infra* Section I.B.

[3] *See generally* David F. Larcker, Allan l. McCall & Gaizka Ormazabal, Proxy Advisory Firms and Stock Option Pricing, 56 J. ACCOUN. ECON. 149, 150 (2013) (explaining how "boards may respond to [proxy advisors] influence by making [compensation plan and corporate governance] choices that increase the likelihood of receiving a favorable recommendation from proxy advisors.") In the context of executive compensation, a 2010 survey found that "54 percent of survey respondents said they had changed or adopted a compensation plan, policy or practice in the past three years primarily to meet the standards of a proxy advisory firm." *See* CENTER ON EXEC. COMPENSATION, A CALL FOR CHANGE IN THE PROXY ADVISORY INDUSTRY STATUS QUO 3-4 (2011).

[4] To get a sense, the combined revenue of ISS and Glass Lewis ranges between approximately 250 and 350 million dollars per annum. *See*, Hearing Before the House of Rep., *supra* note 1, at 31.

[5] Letter from Wachtell, Lipton, Rosen & Katz, to Elizabeth M. Murphy, Sec'y, SEC 6 (Oct. 19, 2010), *available at* http://www.sec.gov/comments/s7-14-10/s71410-129.pdf [hereinafter: Wachtell Letter].

[6] Hearing before the House of Rep., *supra* note 1, at 7 (introducing the subject of public shareholder proxy advising.) (a statement of Harvey Pitt, founder and CEO of global business consultancy firm Kalorama Partners, formerly 26th Chairman of the SEC, on behalf of the U.S. Chamber of Commerce).

recommendations have been described as "a strong predictor" of voting outcomes,[7] and "a milestone" for many crucial deals.[8] The question, "'What will ISS say?' is regularly asked in the board rooms,"[9] and dissidents of managements frequently admit that they "couldn't have won without ISS."[10] Recent market and legal developments, such as the Dodd-Frank Act's Say-on-Pay provisions, have further fortified proxy advisors' potency. Given such immense power, it is no wonder that management teams frequently lobby proxy advisors to endorse their positions. As Chief Justice of the Delaware Supreme Court Leo Strine noted: "[P]owerful CEOs come on the bended knee to Rockville, Maryland, where ISS resides, to persuade the managers of ISS of the merits of their views about issues like proposed mergers, executive compensation, and poison pills."[11]

Recognition of the major role played by proxy advisory firms has also sparked much criticism. Critics persistently complain that proxy advisory firms' activities lack transparency, that proxy advisors operate in oligopolistic markets, that they have a check-the-box mentality, and that they suffer from conflicts of interest.[12] But above all, critics have accused proxy advisors of having no "skin in the game."[13]

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[7] Transcript of Proxy Advisory Firms Roundtable, SEC 41-42 (Dec. 5, 2013), https://www.sec.gov/spotlight/proxy-advisory-services/proxy-advisory-services-transcript.txt, at 17 [hereinafter: SEC Roundtable].

[8] In a 25-page report issued in March 2002, ISS supported the merits of the HP and Compaq merger. Michael Capellas, Compaq chairman and CEO, noted in a statement that "Today's ISS recommendation to Hewlett-Packard shareholders represents an important milestone in the merger process…." *See* Jim Greer, *Compaq, HP Merger Deal Lands Critical Support*, HOUSTON BUS. J. (Mar. 11, 2012), https://www.bizjournals.com/houston/stories/2002/03/11/story4.html.

[9] Hearing Before the House of Rep., *supra* note 1, at 16.

[10] *See* Shawn Tully, *Taking a Guesswork Out of Proxy Voting*, FORTUNE (Dec. 21, 2006), available at http://archive.fortune.com/magazines/fortune/fortune_archive/2006/12/25/8396763/index.htm

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

[12] *Infra* Part I.C.

[13] See *generally* Asaf Eckstein, *Skin in the Game for Credit Rating Agencies and Proxy Advisors: Reality Meets Theory*, 7 Harv. Bus. L. Rev. 221 (2017).

Despite their great influence over companies' votes and practices, proxy advisory firms "have no economic interest in the companies for which they are giving their recommendation."[14] They operate "without a horse in the race,"[15] and on top of that "[do not] owe fiduciary duties to the corporations whose policies they seek to influence."[16] Put differently, proxy advisory firms are not subject to the impact that their advice has – both positive and negative – on the public corporations and their shareholders.

While Congress and the SEC contemplate legislation and regulation to tackle some of the shortfalls of proxy advisor involvement without sharing in the outcome of their advice, we offer a different approach – designing a suitable pay-for-performance scheme for proxy advisory firms. In contrast to the current flat fee for advisory services, we offer a novel model which is based on a long/short position on the shares of the company that is the subject of the vote recommendation. This model is suitable for vote recommendations that have a large impact on the welfare of the shareholders of the relevant company. In this Article we concentrate on M&A deals. In many cases, proxy advisors' recommendations can make or break a transaction that has a huge impact on the shareholders on both sides of the transaction.

In designing a pay-for-performance scheme aimed at improving proxy advisors' recommendations in the M&A context, one can take advantage of the market value of the shares of the target. However, this presents a twofold challenge. First, on the target side, when a cash bid is ultimately accepted, the target is delisted and it is impossible to use the market price of the target's stock in the compensation scheme. Second, the shareholders of the target firm may overrule the advisory firm's recommendations and vote against the advice. In such a case, the compensation scheme

[14] Hearing Before the House of Rep., *supra* note 1, at 9 (testimony of Timothy J. Bartl, President of the Ctr. On Exec. Comp.). *See also* Commissioner Daniel M. Gallagher, *Outsized Power & Influence: The Role of Proxy Advisers*, WASHINGTON LEGAL FOUNDATION (Working Paper No. 187, August 2014), *available at* http://www.wlf.org/upload/legalstudies/workingpaper/GallagherWP8-14.pdf, at 8.

[15] Wachtell Letter, *supra* note 5, at 1.

[16] Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1765 (2006).

should be carefully crafted to reflect the value of the recommendation of the advisor and not the contradicting decision of the clients.

Our proposed model is designed to deal with these two challenges, at least in part. We suggest that in the case of an advisory firm recommendation to reject a bid, and an ensuing decision by the shareholders (in line with the recommendation) to reject the bid, the advisory compensation shall be crafted to put the proxy advisor in a long position on the target stock. However, if the advisory firm recommends accepting a bid, and the bid is rejected contrary to the advisory firm's recommendation, the advisory firm's fee shall be crafted to put the proxy advisor in a short position on the target stock. Such a compensation structure provides the proxy advisors with a healthy portion of skin in the game that does not exist under today's framework. Because there is always a chance that the bid will be rejected, or even more frequently, withdrawn, the proposed pay-for-performance scheme means that the proxy advisor must be ready to put its money where its mouth is. This is especially true given the increasing number of failed M&A deals. In 2016 more than 20% of the announced 3.9 trillion global deal volume has eventually broken apart.[17] Hence, proxy advisors should always be ready to bear the financial consequences of their recommendations.

To explain how our scheme plays out, consider a bid of $35 per share for a target that is traded at $30 per share. If the proxy advisor recommends rejecting the deal, then it must be prepared to stand behind its recommendation. If the bid is indeed rejected (or withdrawn before the vote), the advisory fee shall be used in part to purchase a forward contract to buy the target shares for $35 each. When the time comes to close the forward agreement (say in two years), the proxy advisor will gain if target share price rose beyond the contract price (which is the rejected deal price of $35), and lose if the target share price did not meet the threshold. Note that when

[17] Matthew Toole, *Deal Making 2016: Surprise Left in Store*, THOMSON REUTERS, *available at* https://financial.thomsonreuters.com/content/dam/openweb/documents/pdf/financial/deal-making-2016.pdf, at 9. *See also Global M&A Review: Full Year 2016*, Dealogic, *available at* https://publishing.dealogic.com/ib/DealogicGlobalMAReviewFullYear2016FINALMEDIA.pdf, at 4.

the target share price reaches exactly $35 at the relevant time, the fee generated by the proxy advisor equals the fixed fee structure under the current pay system. Like the shareholders, the proxy advisor would neither gain nor lose from the rejection of the bid.

A contrary scenario follows if the proxy advisor advises the clients to accept the $35 bid. Here too the proxy advisor must be prepared to put its money where its mouth is. In case the bid is rejected against the recommendation, the advisory fee shall be used in part to purchase a forward contract to sell the target shares for $35 each. When the time comes to close the forward agreement (say in two years), the proxy advisor will gain if target share prices are below the contract price (which is the rejected deal price), and lose if the target share prices rose beyond the threshold.

To conclude, our model of a long/short compensation scheme improves proxy advisors' incentives and makes their recommendations more credible. This incentive-aligning compensation scheme therefore also alleviates concerns recently voiced by the U.S Congress, the SEC, practitioners, and the media. In this Article, we explain why our proposal is important and why a similar scheme has not emerged in the market thus far. We will also explain that while we do not recommend making our proposed model mandatory, we believe that the regulator should encourage or at least acknowledge its benefits, which should allow it to flourish. SEC'S Staff Legal Bulletin No. 20 (SLB-20), issued in June 2014, requires investment advisors (i.e., institutional investors) to ascertain that proxy advisory firms have the capacity and competency to adequately analyze proxy issues. SLB-20 ignores, however, the important aspect of proxy advisors' fee. We suggest amending SLB-20 to require institutional investors to contemplate whether the proxy advisor's fee arrangement promotes effective performance. Specifically, they should consider if the advisor fee structure should be sensitive, at least in part, to advisors' performance.

The Article continues as follows: Part I provides background for our inquiry by describing the evolution of proxy advisory firms and the structure of the proxy advisory industry. Part I then continues by describing the influence of proxy advisors on the votes of institutional investors, as well as the criticism directed toward proxy advisors (in particular the criticism that they have no skin in the game.) Part II delineates the existing legislative and regulatory setup that governs proxy advisors' operation as well as the proposed legislation aimed at improving the procedures that proxy advisors use in formulating voting recommendations. We show how these existing and proposed legal safeguards have limited power in enhancing the quality of the advisors work. As such, this Part lays the groundwork for the incentive-based model for proxy advisory firms, which we expand upon in Part III. Following the introduction of our proposal, we consider certain questions and objections that are raised by our incentive-based model. Part IV briefly concludes the discussion and sheds light on some hidden benefits of our proposal.

I. BACKGROUND

A. The Evolution of the Proxy Advisory Industry

Proxy advisory firms provide institutional investors with research and recommendations regarding how to vote on various matters as shareholders in public corporations. ISS, which controls approximately 61 percent of the market, and is seen as the leader of the proxy advisory industry,[18]was founded in 1985.[19] The proxy industry is exceptionally concentrated. ISS was a monopoly for almost twenty years until its main competitor, Glass Lewis, was established in 2003. Today Glass Lewis has a market share of approximately 36 percent.[20] The other, much smaller firms, that operate within the advisory industry are Egan-Jones Proxy Services (Egan-Jones), operating since 2002; Marco-Consulting Group, operating since 1988; and ProxyVote Plus which was formed in 2002.[21]

[18] Tamara C. Belinfanti, *The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control*, 14 STAN. J.L. BUS. & FIN. 384, 397 (2010).

[19] *Id*.

[20] *Id*., at 395-396.

[21] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-17-47, CORPORATE SHAREHOLDER MEETINGS: PROXY ADVISORY FIRMS' ROLE IN VOTING AND CORPORATE GOVERNANCE PRACTICES 7-8 (2016) [hereinafter GAO 2016], *available at* file:///C:/Users/User/Desktop/GAO.pdf. There are also several European firms that offer international research. *Id*., at 6 & n. 10. Another proxy advisory firm, Proxy Governance, Inc. was acquired in 2011 by Ernst & Young.

While the business models of proxy advisory firms may vary from firm to firm, it is important to note that ISS provides both proxy voting recommendations to institutional investors and consulting services to corporations seeking assistance with improving their corporate governance ratings or with crafting proposals to be presented to shareholders. To avoid potential conflict of interest, other proxy advisors do not offer corporate governance advice to public companies, and instead sell their advisory services exclusively to institutional investors.[22]

A few major factors have fueled the proxy advisory industry. First, the growth in importance of the proxy advisory industry closely follows the immense growth of institutional investors over the past few decades.[23] Institutional investors, the proxy advisors' clients, now account for around 70% of share ownership in the largest U.S corporations.[24] Moreover, the largest twenty-five institutions hold more than 30% of all U.S. corporate shares, and the largest ten managers manage 23.4% of all assets.[25] Second, during the last two decades, corporate law and regulation have significantly expanded the types of issues now subject to shareholder votes. Accordingly, institutional investors are being called upon much more frequently to cast their votes. This load has created a strong relationship between institutional investors and proxy advisory firms.[26] To illustrate, every year BlackRock, one of the largest institutional investors and money managers, "vote[s] globally at more than 15,000 shareholder meetings, on over 130,000 proposals."[27] Similarly, Vanguard, another major money manager,

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[22] *See* Belinfanti, *supra* note 18, at 397 (explaining that such potential conflict exists only for ISS, because the other proxy advisors do not provide consulting services); *see also* Hearing Before the House of Rep., *supra* note 1, at 403 (statement of Katherine H. Rabin, Chief Exec. Officer, Glass Lewis & Co.) (stating that Glass Lewis does not provide consulting services).

[23] Asaf Eckstein, *Great Expectations: The Peril of an Expectations Gap in Proxy Advisory Firm Regulation*, 40 DEL. J. CORP. L. 77, 89-90 (2015).

[24] *Id; Marcel Kahan & Edward Rock, Embattled CEOs*, TEX. L. REV. 987, 995-97 (2010) (discussing the rise in power of institutional investors and its consequences).

[25] Zohar Goshen & Sharon Hannes, *Delaware's Retreat* (working paper 2018) (on file with the authors).

[26] Eckstein, *supra* note 23, at 90.

[27] BlackRock, *Investment Stewardship*, https://www.blackrock.com/corporate/en-gb/about-us/investment-stewardship (last visited October 30, 2017).

voted at 12,785 meetings in the 2015 proxy season,[28] 16,740 meetings in the 2016 proxy season, and 18,905 in the 2017 proxy season.[29] Finally, State Street Global Advisors, a third major money manager, voted at 15,471 meetings in the 2015 proxy season and at 17,337 meetings in the 2016 proxy season.[30]

Third, regulatory initiatives that have reinforced the fiduciary duties of institutional investors' duty to vote their proxies in the best interest of their clients have enhanced proxy advisors' power. The 1988 Department of Labor opinion letter regarding pension funds,[31] and a 2003 SEC rulemaking regarding mutual funds and investment advisors, requiring institutional investors to disclose how they voted on proxy proposals presented at shareholder meetings are two major regulatory initiatives that have done this.[32] Relatedly, two SEC interpretations, issued in 2003 and 2004, clearly indicated that investment advisors could discharge their duty to vote their proxies (and demonstrate that their vote was not a product of a conflict of interest), if they voted in accordance with a predetermined policy and based on the recommendations of an independent third party - a proxy advisory firm.[33]

The key takeaway here is that the growth of institutional investors, the increase in the volume of proxy votes, the regulatory mandates regarding the duty to vote and the clearance from conflict of interests to institutional investors who use proxy advisory

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[28] Proxy season begins on July 1st and ends on June 30th the next year.

[29] Vanguard, *Investment Stewardship 2017 Annual Report*, https://about.vanguard.com/investment-stewardship/annual-report.pdf, at 6.

[30] State Street Global Advisors, *2016 Annual Stewardship Report*, https://www.ssga.com/investment-topics/environmental-social-governance/2017/2016-Annual-Stewardship-Report-Year-End.pdf 4 (last visited October 30, 2017).

[31] Eckstein, *supra* note 23, at 91. The 1988 Department of Labor letter is commonly known as the "Avon Letter". This letter explains that "shareholder voting rights are considered valuable pension plan assets under the Employee Retirement Income Security Act (ERISA) and therefore the fiduciary duties of loyalty and prudence applied to proxy voting." This requires "pension plan fiduciaries…[to] vote the plan's shares on the basis of active analysis, regardless of whether or not the fiduciary was certain that expending time and effort to analyze how to vote would create value for a fund." *Id.*

[32] *Id.*, at 91-92; *see also* Martijn Cremers & Roberta Romano, *Institutional Investors and Proxy Voting on Compensation Plans: The Impact of the 2003 Mutual Fund Voting Disclosure Regulation*, 13 AM. L. ECON. REV. 220 (2011).

[33] Eckstein, *supra* note 23, at 92-93.

services, have all led to a dramatic spur in importance for proxy advisory firms.

B. Proxy Advisors' Impact

As explained above, proxy advisory firms play a crucial role in the proxy voting system. As such, it should come as no surprise that their influence on shareholder voting is significant. Scholars have recently provided empirical support for advisors' power. For example, Cai, Garner and Walking found that in director elections ISS is able to sway a significant fraction of the shareholder votes.[34] Bethel and Gillan found that "ISS recommendations unfavorable to management were associated with 13.6% to 20.6% fewer votes cast in favor of management, depending on proposal type."[35] In the context of executive compensation, a study by Cotter, Palmiter and Thomas, found that say-on-pay proposals with a positive ISS recommendation received on average of 28.2% more shareholder support than say-on-pay proposals with a negative ISS recommendation.[36] Similarly, a 2013 study by Ertimur, Ferri and Oesch found that negative ISS and Glass Lewis recommendations are associated with 25% and 13% more votes against executive compensation plans, respectively.[37] Finally, a 2015 study by Nadya Malenko and Yao Shen also found that negative ISS

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[34] *See* Jie Cai, Jacqueline L. Garner & Ralph A. Walking, *Electing Directors*, 64 J. FIN. 2389, 2391 (2009) (finding that directors receiving a negative recommendation from ISS receive 19% fewer votes). *But cf.* Stephen Choi, Jill Fisch & Marcel Kahan, *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. 869, 870 (2010) (analyzing the significance of voting recommendations issued by proxy advisors in connection with uncontested director elections, estimating that an ISS recommendation shifts 6%-10% shareholder votes and concluding that the influence of ISS is overstated.).

[35] Jennifer E. Bethel & Stuart L. Gillan, *The Impact of the Institutional and Regulatory Environment on Shareholder Voting*, 31 FIN. MGMT. 29 (2002).

[36] James F. Cotter, Alan R. Palmiter & Randall S. Thomas, *The First Year of Say-on-Pay Under Dodd-Frank: An Empirical Analysis and Look Forward*, 81 GEO. WASH. L. REV. 967, 982 (2013).

[37] Yonca Ertimur, Fabrizio Ferri, & David Oesch, *Shareholder Votes and Proxy Advisors: Evidence from Say on Pay*, 51(5) J. ACC. RES. 951 (2013). *See also* Yonca Ertimur, Volkan Muslu & Fabrizio Ferri, *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).

recommendations reduce the votes in favor of say-on-pay proposals by approximately 25%.[38]

Furthermore, the evidence of direct influence described above hardly tells the whole story. These studies understate advisors' influence on the market as a whole, given that companies try to meet the proxy advisors' standards and expectations in the first place, thereby avoiding the need for a vote.[39] Bear in mind that in many cases, a public company's voting block held by ISS clients has much more influence on the voting results than the largest shareholder of the company.[40]

In many cases, therefore, proxy advisors' recommendations can make or break a transaction. For example, in 2001, when Hewlett-Packard's then-CEO Carly Fiorina famously announced that the technology giant proposed to merge with Compaq Computer Corp., she set off a firestorm of controversy. ISS

[38] Nadya Malenko and Yao Shen, *The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design*, REV, FIN, STUD. (2016).

[39] Hearing Before the House of Rep., *supra* note 1, at 42 (noting, for example, that in a 2010 survey conducted by the Center on Executive Compensation and the HR Policy Association, 54 percent 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 7, at 41-42 (a statement of Michael Ryan, Vice President, Business Roundtable); *Id.*, at 138 (a statement of Hoil Kim, Vice President, Chief Administrative Officer, General Counsel, GT Advanced Technologies). Finally, see David F. Larcker, Allan L. McCall & Gaizka Ormazabal, *Outsourcing Shareholder Voting to Proxy Advisory Firms*, 58(1) J. L. & ECON. 173 (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).

[40] *See, e.g.*, Letter from Andrew Bonzani, Vice President, Assistant Gen. Counsel, and Sec'y, IBM, to Elizabeth Murphy, Sec'y SEC, Comments on File Reference No. S7-14-10, Concept Release on the US Proxy System, Release No. 34-62495, October 15, 2010, *available at* https://www.sec.gov/comments/s7-14-10/s71410-84.pdf, at 3. Similarly, in 2003, W. James McNerney Jr., then chairperson of 3M Corporation, stated in a letter to the SEC that ISS effectively controlled the vote of 50% of 3M‟s total shares outstanding. *See* Comment from W. James McNery, Jr. on SEC Proposed Rule, SEC (December 5, 2003), *available at* https://www.sec.gov/rules/proposed/s71903/3m120503.htm. Finally, see William J. Holstein, *Is ISS Too Powerful? And Whose Interests Does it Serve?*, CBS NEWS http://blogs.bnet.com/ceo/?p=1100&tag= content;col1, (Feb. 7, 2008) ("ISS may control 30 percent of the vote in any proxy battle.").

eventually issued an opinion backing the deal that turned out to be crucial as ISS clients controlled about 23 percent of HP's outstanding shares.[41] The merger was completed. According to one Merrill Lynch (now part of Bank of America) analyst that covered the deal "If [ISS] had gone the other way, the deal would have been dead."[42] Similarly, ISS's recommendation to approve Royal Dutch Shell PLC's takeover of BG Group PLC – valued at about $51 billion – was considered influential "as more than half of shell's top 50 shareholders subscribe to the adviser's services."[43]

Finally, as recently demonstrated, the views of proxy advisors are taken into account by the court when judging directors' decisions. In *re Zale Corporation*, the Delaware Court of Chancery rejected the claim that the Zale board acted in bad faith by agreeing to an unreasonable merger price, while noting that ISS supported the transaction.[44]

C. Criticism and Calls for Intervention

The dramatic increase in proxy advisors' power has been followed by extensive criticism regarding many aspects of the advisory market and advisors' operations. This Section of the Article briefly outlines the major criticisms. First, critics point to the extreme lack of competition in the proxy advisory industry. As explained before, ISS and Glass Lewis currently enjoy a duopoly on providing proxy advisory services; no other firm has a significant enough market share to be considered a serious

[41] *See* Luisa Beltran, ISS Back HP-Compaq Merger, CNN Money (Mar. 5, 2002), http://money.cnn.com/2002/03/05/deals/iss_hp/index.htm.

[42] *See* Peter Burrows & Andrew Park, *Compaq and HP: What's an Investor to Do?*, BLOOMBERG BUS. WK, (Mar. 18, 2002), at 62. Analyst Dan Niles of Lehman Brothers similarly said, "Whichever way [ISS] votes, that will be the way the deal goes." *See* Luisa Beltran, *ISS Could Kill HP-Compaq*, CNN MONEY (Mar. 4, 2002), http://money.cnn.com/2002/03/04/deals/iss_hp/index.htm.

[43] Selina Williams, *Shell's BG Group Takeover Backed by Shareholder Adviser*, WALL ST. J. (Jan. 8, 2016).

[44] *In re Zale Corp. S'holders Litig*., No. CV 9388-VCP, 2015 WL 5853693, at *16 (Del. Ch. 2015) ("ISS's support for the Merger [is] evidence of the Merger's fairness.") Interestingly, Glass Lewis recommended voting against the merger in that case.

competitor.[45] A recent empirical study suggests that competition is highly important in improving the quality advisory services. This study demonstrated that "increased competition [created by] Glass Lewis' entry into the proxy market has reduced ISS's favoritism to corporate managers."[46]

Scarce competition and market concentration stems in part from the fact that the advisory market builds significantly on reputation, which creates mighty entry barriers. Institutional investors are likely to prefer the services of an experienced and well-known proxy advisor like ISS and Glass Lewis rather than the services offered by a new player.[47] Economics of scale serve as another significant barrier.[48] Because there are significant fixed costs for the advisory operation, it is much easier to bear these costs when the advisory has a large client base. New comers to the industry do not have this advantage. Hence, it is unlikely that ISS and Glass Lewis would be subject to fierce competition any time soon.

Another major criticism points to the lack of transparency concerning the way proxy advisors formulate their

[45] *See* JAMES K. GLASSMAN & J. W. VERRET, HOW TO FIX OUR BROKEN ADVISORY SYSTEM 8 (2013); *see also* Hearing Before the House of Rep., *supra* note 1, 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).

[46] Tao Li, *Outsourcing Corporate Governance: Conflicts of Interest and Competition in the Proxy Advisory Industry*, MGMT. SCI. (forthcoming 2018) (draft posted Aug. 2016) (manuscript at 4), https://doi.org/10.1287/mnsc.2016.2652.

[47] *See, e.g.*, Hearing Before the House of Rep., *supra* note 1, at 31. Lynn Turner, a former regulator at the SEC and a senior executive and head of research at Glass Lewis from 2003 to 2007 stated: "Having started Glass Lewis, I would totally agree with that. …we had to be able to cover 5,000 or 10,000 companies right out of the gate, so you have to have the ability to raise some money, to ramp the scale, put in the technologies, and then get institutional investors to be willing to sign on. *And they are reluctant to sign on to someone who has never done it before*, so--and it is not a big marketplace." (emphasis added).

[48] *See, e.g.*, *id*, at 30 ("Mr. Holch [Niels Holch, Exec. Director of Shareholder Communications Coalition]. I think one of the problems is for institutional investors *you need to have a certain amount of scale to function in this market*. You have to cover 13,000 annual meetings. The proxy statements, as Darla Stuckey said earlier, average 100 pages. *You need to be of a certain size to really service the marketplace*…" (emphasis added).

recommendations, which gives companies "no real opportunity to review, or even understand, the rationale for their recommendations or how various factors are weighed, if at all."[49] In hindsight, it turns out that proxy advisors sometimes base their recommendations on inaccurate information.[50] Another criticism argues that proxy advisory firms have a check-the-box mentality, although a more thoughtful, case-by-case analysis is needed in the industry. According to this criticism, proxy advisors simply do not have the resources to tailor arrangements to the particular features of different companies.[51]

Additionally, the leading proxy advisor, ISS, is criticized for inherent conflicts of interest derived from the fact that it provides proxy voting recommendations to institutional investors on the one hand, and consulting services to corporations seeking assistance with proposals to be presented to shareholders on the other hand.[52] Finally, and most relevant to our Article, a major criticism points to proxy advisors' lack of "skin in the game;" despite their increasing power and influence on shareholders' voting decisions and market practices, they have no stake in the corporations that are affected by their actions.[53] The proxy advisor do not benefit or suffer, based on the outcomes of the votes they are advising on. This leads to decreased incentives to provide quality advice.

[49] *See* Letter from Edwards S. Knight, Exec. Vice President., Gen. Counsel & Chief Reg. Officer, NASDAQ OMX, to Elizabeth M. Murphy, Sec'y SEC 5 (Oct. 8, 2013) [hereinafter NASDAQ Petition], *archived at* https://www.sec.gov/rules/petitions/2013/petn4-666.pdf. *see also* Hearing Before the House of Rep., *supra* note 1, 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).

[50] Eckstein, *supra* note 23, at 114-15.

[51] *Id*., at 80.

[52] Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42,982, 43,011-12 (proposed July 14, 2010) (to be codified at 17 C.F.R. pts. 240, 270, 274, et al.) [hereinafter SEC Concept Release], *archived at* http://perma.cc/5VL3-RS6J. *See also* Sagiv Edelman, *Proxy Advisory Firms: A Guide for Regulatory Reform*, 62 EMORY L.J. 1369, 1383-84 (2013) (expressing concern that the integrity of voting recommendations issued by the proxy advisory firm could be tainted by business considerations). Belinfanti, *supra* note 18, at 397 n.71 (explaining the second potential conflict exists only for ISS, because the other proxy advisors do not provide consulting services).

[53] Eckstein, *supra* note 13, at 231-233.

In the absence on a direct financial award or penalty, there is a fear that proxy advisors would not invest enough in the accuracy of their recommendations. Moreover, there is no force to counter mild biases that arise and generally push the advisor to recommend that the shareholders vote for a proposed merger. Thus, the adviser may be inclined to recommend for a certain transaction in order to evade confrontation with management. Recommending in favor of a merger has another benefit from the point of view of the advisor. Once a merger succeeds (and a favorable recommendation makes it is more likely to succeed) it is extremely hard to figure out whether the recommendation of the advisor was well advised. Following the merger the shares of the target vanish and it is impossible to compare the deal price with the market price of the target shares in the long run. The opposite is true in the case of a rejected bid. If proxy advisors had skin in the game they would have good reason to overcome these biases.

The vocal criticism led the SEC to issue Staff Legal Bulletin 20 (SLB-20), an interpretative, non-binding release of the SEC's staff regarding proxy voting system,[54] as well as proposed legislation[55] that mainly aims to increase the level of transparency in proxy advisors' operations. As we explain in Part II, although existing and proposed legislation and regulation have the potential to make some progress in improving proxy advisors' operation, they have limited power and are not able to guarantee the effectiveness of advisors' work.

II. THE LIMITED POWER OF THE EXISTING AND PROPOSED LEGAL AND REGULATORY FRAMEWORKS

Traditionally, proxy advisors have been subject to relatively lax legal and regulatory discipline. This Part of the Article outlines the legal and regulatory framework relevant to proxy advisors operation. It explains how proxy advisors may be subject to the federal securities laws in two respects: they may be subject to the SEC proxy rules and they may meet the definition of "investment adviser" under the Advisers' Act and thus be subject to corresponding regulation under the Act. This Part also contemplates SLB-20 as well as currently proposed legislation. As demonstrated

[54] *See infra* Part II.C.
[55] *See infra* Part II.D.

below, there are good reasons to suspect that the legal and regulatory setup – both current and proposed – hardly guarantee effective proxy advisory operations.

A. The Securities Exchange Act of 1934

Under the SEC rules, when soliciting proxies, certain information must be disclosed in writing to shareholders in a "proxy statement". The disclosure requirements for what must be included in a proxy statement are quite burdensome and require fairly extensive disclosures.[56] The definition of solicitation is broad,[57] and according to the SEC's view, because proxy advisors "provide recommendations that are reasonably calculated to result in the procurement, withholding, or revocation of a proxy," then "as a general matter, the furnishing of proxy voting advice constitutes a 'solicitation'" and hence is subject to the information disclosure requirements of the proxy rules.[58]

The SEC view stated above has been widely debated. Whether or not proxy advisory firms indeed "solicit" proxy votes, as such term is defined in the proxy rules, has remained open and the debate over these questions shows no signs of waning.[59]

Moreover, Rule 14a-2(b)(3) of the Exchange Act exempts from the informational and filing requirements of the federal proxy rules proxy voting advice by any advisor to any other person with whom the advisor has a business relationship. For such an

[56] For an overview of the information required in the proxy statement, see EY, *2017 Proxy Statements: An Overview of the Requirements and Observations About Current Practice*, file:///C:/Users/User/Downloads/2017proxystatements_03267-161us_1december2016-v2%20(3).pdf.

[57] A "solicitation" is defined under Exchange Act Rule 14a-1(*l*) to include "the furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy." *See* 17 C.F.R. 240.14a-1(l).

[58] SEC Concept Release, *supra* note 52 at 43,009. *See also* Sagiv Edelman, *Proxy Advisory Firms: A Guide for Regulatory Reform*, 62 EMORY L. J. 1369, 1377-1378 (2013).

[59] *See, e.g.*, Statement of Gary Retelny, President and CEO of ISS to the *Subcomm. on Capital Mkts. & Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.* 14, A-3 – A-4 (May 17, 2016), https://www.issgovernance.com/file/duediligence/iss-statement-hfsc-17-may-2016.pdf (explaining why proxy advisors do not "solicit" proxy votes).

exemption to hold, four conditions must be met:[60] "(i) The advisor renders financial advice in the ordinary course of his business"[61]; "(ii) The advisor discloses to the recipient of the advice any significant relationship with the registrant or any of its affiliates, or a security holder proponent of the matter on which advice is given, as well as any material interests of the advisor in such matter"[62]; "(iii) The advisor receives no special commission or remuneration for furnishing the proxy voting advice from any person other than a recipient of the advice and other persons who receive similar advice under this subsection"[63]; and (iv) "The proxy voting advice is not furnished on behalf of any person soliciting proxies or on behalf of a participant in an election subject to the provisions of § 240.14a-12(c)."[64]

The exemption offered by Rule 14a-2(b)(3) seems quite fit to cover the operations of the proxy advisory industry. In practice, the SEC gives a high degree of deference to those that apply the exemption.[65] And, it seems that proxy advisors themselves feel protected under the exemption. As Katherine H. Rabin, CEO of Glass Lewis, recently said, "Commercial proxy voting advisors operating today, including Glass Lewis, are generally deemed by the SEC as qualifying for the exemptions based on… 14a-2(b)(3)."[66] The bottom line is that the proxy rules hardly influence the operations of proxy advisors. The main impact is achieved by the fact that proxy advisory firms make sure they meet the requirements of the exemption discussed above.

B. The Investment Advisers Act of 1940

[60] 17 C.F.R. § 240. 14a-2(b)(3).

[61] *Id*., § 240. 14a-2(b)(3)(i).

[62] *Id*., § 240. 14a-2(b)(3)(ii).

[63] *Id*., § 240. 14a-2(b)(3)(iii).

[64] *Id*., § 240. 14a-2(b)(3)(iv). This includes "[s]olicitations by any person or group of persons for the purpose of opposing a solicitation subject to this regulation by any other person or group of persons with respect to the election or removal of directors at any annual or special meeting of security holders". *Id.,* § 240. 14a-12(c).

[65] SEC Staff Legal Bulletin No. 20, *infra* note 81 (provides explanation on how the SEC defers the exemption).

[66] Statement of Katherine H. Rabin, CEO Glass, Lewis & Co., submitted to the H, Comm. on Fin. Serv's (Sept. 13, 2016), *available at* http://www.glasslewis.com/wp-content/uploads/2016/09/2016_0912_Glass-Lewis-Statement-re-H.R.-5983_final.pdf.

Under the Investment Advisers Act of 1940, a person is an "investment adviser" if the person engages, for compensation, in the business of advising others as to the value of securities, or certain other matters concerning securities.[67] In turn, the SEC's view is that proxy advisory firms meet the definition of investment adviser.[68] According to Section 206 of the Advisers Act, investment advisers owe a fiduciary duty to their advisory clients.[69] Section 206 also contains antifraud provisions that apply to any person that meets the definition of investment adviser, and as such may apply to proxy advisors.[70]

Although proxy advisors are subject to certain duties under the Advisers Act, as explained above, advisors are not required to register with the SEC under the Advisers Act.[71] Proxy advisors may, however register voluntarily, and if they choose to register, they become subject to a number of additional regulatory requirements. Specifically, they are required to disclose arrangements that may lead to conflicts of interest with their client;[72] to adopt, implement, and annually review an internal compliance program designed to prevent the adviser (or its employees) from violating the Advisers Act;[73] to designate a chief compliance officer to oversee the compliance program,[74] and more.

Currently, ISS, Marco Consulting, and ProxyVote Plus are registered as investment advisers, while Egan-Jones and the second largest proxy advisor – Glass Lewis – are not registered with the

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[67] Investment Advisers Act of 1940 § 202, 15 U.S.C. §80b-2(a)(11) (2006).

[68] SEC Concept Release, *supra* note 52 at 43,010 ("advisory firms provide analyses of shareholder proposals, director candidacies or corporate actions and provide advice concerning particular votes in a manner that is intended to assist their institutional clients in achieving their investment goals with respect to the voting securities they hold. In that way, proxy advisory firms meet the definition of investment adviser because they, for compensation, engage in the business of issuing reports or analyses concerning securities and providing advice to others as to the value of securities.").

[69] SECConcept Release, *supra* note 52 at 43,010 ("The Supreme Court has construed Section 206 of the Advisers Act as establishing a federal fiduciary standard governing the conduct of investment advisers,").

[70] *Id*.

[71] SEC Concept Release, *supra* note 52, at 43,009-10.

[72] Advisers Act Rule 204-3 [17C.F.R. §275.204-3].

[73] Advisers Act Rule 206(4)-7(a) [17C.F.R. §275.206(4)-7(a)].

[74] Advisers Act Rule 206(4)-7(c) [17C.F.R. §275.206(4)-7(c)].

SEC as investment advisers.[75] Such a situation, in which only part of the industry is registered, has attracted heavy criticism from those calling to develop a uniform legal or regulatory framework that requires proxy advisors to register as investment advisors.[76] However, registration with the SEC by itself is not a panacea, since SEC's enforcement against proxy advisors under the Advisers Act tend to be sporadic, at the most.[77]

C. Calls for Reform and Staff Legal Bulletin 20 (SLB-20)

Given the lax legal and regulatory regime described above, as well as the rapid growth in the importance of proxy advisors over the past several years, public companies have urged policymakers to take a stronger position on the proxy advisory industry. In response, policymakers have started to seek solutions that would help to ease the public companies' concerns.

In 2010, the SEC issued a Concept Release that focused on the U.S. proxy system in general and on proxy advisors in particular.[78] The House of Representatives held a hearing on the matter in June of 2013,[79] and the SEC followed this hearing with a roundtable discussion in December of 2013.[80] No rulemaking initiatives resulted from these discussions until June 30, 2014, when the Investment Management and Corporate Finance Divisions of the SEC issued a joint Legal Bulletin No. 20 (SLB-20), outlining the responsibilities of proxy advisors and institutional investors when casting proxy votes.[81]

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[75] GAO 2016, *supra* note 21, at 10.

[76] *See, e.g.*, Shareholder Communications Coalition, *Time to Rein in Proxy Advisory Firms* (June 23, 2015), *available at* http://shareholdercoalition.com/content/time-rein-proxy-advisory-firms-june-23-2015.

[77] *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-765, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING 4 (2007) [hereinafter GAO 2007], http://www.gao.gov/new.items/d07765.pdf ("To date, SEC has not identified any major violations and has not initiated any enforcement action against proxy advisory firms.").

[78] SEC Concept Release, *supra* note 52.

[79] Hearing Before the House of Rep., *supra* note 1.

[80] SEC Roundtable, *supra* note 7.

[81] SEC Staff Legal Bulletin No. 20 (IM/CF) (June 30, 2014), https://www.sec.gov/interps/legal/cfslb20.htm *archived at* http://perma.cc/L7KN-MD8R (consisting of a set of questions and answers

SLB-20 is a non-binding regulation providing procedural guidance regarding the responsibilities of institutional investors regarding proxy voting and reliance on proxy advisory firms. SLB-20 prompts institutional investors to take an active role on behalf of their clients, particularly in evaluating and overseeing any proxy advisory firm they may engage to assist in fulfilling their voting responsibilities.[82] In brief, SLB-20 states that when considering whether to retain or to continue retaining any particular proxy advisory firm to provide proxy voting recommendations, an institutional investor should ensure that the proxy advisory firm has the capacity and competency to adequately analyze proxy issues.[83]

In addition to verifying of the quality of the advisory firm's personnel, institutional investors are urged to consider the "robustness" of the proxy advisory firm's policies and procedures. Specifically SLB-20 requires investors to (i) to ensure that proxy voting recommendations are based on current, accurate information and (ii) to identify and address any conflicts of interest and other considerations affecting the nature and quality of the advice and services provided.[84]

Moreover, SLB-20 requires that an institutional investor must oversee a proxy advisory firm on an ongoing basis to ensure that the advisor continues to guide proxy voting in the best interests of the investment adviser's clients. If an institutional investor determines that a proxy advisory firm's recommendations were based on inaccurate information, it must investigate the error and determine whether the proxy advisory firm addressed such errors.[85] Finally, according to SLB-20, public corporations who are the subject of proxy advisor recommendations, should be granted a proactive role in reviewing the information in proxy voting reports and submitting any necessary corrections.[86] Remarkably, and most relevant to our article, SLB-20 completely ignores the important

summarizing investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms, as well as the availability and requirements of two exemptions to the federal proxy rules that are often relied upon by proxy advisory firms) [hereinafter SLB 20].

[82] *Id*.

[83] *Id.*

[84] *Id.*

[85] *Id.*

[86] *Id.*

matter of proxy advisors fees. The idea that fee structures may have an important impact on advisor performance, for better or for worse, has not surfaced. This void is illustrative of the entrenched nature of the current flat-fee arrangements.

The key takeaway from SLB-20 is that institutional investors now have to monitor the proxy advisory firms they employ. However, it is doubtful if institutional investors are willing to play a much more active role in supervising proxy advisors. Proxy advisors play a valuable role in providing institutional investors with research on matters put forth for a vote.[87] They take a great burden off the shoulders of institutional investors, and prevent duplicative research on the same matter. In a sense, subjecting proxy advisors to tight supervision of institutional investors would take away part of the benefits of relying on proxy advisors in the first place.

It therefore comes as no surprise that institutional investors strongly oppose new legislation and regulation for proxy advisors.[88] To sum up this section of the Article with a statement of Daniel M. Gallagher, former commissioner at the SEC, regarding SLB 20: "I had hoped that Staff Legal Bulletin No. 20, which was issued a year ago, would have been the catalyst for improvement. But so far it appears like many market participants have taken a 'business as usual' approach."[89]

[87] Hearing Before the House of Rep., *supra* note 1, at 12 (testimony of Michael P. McCauley, Senior Officer, Investment Programs and Governance, Florida State Board of Administration (SBA)). Proxy advisors gather useful information and assist with providing analysis of the issues in question. *See Id.*, at 17 (a testimony of Lynn Turner, Manager Director, LitiNomics, Inc.). Proxy advisors "take and distill the information down," and "standardize the ability to read" that material. *See* SEC Roundtable, *supra* note 7, at 150 (statement of Michael Ryan, the Vice President of Business Roundtable).

[88] On April 24, 2017, the Council of Institutional Investors (CII) delivered a letter to House Financial Services Committee Chairman Jeb Hensarling and Ranking Member Maxine Waters, opposing the new legal scheme included in the Financial CHOICE Act discussed in Section II.D. In particular, the CII opposes Congressional interference with proxy advisors operation. *See* Letter from Jeffrey P. Mahoney, Gen. Counsel, Council of Institutional Investors, to Hon. Jeb Hensarling and Maxine Waters 6-8 (April 24, 2017), http://www.cii.org/files/issues_and_advocacy/correspondence/2017/Apr%2024%20Letter%20Committee%20on%20Financial%20Services_FINAL.pdf.

[89] Commissioner Daniel M. Gallagher, *Activism, Short-Termism, and the SEC: Remarks at the 21st Annual Stanford Directors' College* (June 23, 2015),

D. The Financial CHOICE Act of 2017

On June 9, 2017, the U.S. House of Representatives passed H.R. 10, the "Financial CHOICE Act of 2017" (the "CHOICE Act"), a Republican proposal that would significantly amend the post-crisis financial regulatory framework implemented under the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[90] The proposed CHOICE Act incorporates several bills that have already passed the Committee on Financial Services of the United States House of Representatives, including the Corporate Governance Reform and Transparency Act of 2016, H.R.5311 that defines proxy advisory firms for purposes of federal securities laws, and requires such firms to register with the SEC.[91]

Indeed, the CHOICE Act requires proxy advisory firms to register with the SEC. As part of the registration process, a proxy advisory firm would have to provide information regarding its procedures and methodologies, its organizational structure, and whether it has a code of ethics.[92] Importantly, the firm would also have to certify that it had "adequate financial and managerial resources to consistently provide proxy advice based on accurate information."[93] In addition, addressing a widespread concern, proxy advisory firms would have to disclose any potential or actual conflicts of interest created by its ownership structure and the services it provides to clients. Specifically, they would have to disclose whether they engage in consulting services for public

available at https://www.sec.gov/news/speech/activism-short-termism-and-the-sec.html/. This statement was made following Gallagher's expression of disappointment that "[u]nfortunately…too many institutional investors uncritically vote the proxy advisory firm recommendations. And proxy advisory firms in turn seem to have done little to address the factors that have given rise to poor research, erroneous recommendations, and conflicted advice." *Id.*

[90] Financial CHOICE Act, H.R. 10, 115th Cong. (2017), https://www.gpo.gov/fdsys/pkg/BILLS-115hr10rfs/pdf/BILLS-115hr10rfs.pdf.

[91] Corporate Governance Reform and Transparency Act, H.R.5311, 114th Cong. (2016). The purpose of this Act is "[t]o improve the quality of proxy advisory firms for the protection of investors and the U.S. economy, and in the public interest, by fostering accountability, transparency, responsiveness, and competition in the proxy advisory firm industry."

[92] Financial CHOICE Act, §482. If the firm does not have a code of ethics, it must provide reasoning for why it has chosen not to have this code. *Id.*

[93] *Id.*

companies, to file a report disclosing their largest clients (which can be disclosed confidentially to the SEC), as well disclose the policies and procedures they have in place to manage conflicts that may arise in this context.[94]

Under the proposed legislation, registered proxy advisory firms would have to file an annual report with the SEC. The filing would contain information on the number of shareholder proposals reviewed in the past year, the number of recommendations that were made, how many employees reviewed the proposals, and how many of the proposals were sponsored by clients of the proxy advisory firm.[95] Proxy advisory firms would also be required to file and make publicly available their policies regarding the formulation of their proxy voting policies and voting recommendations. The bill further gives public corporations the right to review and comment on a proposed recommendation by a proxy advisory firm "in a reasonable time" before the recommendation is presented to investors.[96] Finally, registered proxy advisory firms would be required to appoint an internal compliance officer, responsible for administering the policies and procedures that are required to be established pursuant to the CHOICE Act and other relevant laws and regulations.[97]

For now, the chances of the CHOICE Act to get the necessary support in the Senate is unclear.[98] Consequently, on October 11, 2017, House bill 4015 – which is mostly a resubmission of last year's HR 5311 – was introduced.[99]

E. The Limited Power of Legislation and Regulation

[94] *Id*.
[95] *Id*.
[96] *Id*.
[97] *Id*.
[98] *See, e.g.*, Dimitri Zagoroff, *House Bill 4015 and the Proposed Regulation of Proxy Advisors*, HARVARD L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Nov. 1, 2017), https://corpgov.law.harvard.edu/2017/11/01/house-bill-4015-and-the-proposed-regulation-of-proxy-advisors/.
[99] The Corporate Governance Reform and Transparency Act of 2017, H.R. 4015, 115th Cong. (2017). *See* Zagoroff, *Id*. (arguing that although it has some differences, H.R. 4015 is most the same as H.R. 5311 and that the compliance scheme of 4015 is the same as that of 5311.)

So far, this Article has outlined the legislative and regulatory approaches aimed at enhancing proxy advisors' effective operation. However, the legislative and regulatory measures currently proposed in the proxy advisory context are incapable of significantly affecting the way that proxy advisory firms process information and provide recommendations.[100] As explained above, the proposals focus mainly on improving transparency,[101] requiring disclosure of advisors' conflicts of interest, providing public companies with draft reports prior to submitting their reports to institutional investors, and permitting these companies to review the accuracy of drafts' factual content and suggest corrections—before a final report is issued.[102] Altogether, these requirements have limited power.

While it is true that increased transparency and adequate opportunity for companies to make their case to the advisory firms before recommendations are made can somewhat enhance the procedural fairness of advisors' decision-making, it is an illusion to believe that these protective measures vest the SEC or anyone else with real control over the advisors' operations. Simply put, mere transparency requirements leave much discretion in the hands of advisors to decide how much transparency to give. This stems from the fact that the very nature of the service that proxy advisors provide is far from a technical one. Advisors can also circumvent fair review of their reports by simply insisting on their factual assessment and adhering to their conclusions.[103] Even when the reports are demonstrated to contain factual errors, advisors may still assert that the recommendations contained within the reports have not been compromised by the errors. For example, a survey conducted by the Society of Corporate Secretaries and Governance Professionals in 2010 indicated that:"[I]n 44% of the instances where issuers found mistakes the proxy advisory firm reviewed its recommendations but was unwilling to change the recommendation or factual assertion. In another 22% of the instances where issuers

[100] This point has been widely discussed in Eckstein, *supra* note 23, and is briefly explained in this Part of the Article.

[101] Part II.D.

[102] *Id.*

[103] Eckstein, *supra* note 23, at 114 (citation omitted).

found mistakes, the proxy advisory firm was unwilling to reconsider the recommendation at all.[104]

Similar results were obtained by a survey conducted in 2010 by the Human Resource Policy Association, which showed that "of the firms that indicated the use of such an inappropriate peer group [by proxy advisory firm], 96% indicated that the peer group was not adjusted in the final version of the report."[105] ISS and Glass Lewis insist that they hardly make mistakes. During a hearing held in the Congress in 2013 on the matter, Katherine H. Rabin, CEO of Glass Lewis, explained that "[O]ften what a corporation indicates is an error is ultimately a difference in interpretation or opinion regarding a certain issue, and therefore requires no correction."[106] She added that "[A]s of May 31, 2013, material errors in Glass Lewis' research (brought to our attention by the company, its advisors or through subsequent disclosure) that resulted in a change to the Glass Lewis recommendation represented one-tenth of 1% of the items up for vote at US companies analyzed by Glass Lewis."[107] It is doubtful, however, if proxy advisors can be so accurate in their analysis.

Similarly, GAO 2016 can best illustrate the limited power of law and regulation. As the report demonstrates, even after the extensive discussions regarding the role of proxy advisors held by the U.S. Congress and the SEC between 2010 and 2013,[108] SLB-20 released in 2014,[109] and threats of stricter legal and regulatory intervention, proxy advisory firms have not allowed companies an open door for reviewing advisors' work. For example, Glass Lewis developed a new process in 2015 by which companies can receive a draft of the data-only version of a report for review before the advisory firm completes its analysis.[110] ISS has also improved its

[104] Hearing Before the House of Rep., *supra* note 1, at 234 (containing written testimony of Darla C. Stuckey, Society of Corporate Secretaries and Governance Professionals).

[105] *Id.* at 113 (containing written testimony of the Center on Executive Compensation). A "peer group" is a group of firms that the proxy advisor compares to the company that raise a matter for a vote. The peer group should have similar relevant characteristics to the company in question.

[106] *Id.* at 416.

[107] *Id.*

[108] SEC Concept Release, *supra* note 52; Hearing Before the House of Rep., *supra* note 1; SEC Roundtable, *supra* note 7.

[109] *Supra* note 81.

[110] GAO 2016, *supra* note 21, at 28.

openness, offering reports “contain[ing] ISS’s analyses and vote recommendations.”[111] Both ISS and Glass Lewis have made it clear, however, that they only allow companies the opportunity to check data for factual errors. They do not allow “a mechanism for conveying disagreement with [their] methodologies or analyses.”[112]

Regarding conflicts of interest, it is unlikely that the SEC will adopt an approach that prohibits ISS from providing services to both institutional investors and public corporations at the same time. Procedures which are designed to prevent an exchange of information between the corporate side and investors side (so called "Chinese Walls") cannot function as a hermetic seal to prevent two-way communication between the two groups.[113]

To summarize, even the procedural mechanisms designed to improve the operation of proxy advisory firms--mainly by proposed legislation that has been up in the air now for almost two years--may still allow those firms a large amount of discretion regarding how they will comply with these new procedures.[114] Therefore, they cannot guarantee a real improvement of proxy advisory firms' quality of services.

III. The Proposed Incentive Pay Scheme for Proxy Advisory Firms

A. A Proposed Model

In this Part, we will propose an incentive pay structure which we believe will properly regulate proxy advisory firms. We illustrate the structure and importance of our proposal with a real-life recent example. On September 28, 2015, Williams Companies, Inc., a publicly traded energy infrastructure corporation, entered into a merger agreement with Energy Transfer Equity.[115]

[111] *Id.* at 29. These reports are offered to Standard and Poor’s 500 companies and some large international companies. They have the opportunity to review them and provide feedback within 1-2 business days.

[112] *Id.* at 28-29.

[113] *See* SEC Roundtable, *supra* note 7, at 123-24 (noting that Chinese firewalls designed within ISS did not prevent communication between the corporate side and the institutional side).

[114] Eckstein, *supra* note 23, at 116.

[115] Williams Companies, Inc., Form 8-K (Sept. 28, 2015), https://www.sec.gov/Archives/edgar/data/107263/000119312515329829/d2002

According to the merger agreement, at the effective time, each issued and outstanding share of Williams's common stock would be cancelled and converted into the right to receive the consideration of the merger. Such consideration would be, at the election of each Williams stockholder, either $43.50 in cash, mixed or stock consideration in Energy Transfer.[116] The deal was valued at about $38 billion, and would have created one of the world's largest energy infrastructure companies, alongside competitors Kinder Morgan Inc. and Enterprise Products Partners.[117] Williams' share price just prior to announcing the deal on September 25, 2015 was $41.60.[118] This was the deal that Williams shareholders were asked to approve, and that proxy advisory firms had to advise on.

Importantly for our purposes, three out of the four of proxy advisory firms that covered the vote – ISS, Egan-Jones and Pensions & Investment Research Consultants Limited ("PIRC")[119]--recommended that Williams stockholders vote "FOR" the proposed transaction with Energy Transfer. Only Glass Lewis recommended that Williams shareholders vote "AGAINST" the proposed transaction.[120]

5d8k.htm. Energy Transfer Equity included Energy Transfer Equity, L.P., Energy Transfer Corp LP, Energy Transfer Corp GP, LLC, LE GP, LLC, and Energy Transfer Equity GP, LLC

[116] Williams Companies, Inc., Schedule 14A (Sept. 28, 2015), https://www.sec.gov/Archives/edgar/data/107263/000119312515330719/d31611ddefa14a.htm.

[117] Energy Transfer Equity to Combine with Williams, WILLIAMS (September 28, 2015), http://investor.williams.com/press-release/williams/energy-transfer-equity-combine-williams (last visited October 29, 2017).

[118] The Williams Companies, Inc. (WMB), Historical Data, YAHOO FINANCE https://finance.yahoo.com/quote/WMB/history?period1=1443214800&period2=1443214800&interval=1d&filter=history&frequency=1d (last visited Dec. 23, 2017) (November 26th and 27th, 2015 were not trading days).

[119] PIRC is Europe's largest independent corporate governance and shareholder advisory consultancy and it was founded in 1986. *See* PIRC, The Voice of Responsible Shareowners, http://pirc.co.uk/about-us-1 (last visited Oct. 29, 2017). *See also* European Securities and Markets Authority, An overview of the Proxy Advisory Industry. Considerations on Possible Policy Options (Mar. 22, 2012), https://www.esma.europa.eu/sites/default/files/library/2015/11/2012-212.pdf, at 10.

[120] Williams, *Three Out of Four Leading Proxy Advisory Firms – ISS, Egan-Jones and Pensions & Investment Research Consultants – Recommend Williams Stockholders Vote "FOR" the Merger Agreement With ETE* (June 20,

Ultimately, the shareholders never had a chance to vote on the deal. The buyer, Transfer Equity, withdrew from the deal.[121] Williams' share price on the closing day of June 24, 2016, the day the deal broke apart, was $21.31.[122] Williams' share price half a year later, on December 23, 2016 was $31.56,[123] and one year later on June 23, 2017, was $28.75.[124]

In hindsight, Williams shareholders lost a lot of money because of the termination of the deal. However, Glass Lewis, who was against the deal and had the bid had not been withdrawn might have caused its clients to vote against it, did not bear any direct cost.[125] In contrast, ISS, Egan-Jones and PIRC who were all in favor

2016), http://investor.williams.com/press-release/williams/three-out-four-leading-proxy-advisory-firms-%E2%80%93-iss-egan-jones-and-pensions-inv

[121] The deal was in doubt for months, with Williams accusing Energy Transfer Equity of actively trying to break the deal. The two companies sued each other. Finally, on June 24, 2016, Vice Chancellor Glasscock of the Delaware Court of Chancery ruled that Energy Transfer Equity is entitled to terminate its merger with Williams, culminating one of the most contentious cases of buyer's remorse in recent memory. *See The Williams Companies, Inc. v. Energy Equity, L.P.*, C.A. No. 12168-VCG (Del. Ch. June 24, 2016).

[122] The Williams Companies, Inc. (WMB), Historical Data, YAHOO FINANCE https://finance.yahoo.com/quote/WMB/history?period1=1466802000&period2=1466802000&interval=1d&filter=history&frequency=1d (last visited Dec. 23, 2017).

[123] The Williams Companies, Inc. (WMB), Historical Data, YAHOO FINANCE https://finance.yahoo.com/quote/WMB/history?period1=1482530400&period2=1482530400&interval=1d&filter=history&frequency=1d (last visited Dec. 23, 2017) (December 24, 2016 was not a trading day).

[124] The Williams Companies, Inc. (WMB), Historical Data, YAHOO FINANCE https://finance.yahoo.com/quote/WMB/history?period1=1498251600&period2=1498251600&interval=1d&filter=history&frequency=1d (last visited Dec. 23, 2017) (June 24, 2017 was not a trading day).

[125] Because Transfer Equity backed out of the deal and not Williams, we do not argue that Glass Lewis stance against the deal had anything to do with the breakdown of the proposed merger. However, the demise of the proposed merger provides an opportunity to evaluate the quality of Glass Lewis advise against the deal and therefore the application of our fee structure is pertinent. In other cases, were shareholders reject the deal *because* of the advice of the proxy advisor, it seems even more suitable that the proxy advisor share the fate of the shareholders who rejected the deal, but this is not a necessary condition for our proposed fee structure. We seek no causal link between the advice of the proxy advisor and the fate of the deal.

of the deal, did not receive any reward for their recommendation, even though at least in hindsight it seems they provided valuable advice.

Our proposed pay scheme aims to correct both related shortfalls, and thus improve proxy advisors' incentives to provide thoughtful advice. Figure 1 below delineates the basic concept we propose. The current flat fee structure should be replaced, at least in part, with incentive pay. Specifically, proxy advisors should be placed in a long position on the stock of the target in case the bid is rejected (or withdrawn) in line with an "AGAINST" recommendation of the advisor. This is because an advisor who is against the bid must manifest its belief in the long-term stand-alone value of the target.[126] A long position is such a bet on the long-term value of the shares.

However, if the bid is rejected (or withdrawn) in contradiction to a "FOR" recommendation of the advisor, the advisor should be placed in a short position on the stock of the target.[127] This is because an advisor who is for the merger should manifest its belief that the long-term stand-alone value of the target would not meet the merger price. A short position is a bet against the long-term value of the shares. Finally, if the bid is accepted, the target stock would no longer trade on the stock exchange. Hence, in such case, and whether or not the advisor was for or against the deal,

[126] In a similar vein professor Lucian Bebchuk once suggested that corporate managers who advocate the rejection of a hostile takeover buy stock of their company. See, Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, U. CHI. L. REV. 973, 1002 (2002)("managers that view the target's independent value as significantly higher than the bid price might elect to take steps that would credibly signal that their recommendation is indeed based on their genuine estimate of the target's value. For example, managers could so signal by committing themselves, in the event that the bid fails, to spend some of their own funds to purchase from the company at the bid price some specified number of shares and hold them for a specified period of time.")

[127] Note that as long as the proxy adviser maintains this short position it has a contrarian interest to the shareholders of the target. This probably means that during this period it should be barred from providing voting recommendations, at least on significant matters that involve discretion. Given that this adviser made a recommendation (which shareholders rejected) to sell the company, such cooling off period may be advisable even in the absence of our fee scheme. Whether or not the advisor is in a short position, it may have an interest to show that the forsaken acquisition, against its advice, was a wrong decision of the shareholders.

a flat fee pay scheme would be used. Figure 1 reflects the key elements of our proposed fee structure.

Figure 1

	Proxy Advisor Recommends to Vote "FOR"	Proxy Advisor Recommends to Vote "AGAINST"
Shareholders Accept the Recommendation	Fixed Fee	Long
Shareholders Reject the Recommendation	Short	Fixed Fee

The conceptual idea manifested in figure 1 is achievable if we use part (or all) of the proxy advisor's fee to buy suitable forward agreements on the stock of the target.[128] We shall illustrate how this plays out in the Williams example. Imagine that a certain part of the advisor's currently fixed fee, and for illustration purposes say $100,000, was used to purchase forward agreements on Williams stock. Let us turn first to Glass Lewis, which recommended rejecting the bid. In such a case Glass Lewis would receive a forward agreement to buy the stock of Williams for $43.50, which is the price of the deal. In contrast, ISS (or Egan-Jones and PIRC), which recommended accepting the bid, would receive a forward agreement to sell the stock of Williams for $43.50. Figure 2 below illustrates the payoff structure that Glass Lewis faces when it holds such a forward agreement to buy Williams shares.

Figure 2

[128] To administer our proposed fee arrangement the proxy advisor and its clients would require the assistance of a trustee, as is customary in employee equity based compensation plans, which has some resemblance to our case. The main task of the trustee would be to buy the requisite forward agreements on the market and hold them for the proxy advisory firm to prevent resale of the forward agreements. In a similar vein, the proxy advisor must commit not to hedge against the forward agreements in any manner. If the trustee cannot buy the forward agreement on the market it will have to find a third party that would be the opposite side of the transaction. The administration of this scheme would certainly involve costs, but given the benefits for the proposal, we believe the costs would be far from prohibitive.

Figure 2 shows that a forward agreement (to buy the shares of Williams for the strike price of $43.50) yields a profit of one dollar for any dollar that Williams' share price tops the deal price upon the closure of the agreement. When Williams' share price passes the deal price, the forward agreement promises its holder to buy Williams shares below their market price. Alternatively, if Williams' share price upon termination of the forward agreement falls short of $43.50, Glass Lewis would bear a loss. In such case, the forward agreement compels Glass Lewis to buy Williams shares above their market price.

This fee structure, therefore, puts Glass Lewis in the same boat as the Williams shareholders, at least in part. The length of the forward agreement should be a reasonable period of time in which the benefits of rejecting the deal (as Glass Lewis advised) are supposed to materialize. Perhaps a one-year timeframe is too short for such purpose, but if this was the period used, then the results would be quite grim for Glass Lewis. Recall that the share price of Williams a year after the deal broke apart ($28.75) is significantly below the deal price ($43.50).

How much exactly would Glass Lewis lose? Assume, for the sake of simplicity, that Glass Lewis received a forward agreement for 2500 shares (the exact number being $100,000 divided by the price of the future agreement to buy shares for $43.50 per share).[129] Let us also assume, for the sake of this example, that the forward agreement is designed to terminate one year after the termination of the deal. Based on the June 23, 2017 share prices, this means that Glass Lewis would bear a loss of $37,000 (the result of 14.75*2500) out of its $100,000 advisory fees for the transaction. As we shall see shortly, Glass Lewis's loss is the mirror image of the gain that ISS (and the other proxy advisors that were for the deal) would make under our proposed fee structure.[130] And, no less important than its direct financial impact, this novel compensation scheme allows both clients and the advisor, as well as the market, to quantify the quality of the advice.[131]

Let us turn then to the fee structure of proxy advisors who recommend for the merger. Figure 3 below illustrates the payoff to the proxy advisors (ISS, Egan-Jones and PIRC) who were in favor of the deal in the Williams case.

[129] The actual price of a forward agreement should equal the current price of the stock on the market together with interest (at the risk free rate) for the period until the expiration of the agreement, and subject to adjustments for dividends. To see why, assume that the holder of the forward agreement also buys a share of the company by borrowing money for this purpose. When the forward agreement expires, the holder also sell her share. This means she has no exposure but for paying interest of the loan. Recall, however, that our proxy adviser is prohibited from hedging her forward position and therefore cannot buy shares of the company.

[130] To get a sense of the numbers, in its 2013 annual report, ISS then-owner MSCI Inc. reported: "revenues related to our ISS Corporate Services products and services represented 29.2% of our Governance business total revenues." MSCI Inc., Annual Report (Form 10-K) (Feb. 28, 2014), at 10. As reflected in the annual report: "[R]evenues related to [MSCI] governance products decreased 0.7% to $122.3 million for the year ended December 31, 2013." *Id.*, at 67. This means that ISS revenue for 2013 was $35.7 million, and based on MSCI's net income/revenue ratio we estimate ISS annual profit was about $7 million. Hence, in order to achieve a substantial impact on the profits of the proxy advisor one may need to increase the use of incentive fees beyond the figures in the text above (by multiplying the amount of shares subject to the forward agreement).

[131] The regulator may wish to take advantage of this quantification and require public disclosure. In a similar manner, Nationally Recognized Statistical Rating Organizations (NRSRO) are required today to disclose extensive information about their performance. Eckstein, *supra* note 13, at 257.

Figure 3

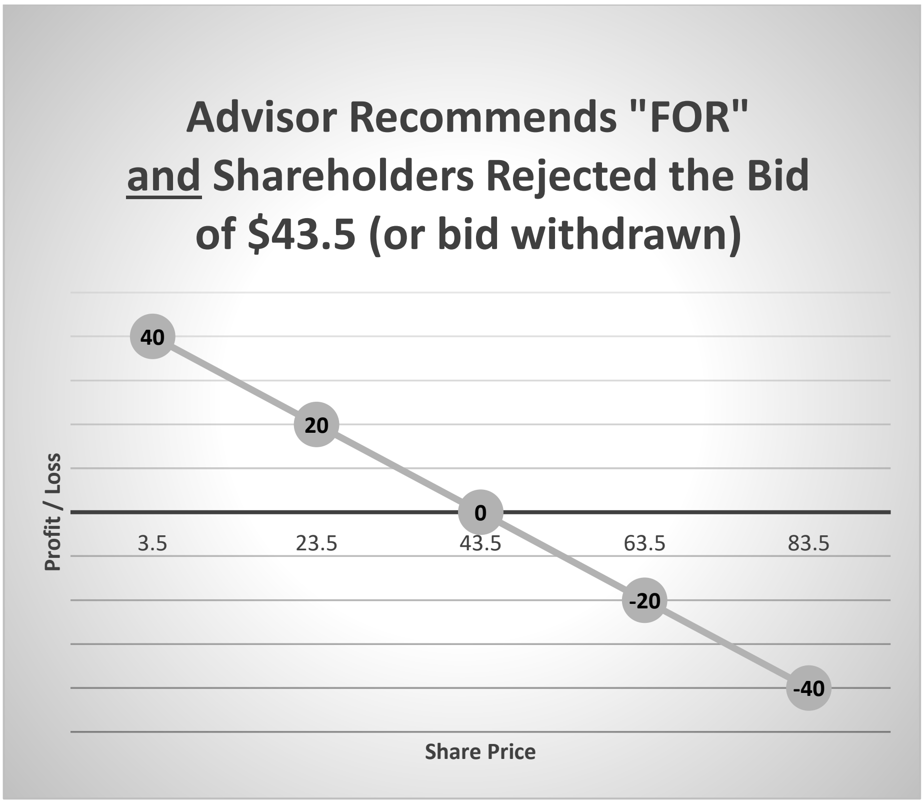

Figure 3 shows that a forward agreement (to sell the shares of Williams for a strike price of $43.50) yields a profit of one dollar for any dollar that Williams' share price falls short of the deal price upon the closure of the agreement. When Williams' share price passes the deal price, however, the forward agreement requires its holder to sell Williams' shares below their market price. For instance, if Williams' share price reached $50 when the forward agreement terminates, then the proxy advisor would have to purchase Williams' shares in the market for $50 and sell it in accordance with the forward agreement for $43.50 (in reality the agreement settles on the difference - $6.50 – without execution of the buy-and-sell transactions).

The opposite is true if Williams' share price upon termination of the forward agreement falls short of $43.50, yielding a profit for ISS. In such case, the forward agreement promises ISS to sell Williams shares above their market price. Recall that ISS was for the deal. Their advice to the shareholders was to get rid of their shares for $43.50. If this turns out to be good advice, given that Williams' shares fall short of this price after the deal breaks down, ISS would have gained from it. In the contrary scenario – they would lose.

The benefits of our proposed fee structure are quite straightforward. Our model of a long/short compensation scheme improves proxy advisors' incentives, which in turn makes their recommendations more credible. This incentive-aligning compensation scheme therefore also alleviates concerns that were recently voiced by the U.S Congress, the SEC, practitioners, and the media.[132] Unlike the current flat fee structure, under our proposed fee structure the advisor may suffer a direct financial loss from what turns out to be a bad recommendation. Similarly, the advisor can now profit from a good recommendation. Put differently, the advisor now has substantial skin in the game. Indeed, our incentive fee scheme kicks in only when the deal breaks apart. However, the incentives are generated ex-ante, when the advisor provides its recommendation before the fate of the bid is clear. Given that the annual volume of rejected or withdrawn bids is enormous,[133] the proxy advisors should always be ready to bear the financial consequences of their recommendations. We now move on to a discussion of possible objections to our proposed fee structure, and additional questions raised by our model.

B. The Need for an Incentive-Based Fee Structure – Further Analysis

1. The Insufficiency of Reputational Mechanisms

Flat-fee structures, by themselves, provide little incentive, if any, for proxy advisors to invest necessary efforts and produce optimal recommendations. However, one might argue that reputational forces may overcome this weakness. After all, proxy advisors have sophisticated clients, institutional investors, which may discontinue the proxy advisor's services if they do not provide good advice. Put differently, why do we not believe in the advisors' reputational concerns and related market mechanisms?

[132] *Supra* note 53 and accompanying text.
[133] *Supra* note 17.

We are hardly the first to identify the weakness in the existing forces that motivate proxy advisors to operate well. The vocal criticism against proxy advisory firms and the calls for stricter legislation and regulation implies much disbelief in these forces.[134] There are a few good reasons to doubt the ability of reputational concerns and other market mechanisms to perfect proxy advisors' incentives. First, it is often hard for outside observers to judge the quality of the advice of the proxy advisor. Even if the result of the advice is bad, it is hard to pass judgment on its ex-ante quality because no one expects a proxy advisor to perfectly predict future developments.

Recall that proxy advisors insist on not disclosing the methodologies used to arrive at their voting recommendations.[135] Proposed legislation aims to improve transparency, but as discussed earlier, we doubt that it will have a meaningful impact. With such a non-transparent decision-making process, it is quite hard to pinpoint weaknesses in the analysis conducted by the proxy advisor. Moreover, most voting recommendations involve complex facts and many uncertainties. Hence, it is difficult to conclude that certain advice was indeed faulty. Therefore, poor advice may not translate into an acute reputational penalty.

Second, given that the industry is governed by a de-facto duopoly (ISS and Glass Lewis dominate approximately 97% of the advisory market),[136] and given the non-trivial entry barriers to the industry,[137] competitive pressures to perform well are compromised. As noted by SEC commissioner Michael Piwowar, "[There] appears to be a stable duopoly preserved by near-impenetrable barriers for new entrants."[138] Third, regulation (and not only business needs) promote institutional investors' use of proxy advisory services. When clients subscribe to a certain service out of their free will, their revealed preference testify to the benefits of the service for them. However, when services are required or promoted by the regulator, there is less reason to believe in their quality. This problem that was termed the problem of "regulatory

[134] *See* Part I.C.
[135] *Supra* note 112.
[136] *Supra* note 45.
[137] *Supra* notes 47-48.
[138] SEC Roundtable, *supra* note 7, at 18.

licenses" is well known in the market for rating agencies,[139] but it also exists to some degree in the market for proxy advice. In 2004, the SEC indicated that reliance on proxy advisory firms may remove the votes of institutional investors from any suspicion of conflict of interest.[140] This position, which gave a significant boost to the proxy advisory industry, also compromises, to some extent, the market powers that should guarantee smooth performance of the advisors. The promotion of those services by the regulator may be a good enough reason to use them, even if proxy advisors do not perform optimally.

2. The Persistence of the Current Fixed Fee Structure

Given the suboptimal nature of the current flat fee structure, one may wonder why an incentive fee structure has not emerged in the proxy industry previously. One answer is that some of the aforementioned forces that prevent market mechanisms and reputational concerns from working well, also impede the creation of a proper incentive structure. To start with, as explained above,[141] if institutional investors use the service of proxy advisors not only for their skills but also because the regulator pushes them do to so, the quality of the advice becomes less important. In such a setting, it is no wonder that incentive pay schemes do not evolve.

Second, given the market concentration in the proxy advisory industry, the two major proxy advisory firms (ISS and Glass Lewis) have little reason to change their pay practices. They have little incentive to rock the boat and compete with one another on any front, including (or especially) in relation to their fees.

[139] *See* Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 683-4 (1999) (explaining how "Absent regulation incorporating ratings … rating agencies sell information and survive based on their ability to accumulate and retain reputational capital. However, … [since from the 1970s credit ratings have been incorporated into hundreds of rules, releases, and regulations] rating agencies begin to sell not only information but also the valuable property rights associated with compliance with that regulation.")

[140] Eckstein, *supra* note 23, at 93 (explaining how No-Action Letters issues by the SEC in May and September 2004 interpreted SEC rules in a manner that allows institutional investors to overcome conflict of interest by relying on proxy advisory firms).

[141] *Id.*

Moreover, the current flat fee arrangement is particularly comfortable for the existing larger players in the industry because it deters entry of other firms. Currently, with a flat fee structure, there is no way to signal quality with the fee structure of proxy advisory services, and therefore reputation is the main avenue of quality assurance. A newcomer to the industry or a small competitor may find it very hard to signal its quality.[142] In sharp contrast to the current scheme, an incentive pay scheme may promote entry to the industry by allowing a high quality player to put its money where its mouth is and establish its reputation based on quality recommendations and advice. From the point of view of the incumbent large players, this is a frightening possibility and they have good reason to preserve the status quo.

Finally, another good explanation for the nonexistence of incentive fees in the proxy advisory industry lies in the fact that proxy advisors' clients – the institutional investors – are themselves under regulation that restricts their ability to receive incentive fees. Institutional investors are financial intermediaries that invest on behalf of the pubic. To prevent excessive risk-taking (in the selection of investments) the relevant regulators of the different institutional investors act against unrestricted incentive fee structures.[143] The results are, for instance, that "97% of all funds, accounting for 92% of all mutual fund assets, charge fees based on a flat percentage of the fund's assets under management."[144]

[142] *See generally* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 THE QUARTERLY J. ECON. 488 (1970) (explaining, in a seminal paper, how quality uncertainty may reduce incentives for sellers of high quality goods to enter the market).

[143] For example, Section 205(a)(1) of the Investment Advisers Act of 1940, prevents investment advisers from taking unwarranted risks by ordering that their "performance fees must be symmetrical, such that if fees are higher than normal after a good year, they must also be lower than normal after a bad year." *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1050 (2007)*; see also* Robert Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225 (2007); Edwin J. Elton, Martin J. Gruber & Christopher R. Blake, *Incentive Fees and Mutual Funds*, 58 J. FIN. 779 (2003); Linlin Ma, Yuehua Tang & Juan-Pedro Gomez, *Portfolio Manager Compensation in the U.S. Mutual Fund Industry* (Oct. 15, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2024027, at 7.

[144] Kahan & Rock, *Id.*, at 1051.

The abovementioned regulation against unrestricted incentive fee structures of institutional investors translates into an environment that does not promote such fee structures for their own service providers – the proxy advisory firms. The logic behind the restrictions on certain incentive fee structures for institutional investors does not apply, however, to incentive fees for proxy advisors. Such fee structures may improve proxy advisors' voting recommendations without leading to excessively risky investments. But perhaps it is too much to expect from institutional investors, who are barred from charging success fees from their clients, to require such fee structure from their proxy advisors.

3. Voluntary versus Mandatory Arrangements

The current flat fee structure is a "sticky" arrangement, in the sense that it will be hard to change it even if it is suboptimal as we suspect it to be. The existing players in the industry – the large proxy advisors and their clients alike – are unlikely to change it for the reasons we delineated above. Despite the inefficiency of the flat fee structure, we do not propose making the incentive fee structure proposed in this Article mandatory. Our proposal is likely to be optimal and useful under certain conditions, but not under others. When and precisely how to use our proposed fee structure is hardly possible for the regulator to decide optimally, and it is preferable to leave the design of the exact arrangement to the market players.

Moreover, a one-size-fits-all solution might not fit here. Our fee structure is perhaps suitable only for certain M&A transactions.[145] The size of the information gap between the proxy advisor and their clients in a given case, the strength of the opinion of the advisor about the particular transaction, and the extent of the dispersion of ownership in the target company, [146] are but a few examples of the relevant factors that could make our proposal more desirable.

[145] Recall that our model is designed to kick in cases where bid is rejected, either in line with an "Against" recommendation of the advisor or in contradiction to a "For" recommendation of the advisor. *See* Figure 1.

[146] When ownership is more dispersed the opinion of the adviser is more important because there is less incentives for each shareholder to make in depth inquiry of the desirability for the proposed M&A transaction. Hence the incentives of the adviser are more important in such setting.

As we discuss below, we believe that a considerable "nudge" from the regulator is required in order to implement our proposal. Nevertheless, our proposed arrangement should not be mandated but rather be structured as an option for the proxy adviser to use whenever it wants to fortify its recommendation and signal its quality and conviction.[147] The arrangement would work best if the market players craft the scheme themselves and use it in the right circumstances.

Moreover, as mentioned above, there are major features of the arrangement that should be tailored by the market and not the regulator. One such feature is the length of the period before the long or short position of the advisor under our proposed arrangement must close. For instance, if the proxy advisory firm advocates against a deal because the full stand-alone value of the target should materialize in two years, then the advisor's long position under our plan should close at the end of such period. Another issue the parties may wish to consider is whether the advisor should keep the option to ask for a release from the incentive scheme at the time the advisor provides its recommendation. This would allow the advisor to signal that it has no strong view about the benefits of the proposed merger when asking for the release, and would fortify its position regarding the bid when the advisor does not ask for such release.[148]

For all of these reasons, we do not believe in a mandated fee arrangement. The inefficiencies of the flat-fee structure should be tackled in other ways. One simple and hopefully effective way would be for the relevant regulators to encourage use of the incentive fee structure. Recall that SLB-20 requires institutional investors that retain proxy advisory firms to undertake due

[147] Leaving the door open for the advisor not to use the incentive fee structure when it does not have a strong opinion may prevent a perverse incentive. Because the incentive fee structure becomes operative only when the shareholders reject the deal, an advisor that has a *mild* negative opinion about the deal may nevertheless encourage the shareholders to approve the deal. Such an affirmative vote would prevent any exposure from a wrong bet against the deal. Therefore, when the advisor can forgo the incentive scheme and reveal his mild recommendation against the deal, all parties benefit.

[148] Carrying this logic even further, the parties may wish the advisor to multiply its "bet" on the bid based on its belief about the quality of the bid - either for the bid or against it. For example, a multiply of 2 means that the advisor would lose or gain 2 dollars instead of one dollar in our original framework.

diligence to ensure that those firms have the capacity and competency to adequately analyze proxy issues.

In this regard, SLB-20 suggests that institutional investors consider whether proxy advisory firms have proper resources and robust policies and procedures.[149] SLB-20's silence regarding proxy advisors' fees is puzzling and needs to be corrected. We suggest amending SLB-20 to require institutional investors to contemplate whether the proxy advisor fee arrangement promotes effective performance. Specifically, the regulator should require institutional investors to consider if the advisor fee structure should be sensitive, at least in part, to advisors' performance. Given the significant influence of the SEC on the industry, such a regulatory push, even in the form of the SEC's interpretive guidance, may be sufficient to tilt the industry towards more efficient fee structures.[150]

4. Risk-Aversion Costs

One type of costs that our proposed fee structure entail, are risk-taking costs which the current flat fee structure evades. Even a good advice may bring about bad results, and a bad advice may end up with good results. For our proposal to work, there only need to be a high correlation between the quality of the advice and the outcome, but we acknowledge the existence of random results. Therefore, unlike the current flat-fee arrangement, our proposed incentive fee scheme exposes proxy advisors to risk. The proposed arrangement therefore entails a real cost – risk aversion cost. Accordingly, proxy advisors should react to this newly imposed

[149] *Supra* notes 82-84.

[150] In that respect, it should be noted that although in theory the SEC's interpretive releases do not have a legally binding effect on the regulated entities, they are highly effective in practice. *See* Donna M. Nagy, *Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework*, 83 CORNELL L. REV. 921 (1998) (showing how courts tend to defer to SEC's regulatory interpretations in no-action letters). *See generally,* Robert A. Anthony, *Three Settings in Which Nonlegislative Rules Should Not Bind*, 53 ADMIN. L. REV. 1313, 1314 (2001) ("...the practical binding effect of an interpretive guidance is a function of the likelihood that it will be challenged in court, and then of the likelihood that the court will uphold the guidance."); Richard J. Pierce, Jr., *Seven Ways to Deossify Agency Rulemaking*, 47 ADMIN. L. REV. 59, 84-85 (1995) (explaining how interpretative rules and policy statements influence courts).

cost and try to compensate for it by increasing their fees.[151] Put differently, proxy advisory services will be more expensive under the new proposal. The benefits of our proposed plan – improved incentives and better advice – should outweigh these costs.

A short comparison to the common use of share-based compensation for executives and employees in public corporations,[152] reveals that risk-bearing costs are unlikely to be prohibitive. Share based (or equity-based) compensation, such as restricted stock and stock options, brings about huge risk bearing costs to executives.[153] This means that stock-based remuneration is more expensive to corporations than payment of regular salaries, and total compensation indeed sky rocketed because of the generous use of these mechanisms.[154] Notwithstanding these tremendous costs, however, public corporations insist that around

[151] *See, generally*, Canice Prendergast, *The Tenuous Trade-off Between Risk and Incentives*, 110 J. POL. ECON. 1071 (2002).

[152] *See, e.g.*, Employee Stock Options Fact Sheet, Nat'l Center for Employee Ownership, https://www.nceo.org/articles/employee-stock-options-factsheet (last visited Jan. 1, 2018) (showing how "[B]road-based options remain the norm in high-technology companies and have become more widely used in other industries as well. Larger, publicly traded companies such as Starbucks, Southwest Airlines, and Cisco now give stock options to most or all of their employees. Many non-high tech, closely held companies are joining the ranks as well.")

[153] Employees are typically risk-averse. The value of stock-based compensation is highly contingent on risk factors and uncertainties far beyond the control of the recipient employees. Risk-averse employees therefore discount the value of stock-based compensation. Firms could substitute this type of compensation with a much lower payment in cash that does not entail uncertainty. The difference between the two alternatives is the cost, or the waste, involved in stock-based compensation. Under reasonable assumptions about risk aversion and diversification, it is estimated that employees value options at "only about half of their cost to the firm." Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSP. 49, 56 (2003); *see also* Sharon Hannes, *Reverse Monitoring: On the Hidden Role of Employee Stock-Based Compensation*, 105 Mich. L. Rev 1421, 1437-38 (2007); Brian J. Hall & Kevin J. Murphy, *Optimal Exercise Prices for Executive Stock Options*, 90 AM. ECON. REV. 209, 211 (2000); Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, 33 J. ACCT. & ECON. 3, 12-13 (2002).

[154] Kevin J. Murphy, *Executive Compensation: Where We Are, and How We Got There* in 2 HANDBOOK ECON. FIN. 274 (George Constantinides, Milton Harris & René M. Stulz eds., 2013) ("As shown in Figure 3.5 (and Figure 2.3 and Figure 2.6), the median pay for CEOs in S&P 500 firms more than tripled between 1992 and 2001, driven by an explosion in the use of stock options.")

40% of total pay is granted to senior managers in the form of stock based compensation.[155]

The frequent use of stock-based incentive compensation for corporate executives is encouraging for our case as well. Our proposed fee scheme is also a stock-based compensation structure that we believe can improve valuable advice. Risk bearing costs for proxy advisory firms seem to be modest in comparison to those born by corporate executives. Corporate executives are generally more vulnerable to this particular risk than proxy advisory firms for at least two reasons. First, the executive is an individual whereas the advisory firm is a deep-pocketed entity, making it much less risk-averse.[156] Second, unlike the corporate executive, the proxy advisory firm can better diversify its portfolio, by accepting this type of compensation from a few clients at the same time.[157] Finally, part of the risk bearing costs that stem from movements in stock prices unrelated to the recommendation of the advisor could be eliminated by neutralizing general stock market trends from the fee scheme.[158] Such improvement comes, however, at the cost of making the fee structure more complicated.

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[155] PAY FOR PERFORMANCE BECOMES MORE DOMINANT IN CEO COMP PLANS, EQUILAR (Sep. 20, 2017), http://www.equilar.com/press-releases/84-pay-for-performance-equity-trends-report.html (explaining how "[i]n fiscal year 2016 alone, the percentage of Equilar 500* companies that provided at least half of CEO equity compensation based on performance awards increased from 52.5% to 60.8%."). *See also* Nuno Fernandes, Miguel A. Ferreira, Pedro Matos & Kevin J. Murphy, *Are U.S. CEOs Paid More? New International Evidence*, 26 REV. FIN. STUD. 323, 328 (2012) (showing that "equity-based pay (consisting of restricted stock, stock options, and performance shares) accounts, on average, for 39% of total pay for U.S. CEOs.").

[156] *See, e.g.* Avraham D. Tabbach, *Criminal Behavior, Sanctions and Income Taxation: An Economic Analysis*, 32 J. LEG. STUD. 383, 392 (2003) ("Under the standard assumption of decreasing absolute risk aversion, that is, the assumption that individuals become more risk averse as they become poorer . . .").

[157] Eckstein, *supra* note 13, at 260 (explaining that risk involved in proxy advisors' 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," and therefore risk-aversion consideration is less relevant to them). Diversification cannot, of course, alleviate the risk of the entire market fluctuations (so called systematic risk). For a discussion on market (systematic) risk and diversification, see RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, CORPORATE FINANCE 154-72 (8th ed. 2006).

[158] The strike price of the forward agreement could be adjusted to cancel out price movements of the market portfolio or a movement of the share price of

5. Increased Liability as an Alternative Solution

Liability and incentive pay structures are two mechanisms that, under certain assumptions, can achieve similar results, although the costs and methods are quite different.[159] In the case of proxy advisory firms, liability is almost unheard of.[160] One might therefore suggest that instead of proposing an incentive-based fee structure, the proper reform should simply aim to increase potential liability of proxy advisory firms. This would, so the argument goes, bring about improved incentives to perform well without any need to replace the existing fee schemes.

However, any successful legal liability regime fundamentally relies on the plaintiff's ability to detect and verify wrongdoing, i.e., to prove it to the court.[161] Where an agent's work is difficult to observe and verify, legal intervention is likely to be less useful, as well as too costly.[162] As mentioned above, this is

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a similar corporation. For example, if the rejected deal price was 43.5$ and the entire market fell by 10% prior to the termination of the forward agreement, the strike price would be adjusted to $39.15 (90% of $43.50). This would mean that the proxy adviser who recommended against the deal would not lose if the share price of the target did not reach $43.50 (but reaches at least $39.15) at the end of the period because of market movements that are unrelated to the target company.

[159] Sharon Hannes, *Compensating for Executive Compensation: The Case for Gatekeeper Incentive Pay*, 98 CAL. L. REV. 385, 433 (2010).

[160] Courts understand this challenge and this is perhaps why "no institutional investor has ever been held liable for failing to vote proxies or voting them 'incorrectly'." *See* George W. Dent, Jr., *A Defense of Proxy Advisors*, 2014 MICH. ST. L. REV. 1287, 1307 (2014).

[161] *See, e.g.*, ROBERT D. COOTER & ARIEL PORAT, GETTING INCENTIVES RIGHT: IMPROVING TORTS, CONTRACTS, AND RESTITUTION 74 (2014) (explaining how "[T]raditional approaches to liability do not work when individual behavior is unverifiable, because officials cannot prove how much harm any injurer caused."). *See also* Lewis A. Kornhauser, *Constrained Optimization: Corporate Law and the Maximization of Social Welfare* in THE JURISPRUDENTIAL FOUNDATIONS OF CORPORATE AND COMMERCIAL LAW 97 (Jody S. Kraus & Steven D. Walt eds., 2000) (explaining how "[D]eterminations of liability and assessments of damages must depend only on verifiable actions or factors.").

[162] Hannes, *Supra* note 159, at 390 (explaining that "[M]ore generally, since accounting and auditing standards involve many uncertainties and a fair amount of unpublicized information, the quality of much of the auditor's work is often unverifiable, unobservable, and, consequently, protected from legal penalty and even reputation backfire.").

exactly the challenge posed by proxy advisory services.[163] Intensified liability is therefore not a promising solution for reform.

A good analogy for our proposal is once again the omnibus use of equity-based compensation for corporate managers. The same reasoning that justifies equity-based compensation for corporate executives also justifies performance fee structures (of the type suggested in this Article) for proxy advisors. Both arrangements generate performance incentives without the need to take anyone to court.[164]

Finally, beyond the obvious disadvantages that stem from the difficulty of observing and verifying the quality of the proxy advisors' work, a legal liability regime inflicts sticks without offering carrots. It is one-dimensional in the sense that it imposes sanctions for misconduct, but it does not provide rewards for success.[165] Our proposed performance fee structure is symmetric, and therefore offer both rewards and penalties. Moreover, the size of the sticks and carrots can be easily calibrated by determining the fraction of the fees that will be subject to our proposal.[166]

IV. Short Summary and Final Notes

Our model of a long/short compensation scheme improves proxy advisors' incentives, which in turn makes their recommendations more credible. This incentive-aligning compensation scheme may therefore alleviate concerns that were recently voiced by the U.S Congress, the SEC, practitioners, and the media. Unlike the current flat fee structure, under our proposed

[163] In a similar vein, the risk of judicial errors constitutes a major justification for the Business Judgment Rule to shield executive decisions from judicial intervention. *See, e.g.*, Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 114-115 (2004); E. Norman Veasey & Christine T. Di Guglielmo, W*hat Happened In Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1424 (2005).

[164] *Id*.

[165] *See generally*, Gerrit De Geest & Giuseppe Dari-Mattiacci, *The Rise of Carrots and the Decline of Sticks*, 80 U. CHI. L. REV. 341, 361 (2013) (explaining how carrots incentivize by effectively rewarding while sticks incentivize only by threatening).

[166] Lawrence A. Cunningham, *Beyond Liability: Rewarding Effective Gatekeepers*, 92 MINN. L. REV. 323 (2007).

fee structure the advisor may suffer a direct financial loss from a bad recommendation. Similarly, the advisor can now profit from a good recommendation. Put differently, the advisor now has substantial skin in the game.

The concentrated nature of the proxy advisory industry, the difficulty of observing the quality of a given advice, and the regulatory push to use proxy advisory services, all compromise the ability of market forces to create proper incentives for proxy advisors. The combination of these factors makes our incentive-based fee structure a proper response in lieu of the current flat fee structure.

In this Article, we illustrate our proposal in the context of recommendations on mergers and acquisitions. Our framework, however, can be adapted to fit any vote that has significant potential impact on the value of the corporation. One good example could be contested elections for the board of directors. The same concept of long/short incentive scheme could be applied in this context as well. The adviser should hold a long position on the stock of the corporation if shareholders accept the advisor recommendations for the slate of directors, and should be placed in a short position if shareholders reject its recommendations. Instead of the deal price, the strike price of the forward contracts in this case should be the value of the shares of the corporation on the eve of the advisor recommendation.[167]

Ironically, proxy advisors would be wise to support our proposed incentive fee structure even if they actually perform flawlessly under the current flat fee structure (an argument we find hard to believe). As mentioned above, third party proxy advisory firms are subject to loud criticism for failing to operate efficiently, and for holding immense power without responsibility. The adoption of an incentive based fee structure of the type advocated by this paper may therefore serve them right from a political economy point of view. An adviser with such a fee structure manifests that its incentives are aligned with those of the

[167] Unlike the context of mergers and acquisitions, which requires rejection (or withdrawal) of the bid for our incentive fee scheme to apply, in the context of contested elections for the board the inventive pay scheme works every time the vote takes place.

shareholders of the corporation in question, and assumes responsibility for its advice. This is a perfect answer for critics.

Finally, proxy advisors argue that having no skin in the game is a virtue and not a sin. They argue that they wish to maintain their disinterested status, which in turn prevents biased advice.[168] We do not believe, however, that being disinterested is a panacea. We prefer that proxy advisors have a stake in their advice, as long as the incentives created by such stake are calibrated correctly. We believe our model of long/short compensation scheme adheres to this principle and improves the current suboptimal flat fee structure. We therefore urge regulators to consider advocating its adoption. Well-crafted incentives may do much better than part of the pending legislative initiative.

[168] Written Statement of Gary Retelny, President and CEO of the ISS to the *Subcomm. on Capital Mkts. & Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.* A-12 (May 17, 2016), https://www.issgovernance.com/file/duediligence/iss-statement-hfsc-17-may-2016.pdf (stating that "[B]ecause advisers are paid to render disinterested advice, fiduciary concerns arise when an adviser or its employees have a personal stake in the subject of their advice," and adding that "[T]his fiduciary concern is the exact opposite of proxy adviser critics' suggestion that proxy advisers should have 'skin in the game.' In fiduciary parlance, 'skin in the game' means 'conflict of interest.'"). *See also* Letter from Mr. Gary Retelny, President of the ISS, to Elizabeth M. Murphy, Sec'y, SEC 14-15 (March 5, 2014), *available at* https://www.sec.gov/comments/4-670/4670-13.pdf (making the same point).