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The Proxy Advisory and Corporate Governance Industry:

The Case for Increased Oversight and Control

Tamara C. Belinfanti*

The proxy advisory and corporate governance industry plays a significant role in shareholder voting and in the formulation of corporate governance policy. The industry operates with relatively little accountability and virtually free from regulatory oversight. Understanding the relationship between this industry and mutual funds, which in the aggregate are the largest owners of publicly traded shares in the United States, is critical to understanding issues of shareholder rights, the meaning of the right to vote in corporate elections, and the role that institutional investors, like mutual funds, play in the corporate landscape.

Mutual funds exercise their substantial voting power by outsourcing key voting functions and corporate governance decisions to the proxy advisory industry. By far, the largest player in the industry is Institutional Shareholder Services (n/k/a RiskMetrics Group, Inc.) (ISS), which is estimated to advise half the world's common stock. This paper examines the factual and theoretical implications on our corporate polity of using proxy advisors like ISS. The paper addresses the problem from an agency theory perspective and argues that the current relationship between mutual funds and third-party agents like ISS is conceptually at odds with corporate law agency theory. In addition, it is a relationship that has

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practical implications for public companies, long-term shareholders, and our corporate landscape in general.

Introduction

Mutual funds are the largest owners of publicly traded shares in the United States and play a central role in global financial markets.¹ At the end of 2007, mutual funds managed an estimated \$26 trillion in assets worldwide and held approximately 24% of U.S. corporate stock.²

Mutual funds have substantial voting clout and the power to affect corporate vote outcomes. Understanding how mutual funds exercise this substantial voting power is critical to understanding issues of shareholder rights, the meaning of the right to vote in corporate elections, and the role institutional investors, like mutual funds, play in the corporate landscape.

In general, mutual funds exercise their substantial voting power by outsourcing key proxy voting functions and corporate governance decisions to third-party agents known as proxy advisors.³ These proxy advisors operate, in large part, free from stringent accountability and regulatory oversight. By far, the largest proxy advisor is Institutional Shareholder Services (n/k/a RiskMetrics Group, Inc.) (ISS).⁴

For a fee, ISS provides purportedly independent proxy research and voting advice to mutual funds and other institutional investors, and corporate governance advice to public companies.⁵ According to ISS, it advises “34 of the top 50” mutual

¹ INVESTMENT COMPANY INSTITUTE, 2008 INVESTMENT COMPANY FACT BOOK 6 – 36 (2008) [hereinafter Investment Company Fact Book] (describing recent mutual fund trends and stating that investment companies “as a whole are the largest group of investors in U.S. companies, holding 27 percent of their outstanding stock”; according to Figure 1.4 of the Investment Company Fact Book, 24% of the 27% of outstanding stock held by investment companies is held by mutual funds).

² See *id.*

³ This article focuses specifically on mutual funds and not other institutional investors, such as pension funds, because in the aggregate, mutual funds are the largest owners of public company stock.

⁴ U.S. GOVERNMENT ACCOUNTABILITY OFFICE, GAO-07-765, REPORT TO CONGRESSIONAL REQUESTORS 6, 13 (June 2007) (This calculation is based on the aggregate portfolio equity size of each proxy advisor’s institutional clients, as reported in Table 1 of the report: Overview of the Major Proxy Advisory Firms).

⁵ As discussed in Part I. A. and B., ISS also publishes corporate governance ratings of public companies.

funds.⁶ As of December 31, 2008, it advised approximately 2,800 organizations,⁷ and at the end of 2007, ISS advised an estimated \$20 trillion of assets.⁸ A 2006 New York Times article reported ISS' estimate that its advice affects the "governance decisions of professional investors controlling... half the value of the world's common stock."⁹

Mutual funds rely on ISS' advice in determining how to vote portfolio shares and 15-20% of mutual funds have even authorized ISS to automatically vote their shares however it sees fit.¹⁰ In addition to providing proxy voting advice and corporate governance related services to mutual funds and other institutional investors, ISS also publishes corporate governance ratings on thousands of public companies. Investors rely on these ratings, known as the "Corporate Governance Quotient" or "CGQ," as indicators of the quality of a company's corporate governance. According to ISS, "ISS' benchmark policies serve as an industry standard and best practice guide to corporate governance."¹¹

ISS plays an increasingly crucial role in corporate ballot issues, the development of corporate governance standards, and is perceived to have significant sway over corporate vote outcomes. As a measure of ISS' influence, consider that at least one study found that ISS has the power to sway approximately 13% to 20% of a given company's corporate vote.¹² Also consider that ISS is largely credited as the deciding voice in pushing through the \$19 billion merger of Hewlett-Packard Co. ("HP") and Compaq in 2002.¹³ Similarly, consider the case of 3M, where in 2003, ISS

⁶ Issproxy.com, Inst. S'holder Servs., *Experience Matters: A Guide to Selecting the Right Proxy Voting Partners*, 11 (2008), available at <http://www.riskmetrics.com/node/135565> (follow "SelectingTheRightProxyVotingPartner.pdf" hyperlink) (last visited Apr. 3, 2009).

⁷ RiskMetrics Group, Inc., Annual Report (Form 10-K), at 15 (Dec. 31, 2008) [hereinafter 2008 Annual Report].

⁸ RiskMetrics Group, Inc., Annual Report (Form 10-K), at 10 (Dec. 31, 2007) [hereinafter 2007 Annual Report].

⁹ See Robert D. Hershey, Jr., *A Little Industry With a Lot of Sway on Proxy Votes*, N.Y. TIMES, June 18, 2006, at S3.

¹⁰ RiskMetrics, *supra* note 8. See also Lynn A. Stout, *Why Should ISS Be The New Master Of The Corporate Governance Universe?* CORPORATE GOVERNANCE. (Dow Jones Financial Information Services, New York, N.Y.) Jan. 4, 2006, at 14 - 15.

¹¹ 2008 Annual Report, *supra* note 7, at 12.

¹² See Jennifer E. Bethel & Stuart L. Gillan, *The Impact of the Institutional and Regulatory Environment on Shareholder Voting 2* (Ctr. for Corp. Gov. Working Paper Series WP 2002-002), available at http://www.lerner.edel.edu/ccg/research_files/CCGWP2002-2.pdf.

¹³ ISS advised its institutional clients, which controlled 23% of HP's shares to vote for the merger. According to one Merrill Lynch & Co. (now Bank of America) analyst when talking about the HP/Compaq merger and ISS' role, "If [ISS] had gone the other way, the deal

effectively controlled the vote of 50% of 3M's total shares outstanding.¹⁴ In a 2003 letter to the U.S. Securities and Exchange Commission ("SEC"), the then Chairman of 3M's board indicated that "[m]any of the top 30 institutional shareholders we contacted in each of the past two years to discuss our position would not engage in any meaningful discussions, often citing adherence to ISS proxy voting guidelines"¹⁵ Corporate law scholar Professor Lynn Stout notes that, "[w]hen institutional investors follow ISS [vote recommendations] en masse, directors of public corporations can expect to see 20%, 30% even 50% of their company's shares being voted not as the directors recommend, but as ISS recommends."¹⁶

This article argues that institutional shareholders' reliance on ISS without any corresponding checks or balances on ISS, presents the hallmark problem of "agency cost" that has plagued corporate law scholars for years.¹⁷ In this article the term "agency costs" is used in the traditional sense to refer to the problems that may arise whenever one party (the "principal," in this case ISS' institutional clients) outsources certain decisions or actions to a third party (the "agent" - ISS).¹⁸

The article addresses a gap in current corporate law literature, which has traditionally focused on the problems of agency created by the separation of ownership and control between the managers of a corporation and its shareholders

would have been dead." See Peter Burrows & Andrew Park, *Compaq and HP: What's an Investor to Do?*, BUSINESSWEEK, Mar. 18, 2002, at 62.

¹⁴ In a 2003 letter to the SEC, the then Chairman of 3M's Board indicated that "[a]pproximately 55% of our top 50 institutional shareholders (representing about 50% of shares outstanding) follow ISS proxy voting guidelines." The letter then went on to note that "...ISS recommended that 3M stockholders approve this year's inapposite shareholder proposal, despite its inconsistency with fundamental notions of lawful corporate governance, and it won 58.9% of the vote." Letter from W. James McNerney, Jr., Chairman of the Board and CEO, 3M Corp., to Jonathan G. Katz, Sec'y, U.S. Sec. & Ex. Comm'n, available at <http://www.sec.gov/rules/proposed/s71903/3m120503.htm>.

¹⁵ *Id.*

¹⁶ Stout, *supra* note 10.

¹⁷ See generally ADOLPH A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 76 (MacMillan Co. 1933) (1932) (discussing generally the agency costs that arise as a result of the separation of ownership from control in a corporation). See also Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301-325 (1983).

¹⁸ It is acknowledged that in cases where ISS is simply providing corporate governance ratings and not performing advisory services on behalf of the mutual fund principal, the agency cost/agency theory framework may not be a perfect fit. However, even where ISS is simply providing corporate governance ratings, because these ratings are often relied upon by investors and substituted for investors own corporate governance diligence, one can argue that ISS acts as a *de facto* agent in the governance ratings space.

(the Berle-Means conception).¹⁹ However, our modern corporate landscape is comprised of a complex web of inter-tangled agency relationships, such as the relationship between ISS, mutual funds and corporations that muddle the traditional Berle-Means conception. Investors' reliance on ISS presents a new flavor of the age-old agency cost problem, which merits thorough examination.²⁰

Part I provides an overview of the proxy advisory and corporate governance industry generally, and ISS specifically,²¹ and examines the primary factors that have fueled the proxy advisory and corporate governance industry's prominence in today's corporate landscape. These include tangible factors such as the 2003 SEC mutual fund disclosure voting regulations (the 2003 SEC Rule),²² the 1988 ERISA pension fund voting requirements,²³ the 2002 Sarbanes-Oxley Act (Sarbanes-Oxley),²⁴ and the proposed New York Stock Exchange (NYSE) Broker Voting Rules.²⁵ In addition, intangible factors such as the current call by academia, the media, and the

¹⁹ See generally BERLE & MEANS, *supra* note 17. See also Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327, 332 (1983) ("[T]his problem of separation of 'ownership' and 'control'...has troubled students of open corporations from Adam Smith [1776] to Berle and Means [1932] and Jensen and Meckling [1976]").

²⁰ See, e.g., Leo E. Strine, Jr., *Toward Common Sense and Common Ground? Reflections on The Shared Interests of Managers and Labor In A More Rational System of Corporate Governance*, 33 J. CORP. L. 1, 17 ("Given the mountains of 401(k) money that American workers, as a practical matter, will entrust to [institutional investors] for generations, the utility of considering measures to guarantee greater alignment seems self-evident to anyone who has listened to corporate law scholars beat the agency cost drum.").

²¹ For the sake of efficiency and for examining the problem of agency in the most intensified form, it should be noted that this article focuses specifically on ISS, instead of the proxy advisory and corporate governance industry as a whole. However, while much of the factual substance under discussion is specific to ISS, the implications of what these facts reveal is generally applicable to the third party proxy advisor and corporate governance industry as a whole and the solutions proffered in Part V are also intended to be implemented in a general way to the entire industry.

²² Disclosure of Proxy Voting Policies Voting Records By Registered Management Investment Companies, Investment Company Act Release No. 25922, 17 C.F.R. 239, 249, 270, 274 (Jan. 31, 2003).

²³ Employment Retirement Income Security Act of 1974, 29 C.F.R. § 2509.94-2 (2006).

²⁴ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in various sections of 11, 15, 18, 28 & 29 U.S.C.).

²⁵ In 2006, the New York Stock Exchange submitted a proposed rule to the SEC to eliminate discretionary voting for all director elections. The proposed rule was not approved by the SEC as the agency was conducting a more expansive review of shareholder access issues. The NYSE resubmitted the proposed rule change on February 26, 2009. If approved by the SEC prior to August 31, 2009, the proposed rule would be applicable to proxy votes for shareholder meetings held on or after January 1, 2010.

business world for greater shareholder control,²⁶ could also have the unintended effect of transferring more power to intermediaries like ISS.

Part II presents an overview of agency theory and its traditional treatment in corporate law scholarship; provides an overview of the primary devices that are recognized as effective controls on agency costs; and conceptualizes the agency costs of ISS.

Part III analyzes features of ISS' business, and the market, legal, and regulatory topography which have created an opportunity for ISS to operate virtually unchecked and with minimal accountability to those whom its decisions affect. Specifically, the article focuses on the following characteristics of ISS' operating framework – (i) the lack of market check on ISS' activities; (ii) the lack of transparency in ISS' decision-making process; (iii) the absence of fiduciary duty restraint; and (iv) the limited ability of ISS' clients to exercise “exit” or “voice,” meaning that ISS' clients may be practically and psychologically restrained in their ability to sever ties from ISS and use another proxy advisor (“exit”), and these clients may have little incentive to voice concerns to ISS (“voice”).²⁷

Part IV addresses several potential counterarguments to the position that ISS agency costs are significant and need to be addressed. These include the argument that ISS is not that influential; the argument that mutual funds are free to vote their portfolio stock however they choose thereby having the ability to curtail any problems of agency; and the argument that the market provides a built-in restraint against ISS agency costs. Part IV demonstrates that both the perception of, and actions of, mutual funds and the market show that these arguments are not persuasive.

²⁶ See, e.g., Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005) (arguing for an increase in the use of shareholder power through various mechanisms, such as increased ballot access, as a means for controlling company managers). See also Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789 (2007) (addressing the argument that shareholders should be given greater influence over boards and arguing that “calls for greater ‘shareholder democracy’ appeal to laymen, the business media, and even many business experts not because they are based on evidence, but because they have a strong emotional allure.”).

²⁷ See ALBERT O. HIRSCHMAN, EXIT, VOICE AND LOYALTY (1970) (discussing the combined strategic use of “exit” and “voice” to increase an organization’s efficiency).

Part V proposes three potential solutions to the agency costs generated by ISS.²⁸ The first solution calls for the SEC to consider regulating the proxy advisory and corporate governance industry, similar to the regulation it is currently contemplating for nationally recognized statistical rating organizations ("NRSROs").²⁹ The second solution contemplates establishing an oversight board for the proxy advisory and corporate governance industry similar in objective and mandate to the Public Company Accounting Oversight Board (PCAOB) established for auditor oversight. The intended goal of this second proposal would be to implement a structure of systematic accountability and checks on the proxy advisory and corporate governance rating industries. The third solution focuses on incentivizing mutual funds to exercise their right to vote on behalf of their underlying fund shareholders in a more meaningful and diligent way. The objective of this third solution would be to encourage ISS mutual fund clients to pay more attention to the quality of ISS' decisions and not simply follow ISS' recommendations.

The article concludes by asserting that outsourcing proxy voting and monitoring functions to ISS creates significant agency costs. On balance, while acknowledging some of the arguments that may temper the significance of these agency costs, and despite the complexities involved in crafting workable solutions to minimize these agency costs, the problem of ISS agency cost is real and should be addressed *ex ante* before mutual fund reliance on ISS proves misplaced. Ultimately, should ISS' advice prove misguided, the parties who stand to bear the brunt of any losses are the individual investor who has entrusted his/her money to mutual funds and the public companies who are impacted by ISS' decisions.

I. The Proxy Advisory and Corporate Governance Industry

Proxy advisory firms provide proxy analyses and voting recommendations to institutional shareholders, while corporate governance rating firms issue

²⁸ In a 2007 article, Professor Paul Rose addresses potential solutions to conflict of interest concerns in the proxy advisory industry. See Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887 (2007) (examining the role of the corporate governance industry as a voluntary regulator and proposing potential solutions to conflict of interest concerns within the proxy advisory industry).

²⁹ See Proposed Rules for Nationally Recognized Statistical Rating Organizations, Exchange Act Release No. 34-57967, 17 C.F.R. pts. 240 and 249b (June 16, 2008), [hereinafter SEC NRSRO Proposed Rule].

governance scores which are supposed to help investors evaluate the quality of a company's corporate governance practices. Both industries have a limited number of participants. ISS is currently the only firm that provides proxy advisory services, offers corporate governance advisory services to public companies, and issues corporate governance ratings on public companies.³⁰

A. The Corporate Governance Rating Industry

The main players in the commercial corporate governance rating industry include ISS, GovernanceMetrics International, The Corporate Library, Audit Integrity, Morningstar, Standard & Poor's, Moody's Investor Services and Fitch Ratings Ltd.. Each firm produces corporate governance ratings of public companies, but the ratings differ in terms of focus, computational methods, qualitative factors, corresponding weights ascribed to each factor, and the assumptions included in the firm's ratings model. The rating firms also differ based on the aggregate number of ratings they produce and whether the ratings are limited to a particular type of public operating company. Some firms make their ratings available to the public while others do not. For example, ISS' CGQ for each company it rates is readily accessible to the public on that company's Yahoo!® Finance page. In contrast, GovernanceMetrics' ratings are available on a subscription basis only.

With the exception of The Corporate Library ratings, all of the corporate governance rating firms use proprietary algorithms and proprietary quantitative analysis to generate their respective corporate governance ratings. ISS' CGQ is explored in depth in Part I.C.2.a. below.

B. The Proxy Advisory Industry

The proxy advisory industry has grown over the past twenty years as a result of various market and regulatory developments. In 1988, the U.S. Department of Labor took the position that the voting of proxies of shares of stock owned by a pension plan was part of the plan's fiduciary duty to manage employee benefit plan

³⁰ ISS' chief competitor, Glass, Lewis & Co. (Glass Lewis), does produce a governance weighting system known as the "Board Accountability Index" or "BAI." The BAI is comprised of all companies in the S&P 500. According to Glass Lewis, the BAI "uses a modified market-cap weighting algorithm that adjusts a company's weight based on the presence or absence of five critical corporate governance features". These "critical corporate governance features" are based on a study by Professors Lucian Bebchuk, Alma Cohen, and Allen Ferrell. See Glass Lewis, Board Accountability Index, <http://www.glasslewis.com/solutions/bai.php> (last visited Apr. 3, 2009).

assets.³¹ This development prompted managers of employee retirement plan assets to seek help from the proxy advisory industry to satisfy their fiduciary responsibilities to vote proxies in the best interests of their clients. The proxy advisory industry, particularly ISS which had been established three years earlier in 1985, began to grow.³² ISS owes much of its growth during this period to the fact that it was the only proxy advisor at the time that covered a range of companies.³³

In the 1990s and early 2000s, ISS' reputation and dominance in the proxy advisory industry continued to increase, and was further accelerated by a rise in shareholder activism by institutional investors.³⁴ In the wake of the corporate scandals and ultimate collapse of companies like Enron and Worldcom, institutional investors became more active and turned to the proxy advisory industry for assistance in assessing the corporate governance practices of operating companies and in performing proxy voting functions.³⁵

The watershed moment for the proxy advisory industry came with the passage of the 2003 SEC Rule that required mutual funds to disclose their complete voting records annually.³⁶ The 2003 SEC Rule also required mutual funds to adopt policies and procedures reasonably designed to ensure that proxies would be voted in the best interests of their clients.³⁷ An unintended consequence of these requirements was a swell in demand for proxy advisory and governance services.³⁸

³¹ See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 4, at 6. See also Proxy Voting by Investment Advisers, 68 Fed. Reg. 6585 (2003) (final rule) (codified in various sections of 17 C.F.R. Part 275). See also ERISA, *supra* note 23 (setting forth the Dept. of Labor's interpretation of ERISA as it applies to the voting of proxies).

³² ISS was not the first proxy advisory firm. Proxy Monitor Inc., which was founded in 1984, preceded ISS. However, in 2001 ISS merged with Proxy Monitor.

³³ Marco Consulting Group (MCG), another proxy advisor, was founded in 1988. However, MCG provides proxy advisory services only to Taft-Hartley funds. See Section I.C. below for a more detailed discussion of MCG and other proxy advisors.

³⁴ See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 4, at 6 - 7.

³⁵ *Id.*

³⁶ See 17 C.F.R. 239, *supra* note 22.

³⁷ See 17 C.F.R. 239, *supra* note 22.

³⁸ ISS, and two other proxy advisors—Proxy Governance, Inc. and Egan-Jones Proxy Services - all reference this 2003 SEC Rule as a significant factor in the increased demand for proxy advisory services. See, e.g., 2007 Annual Report, *supra* note 8, at 24 ("ISS' historical growth has been due to increased regulatory requirements, highly visible corporate scandals, increased shareholder activism and corporate chief executive officers and boards of directors that are increasingly concerned about, and responsive to, shareholder concerns."). See also Proxy Governance, Inc., <https://www.proxygovernance.com/content/pgi/content/history.shtml> [hereinafter PGI] (last visited Apr. 3, 2009) ("In 2003, encouraged by a

The SEC adopted the 2003 SEC Rule with the hope that "requiring greater transparency of proxy voting by funds [would] encourage funds to become more engaged in corporate governance of issuers held in their portfolios, which [in turn would] benefit all investors and not just fund shareholders."³⁹ For their part, mutual funds have become "more engaged in corporate governance" by outsourcing key monitoring and voting functions to agents like ISS. According to Professor Lynn Stout, "the actual result [of the SEC's 2003 Rule] has been to drive the fund industry even deeper into the arms of ISS."⁴⁰

This increased coziness between ISS and other proxy advisors, on one hand, and mutual funds and institutional investors, on the other, shows no signs of abating. The current financial crisis may well result in further regulation regarding corporate governance standards and if it does, then ISS and other proxy advisors are likely to see an increase in the demand for their services.⁴¹ In addition, the percentage of equity securities held by institutional investors, particularly mutual funds, continues to increase sharply.⁴² These investors are more likely to receive voting advice from proxy advisors and be influenced by these advisors' recommendations.

In addition, current proposals for greater shareholder rights championed by corporate law scholars⁴³ will actually transfer more influence to ISS and the proxy advisory industry, as institutional shareholders, and not individual shareholders, are the predominant shareholders of record in modern corporate society. Many of these

developing regulatory environment that would expand the market for proxy advisory and voting services, [our parent company] reinitiated developmental work [to create a proxy advisory service]"); Egan-Jones Proxy Services <http://www.ejproxy.com/> [hereinafter Egan-Jones] (last visited Apr. 3, 2009) ("With SEC mandated proxy voting disclosure rules pushed to the forefront by renewed concerns of corporate governance...professional investors and fund managers will increasingly find value in [our] services.").

³⁹ Disclosure of Proxy Voting Policies Voting Records by Registered Management Investment Companies, Investment Company Act Release No. 25,739, 17 C.F.R. §§ 239, 249, 274 (Sept. 20, 2002).

⁴⁰ See Stout, *supra* note 10.

⁴¹ ISS acknowledged this in its 2008 Annual Report. See 2008 Annual Report, *supra* note 7 at 16 ("In general, regulation has been a key driver to our business growth. In the event that the current financial crisis results in further regulation, we believe that such regulation could be a driver for growth in our business.").

⁴² See Investment Company Fact Book, *supra* note 1.

⁴³ See generally Bebchuk, *supra* note 26; Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 38 UCLA L. REV. 871, 895 (1992) (arguing for greater institutional voice).

institutional investors in turn outsource their proxy monitoring and information gathering functions to third-parties like ISS. As Vice Chancellor Leo Strine of the Delaware Court of Chancery stated, “[t]he influence of ISS and its competitors over institutional investors’ voting behavior is so considerable that [one] should be concerned that any initiative to increase stockholder power will simply shift more clout to firms of this kind – firms even more unaccountable than their institutional investor clients.”⁴⁴

Finally, the proposed NYSE broker voting rule would have the effect of transferring more sway over proxy voting outcomes to ISS and other proxy advisors.⁴⁵ Current NYSE rules permit brokers to vote on “routine” proposals if the beneficial owner of the stock has not provided specific voting instructions to the broker at least ten days prior to a scheduled meeting.⁴⁶ Uncontested director elections are considered “routine” under the NYSE’s current rules. The proposed amendments would make *all* director elections “non-routine,” however, which would mean that brokers would only be able to vote on director elections if they have received instructions from beneficial owners. If the proposed amendments become effective, and issuers/brokers are unable to obtain voting instructions from large numbers of individual shareholders, then there will be a significant shift in voting power from brokers to institutions, such as mutual funds, and in turn to proxy advisors like ISS.⁴⁷ A 2002 study found that ISS recommended that shareholders vote against 78.1 percent of the proposals that the authors estimated to have been determined by broker discretionary votes.⁴⁸

Institutional investors’ reliance on proxy advisors has become a permanent and central feature of today’s corporate vote. Understanding what these proxy advisors do and the limitations inherent in relying on their advice, is key to maintaining the integrity of the corporate vote.

⁴⁴ Leo E. Strine, Jr., *Towards A True Corporate Republic: A Traditionalist Response To Lucian’s Solution For Improving Corporate America* (John M. Olin Center For Law, Economics, and Business, Harvard University, Discussion Paper No. 541, 2/2006), available at http://www.law.harvard.edu/programs/olin_center/papers/541_Strine.php (follow “541: PDF link to download”).

⁴⁵ See *supra* note 25 (discussing the NYSE proposed rule change).

⁴⁶ See *supra* note 25.

⁴⁷ See David A. Katz & Laura A. McIntosh, *Activist Shareholders Would Gain Power From Proposed Rule Change*, New York Law Journal (2009) (discussing effects of the NYSE proposed rule change regarding broker discretionary votes).

⁴⁸ Bethel & Gillan, *supra* note 12.

C. The Players in the Proxy Advisory Industry

According to a 2007 Report by the United States Government Accountability Office examining “Issues Relating to Firms That Advise Institutional Investors on Proxy Voting” (the GAO Report),⁴⁹ the proxy advisory industry in the U.S. is comprised of five major firms, “with ISS serving as the dominant player . . .”⁵⁰ The other four players in the industry are Marco Consulting Group (MCG), Glass Lewis & Co. (Glass Lewis), Proxy Governance, Inc. (PGI) and Egan-Jones Proxy Services (Egan-Jones). MCG, Glass Lewis, PGI and Egan-Jones have “much smaller client bases [than ISS] and are “relatively new to the market,”⁵¹ with Glass Lewis, PGI and Egan-Jones created within the past seven years.⁵² Of the four proxy advisors identified in the GAO Report, ISS considers Glass Lewis and PGI to be its primary competitors.⁵³

Below is a brief overview of MCG, Glass Lewis, PGI and Egan-Jones, as well as a more detailed overview of ISS and its operations.

1. MCG, PGI, Egan-Jones and Glass Lewis

MCG, PGI and Egan-Jones, together control approximately three percent of the proxy advisory industry.⁵⁴ Glass Lewis controls approximately 36 percent of the market.⁵⁵

MCG was established in 1988 to provide investment analysis and advice to Taft-Hartley funds.⁵⁶ Since inception, MCG has expanded its client base to include

⁴⁹ See generally U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 4.

⁵⁰ *Id.* at 7. A sixth proxy advisor, CtW Investment Group, was formed in February 2006 and provides a limited number of recommendations to union pension funds. See CtW Investment Group – Who We Are, *available at* <http://www.ctwinvestmentgroup.com/index.php?id=1> (last visited Apr. 3, 2009).

⁵¹ See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 4.

⁵² See *id.* at 7-8.

⁵³ 2007 Annual Report, *supra* note 8. See also 2008 Annual Report, *supra* note 7.

⁵⁴ See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 4. The GAO Report indicated that ISS' clients manage approximately \$25.5 trillion in equity assets, Glass Lewis' clients manage approximately \$15 trillion, PGI's clients manage approximately \$1 trillion and MCG's clients manage approximately \$85 billion. Equity assets under management were not provided for Egan-Jones' clients.

⁵⁵ See *id.*

⁵⁶ The Labor Management Relations Act, also known as the Taft-Hartley Act, allows for the establishment of multiemployer trust funds, known as Taft-Hartley funds, for the purpose of providing pension and welfare benefits to employees and their families. Labor Management Relations Act, 29 U.S.C. § 141 (2007).

public employee benefit plans.⁵⁷ MCG's services are specifically targeted to benefit plan sponsor clients and approximately 4% of its revenues derive from its proxy voting services.⁵⁸ MCG is not affiliated with any other company or organization and it is privately owned by the employees of the firm.⁵⁹ PGI was established in 2004 and provides proxy analysis and voting advice. PGI is a wholly-owned subsidiary of FOLIOfn, Inc., a financial services company that also provides brokerage services and portfolio management technology for individual investors and investment advisers.⁶⁰ PGI provides research coverage and proxy voting recommendations on both U.S. and non-U.S. publicly reporting companies. The scope of PGI's coverage is determined by the "securities held in client portfolios."⁶¹ PGI describes its analyses as "transparent" and states that it does provide "clearly stated rationales for all . . . recommendations."⁶² Similarly, Egan-Jones provides proxy advisory services to institutional clients. Egan-Jones was established in 2002 as a division of Egan-Jones Rating Company, which was incorporated in 1992.⁶³ Egan-Jones markets itself as providing advice that is conflict-free, having deep expertise in credit risk analyses, and being the low-cost provider in the proxy advisory industry.⁶⁴

Based on market share and market perception, ISS' main competitor is Glass Lewis.⁶⁵ A 2004 New York Times article declared that "Glass Lewis has unseated [ISS]...from its position as the undisputed leader in the field."⁶⁶ Like PGI and Egan-Jones, Glass Lewis provides proxy research and voting recommendations to institutional investors. Glass Lewis' coverage appears to be more expansive than PGI's and Egan-Jones', covering 16,000 public companies across 65 countries.⁶⁷ Glass Lewis was founded in 2003 and in 2007 it became an independent wholly-owned

⁵⁷ Marco Consulting Group, http://www.marcoconsulting.com/Company_history.html (the "Company History" section of the website) (last visited Apr. 3, 2009).

⁵⁸ See *id.*

⁵⁹ See *id.*

⁶⁰ See PGI, *supra* note 38.

⁶¹ See *id.*

⁶² See *id.*

⁶³ See Egan-Jones, *supra* note 38.

⁶⁴ *Id.*

⁶⁵ See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 4.

⁶⁶ Gretchen Morgenson, *How To Succeed on Wall Street, Conflict-Free*, N. Y. TIMES, Dec. 19, 2004, at S3.

⁶⁷ Glass Lewis & Co., *What We Do*, <http://www.glasslewis.com/solutions/index.php> (last visited Apr. 3, 2009) [hereinafter Glass Lewis]. PGI's website indicates that its parent company casts electronic proxy votes on "more than 4,000 companies." See PGI, *supra* note 38.

subsidiary of Ontario Teachers' Pension Plan Board.⁶⁸ Glass Lewis' clients collectively manage more than \$15 trillion in assets,⁶⁹ compared to ISS, whose clients manage approximately \$25.5 trillion in assets.⁷⁰

Glass Lewis has been able to make inroads into ISS' market share because Glass Lewis, like ISS, offers broad coverage and services. Unlike ISS, however, Glass Lewis does not sell its corporate governance advice to public companies.⁷¹ Glass Lewis is thus free from the perceived conflict-of-interest problems that cloud ISS' recommendations. Even though Glass Lewis has been able to cut into ISS' market share, the current gap between Glass Lewis' coverage and that of ISS is stark. ISS offers proxy advice on over 50,000 companies, while Glass Lewis offers proxy advice on only 16,000 companies. ISS remains the clear industry leader.

2. ISS

Founded in 1985, ISS has become the market leader in both corporate governance ratings and proxy voting recommendations.⁷² ISS remained a private company until 2008 when it was acquired by RiskMetrics Group, Inc.⁷³ ISS maintains substantial power and influence over both corporate voting decisions and corporate governance issue. ISS controls the bulk of the industry with over 61% market share.⁷⁴ As a measure of ISS' influence, consider the following:

- ISS provides voting recommendations to approximately 1,650 financial institutions and to 1,200 corporations and professional service organizations.⁷⁵

⁶⁸ See Glass Lewis, *supra* note 67.

⁶⁹ See *id.*

⁷⁰ See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 4, at 7.

⁷¹ See Glass Lewis, *supra* note 67. See also Morgenson, *supra* note 66. Because ISS has been heavily critiqued for having a conflict of interest (See *infra* note 87), other competitors such as Egan Jones also market themselves as being free from conflict of interest concerns. See Egan Jones, *supra* note 38 ("[T]he integrity of our recommendations is not clouded with complication of also selling corporate directors and managers consulting services pertaining to [the same] shareholder proposals [on which we provide advice].").

⁷² See also Hershey, *supra* note 9. See generally U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 4.

⁷³ RiskMetrics acquired ISS in January 2007 for an estimated \$550 million. However, RiskMetrics did not go public until January 2008. See Jeff Nash, *Advise this: Glass Lewis On The Block*, FIN. WK.; September 24, 2007. See also 2007 Annual Report, *supra* note 8.

⁷⁴ See *supra* note 54.

⁷⁵ 2007 Annual Report, *supra* note 8, at 14.

- By ISS' own estimates, its opinions affect the governance decisions of institutional investors controlling \$20 trillion in assets.⁷⁶
- ISS claims to advise "24 of the top 25" and "31 of the top 100" mutual funds, all "25 of the top 25" asset managers and "17 of the top 25" public pension funds.⁷⁷
- Approximately 15-20% of ISS' clients utilize a service that automatically votes the clients' shares according to its recommendations.⁷⁸
- ISS' coverage is the most expansive of all the proxy advisors, covering more than 50,000 companies,⁷⁹ and in 2008 ISS issued proxy research and vote recommendations for over 45,000 shareholder meetings across 110 countries.⁸⁰
- In 2008, ISS cast 7.6 million ballots on behalf of its clients, representing over 1.3 trillion shares.⁸¹

a. ISS' Services

ISS divides its services into three categories. The first category is its "Governance Research" service, which consists of its proxy advisory services, custom proxy advice services, "M&A Edge," "Voting Analytics," and CGQ ratings. The second group of services is its "Fiduciary Services," consisting of proxy voting services, SEC Class Action Services, Vote Disclosure Services, and Global Proxy Distribution. ISS' third class of services is its "Enabling Governance" service, which consists of its Policy "Gateway," "Governance Exchange" and "Policy Exchange."

ISS provides its services on a subscription basis. While clients may select individual services, the bulk of ISS' clients choose to bundle their services.⁸² ISS sets

⁷⁶ *Id.*

⁷⁷ RiskMetrics Group, EXPERIENCE MATTERS: A GUIDE TO SELECTING THE RIGHT PROXY VOTING PARTNERS 9 (2008),

<http://www.riskmetrics.com/sites/default/files/SelectingTheRightProxyVotingPartner.pdf>

⁷⁸ See 2007 Annual Report, *supra* note 8. See also Dean Starkman, *A Proxy Advisor's Two Sides: Some Question Work of ISS for Companies It Scrutinizes*, WASH. POST, Jan. 23, 2006, at D1 (citing a statement by Susan E. Wolf, chairman of the Society of Corporate Secretaries and Governance Professionals and Vice President at Schering-Plough Corporation).

⁷⁹ 2007 Annual Report, *supra* note 8, at 10.

⁸⁰ 2008 Annual Report, *supra* note 7.

⁸¹ *Id.*

⁸² See *id.* at 11 ("Although some of our Proxy Research and Voting clients purchase our proxy research on a stand-alone basis, the vast majority purchase a comprehensive research and voting product.").

its subscription rate so that the total cost of its services decreases the more services a client receives from ISS. ISS does not offer its services to individual investors.

In its role as proxy advisor, ISS reviews the various company and shareholder proposals put up for vote at a company's annual meeting, analyzes these proposals, and offers advice on how institutional investors should vote their shares. Prior to the start of each proxy season ISS releases a statement about its proxy voting policies in which it highlights the key changes to its policies from the previous year. For example, at the end of 2008 ISS updated its proxy voting policies for 2009 to expand the executive compensation pay practices that it will consider in making a vote recommendation.⁸³ Practices such as tax gross-ups on executive perks and "walk away" rights that provide for the payment of severance upon a voluntary resignation, may now trigger a withhold recommendation from ISS.⁸⁴ ISS views its policy changes as necessitated by a changing and dynamic corporate environment.⁸⁵ In contrast, ISS' critics view many of these policy changes as being symptomatic of under-informed judgments in the first instance rather than well thought out policies, or as being part of a continued march to advance activist agendas at the expense of allowing corporate boards to make decisions traditionally within their control.⁸⁶

On the corporate governance side, ISS issues corporate governance ratings for public companies *and* offers a service to public companies whereby these companies can hire ISS to help them improve their corporate governance. Not

⁸³ See Press Release, RiskMetrics Group, RiskMetrics Group Releases 2009 Proxy Voting Policies (Nov. 25, 2008), *available at* http://www.riskmetrics.com/press/2009_policy.

⁸⁴ See U.S. Corporate Governance Policy 2009 Updates, RiskMetrics Group, (Nov. 25, 2008), *available at* <http://www.riskmetrics.com/sites/default/files/RMG2009PolicyUpdateUnitedStates.pdf>.

⁸⁵ See, e.g., RiskMetrics Group, RiskMetrics Group 2009 Benchmark Voting Policy Updates, Harvard Law School Corp. Gov. Forum, Dec. 23, 2008, *available at* <http://blogs.law.harvard.edu/corpgov/2008/12/23/riskmetrics-group-2009-benchmark-voting-policy-updates/> ("This year's policy revisions reflect the unprecedented market turmoil that has sparked investor and regulatory focus on executive compensation practices, board accountability and oversight, and the quality of financial reporting.").

⁸⁶ See, e.g., Stout, *supra* note 10 ("[T]here is reason to doubt whether ISS analysts have particularly good insight into what makes for 'good corporate governance.' Instead, ISS seems to simply follow governance fads and fancies."). See also David A. Katz & Laura McIntosh, *RiskMetrics Update Continues to Hamper Director Discretion*, New York Law Journal (Jan. 23, 2009), *available at* <http://www.law.com/jsp/ihc/PubArticleIHC.jsp?id=1202427663057> ("[The 2009] policy updates continue [ISS'] trend of espousing policies that tend to shift control from boards of directors to shareholders, including activists and special interest groups.").

surprisingly, this aspect of ISS' business has led to charges that ISS is conflicted.⁸⁷ In response to these charges, ISS has created a firewall between its corporate governance ratings and corporate governance advice businesses, and has created a separate subsidiary (ISS Corporate Services) to provide governance services to corporations.⁸⁸ Despite ISS' efforts to avoid conflict-of-interest concerns, these concerns are still widely prevalent in the market.

b. The "CGQ" - ISS' Corporate Governance Ratings

ISS' corporate governance ratings are generated by a proprietary system known as the "Governance Analytics" platform. ISS refers to this resulting rating as the "Corporate Governance Quotient" (CGQ), and describes it as "a dynamic corporate governance rating tool that helps investors manage investment risk and drive value while also helping corporations perform peer analysis and benchmark their corporate governance practices."⁸⁹ According to a study from Stanford University, board members perceive a link between a company's CGQ and how ISS

⁸⁷ See Morgenson, *supra* note 66. Not surprisingly, ISS vehemently denies charges that its advice suffers from a conflict of interest. See, e.g., Institutional Shareholder Services, Inc., SEC No-Action Letter (September 15, 2004), available at <http://sec.gov/divisions/investment/noaction/iss091504.htm> (responding to letter from ISS requesting relief that an adviser may fulfill its duties under the Adviser Act to determine that an independent proxy adviser is capable of making impartial recommendations by examining the conflict of interest procedures that the adviser has adopted. In ISS's letter, as reproduced in the SEC response, ISS maintains that it "has erected a firewall between its institutional and corporate activities in order to maintain the highest level of objectivity" and that its proxy voting staff and corporate governance staff operate out of separate and secure areas.). *Contra* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 4, at 4 ("[T]he business model of [ISS]... has been cited by industry participants and analysts as creating a significant potential conflict of interest."); see also Report And Recommendations Of The Proxy Working Group To The New York Stock Exchange, available at http://www.nyse.com/pdfs/PWG_REPORT.pdf [hereinafter NYSE Working Group] (recommending, inter alia, that further investigation be conducted on the role of institutional advisory services that make "vot[e] recommendations and/or decisions over shares in which they do not own or have an economic interest." The Working Group indicated that it believed that proxy advisory firms have "the potential for possible conflicts.").

⁸⁸ 2008 Annual Report, *supra* note 7, at 16.

⁸⁹ Memo from Institutional Shareholder Services to US CGQ-rated companies Re: CGQ Methodology Evolves to Align Rating with Financial Performance, <http://www.acte.org/initiatives/csr/CGQevolvingmethodologyWP.pdf> (last visited Apr. 3, 2009).

advises its clients to vote on particular proxy proposals put forth on the company's ballot.⁹⁰

ISS analyzes 65 factors to determine each U.S. company's CGQ and analyzes 55 factors for non-U.S. companies.⁹¹ The 65 rating factors that comprise the CGQ for U.S. companies fall into the following eight categories: (i) "Board;" (ii) "Audit;" (iii) "State of Incorporation;" (iv) "Executive and Director Compensation;" (v) "Qualitative Factors;" (vi) "Ownership;" (vii) "Director Education;" and (viii) "Charter/Bylaws."⁹² Each company is assigned two CGQ ratings: a market CGQ, which compares the company to the relative market index (e.g., S&P 500, Mid-Cap 400 or Small Cap 600) and an industry CGQ, which compares the company to its industry peer group (e.g., travel and leisure or healthcare equipment and services).

Over time, ISS has added and subtracted factors from the CGQ and has changed the weight it accords to these factors in an attempt to reflect current corporate governance trends.⁹³ For example, in 2006 the CGQ was updated to include ratings criteria for options backdating, director withhold recommendations and majority voting.⁹⁴

ISS uses proprietary weights to construct the CGQ. ISS does not disclose the weight assigned to each variable or the inter-relationship among the various sub-variables and variables, which individually and collectively may impact a company's

⁹⁰ See Robert Daines et al., *Rating the Ratings: How Good Are Commercial Governance Ratings?* 4 (June 26, 2008) (Stanford University Rock Center for Corporate Governance, Working Paper) [hereinafter Daines Study] ("[I]n our interviews with board of directors, we find that board members believe that [corporate governance] ratings are an influential and important input into the recommendations made to shareholders concerning proxy statement proposals."). However, the Daines Study went on to note that "we find virtually no evidence that ISS ratings affect... [the] proxy proposal recommendations made by ISS..." Similarly, in a 2007 article, Professor Paul Rose noted that: "Proxy advisers generally base their decisions on corporate governance standards that are derived from the same policies as those used to formulate governance ratings and related governance advice." See Rose, *supra* note 28, at 898.

⁹¹ Issproxy.com, US Corporate Governance Quotient Criteria, <http://www.issproxy.com/issgovernance/esg/uscgqcriteria.html> (last visited Apr. 3, 2009) [hereinafter CGQ Criteria].

⁹² See CGQ Criteria, *supra* note 91.

⁹³ Oppenheimer Corporate Finance & Transactions Alert, *What's Your CGQ "IQ"?, What Every Corporate Executive Should Know About The Corporate Governance Quotient*, http://www.oppenheimer.com/newsletters/CGQ_IQ.pdf (last visited Apr. 3, 2009) ("The CGQ methodology is updated periodically to reflect the most current corporate governance trends.").

⁹⁴ *Id.*

CGQ score. ISS maintains that it has weighted the proprietary variables in each category according to how important it determines each variable to be.

c. Critiques of ISS' Services

No one except ISS knows exactly how the CGQ is derived, yet the CGQ has become the benchmark for assessing the quality of a public corporations' corporate governance. Moreover, it is questionable whether ISS' CGQ is a reliable benchmark.

ISS has been criticized for suffering from conflict of interest problems,⁹⁵ using faulty analysis, making errors, mistakes or omissions that impact its proxy voting advice and CGQ ratings,⁹⁶ hiring relatively unskilled employees to conduct governance analysis,⁹⁷ being "blatantly opportunistic" in peddling its services,⁹⁸ and for merely following the fad of the time instead of developing sound corporate governance policies.⁹⁹ As Professor Lynn Stout noted in a 2006 article:

[T]here is reason to doubt whether ISS analysts have particularly good insight into what makes for 'good corporate governance.' Instead, ISS seems to simply follow governance fads and fancies. [For example, ISS' position on staggered boards and other anti-takeover protections is] extreme . . . and relies on some flawed academic studies that looked only at how anti-takeover protections

⁹⁵ See Morgenson, *supra* note 66; See also U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 4; NYSE Working Group, *supra* note 87.

⁹⁶ See Monica Langley, *Want to Lift Your Company's Ranking on Corporate Governance? Buy the Test*, WALL ST. J., June 6, 2003 (quoting ISS' Senior Vice-President, Patrick McGurn statement that, "occasionally we miss one" and his acknowledgment that in at least one instant ISS "had not made the [appropriate] disclosures nor check[ed] the reports to see if it had." The Senior Vice-President then stated, "We screwed up... [and ISS] was embarrassed by the [revealed] operational misstep.")

⁹⁷ See Rose, *supra* note 28, at 897 ("ISS...has been known to use relatively unskilled temporary employees to conduct governance reviews...") (citing article by Eleanor Laise, *Is This The Most Influential Man on Wall Street?*, SmartMoney Mag., Oct. 16, 2002).

⁹⁸ Langley, *supra* note 93. (Agilent Technologies Inc.'s General Counsel, Craig Nordlund, in discussing conversations with ISS over ISS' ratings of Agilent and the use of ISS' services, noted that ISS notified Agilent that "it would be rating [Agilent] on its corporate governance and that, for a fee of \$16,000, [ISS] could provide guidance [to Agilent] on improving its scores." Nordlund related that he told ISS, "[t]his is blatantly opportunistic. I feel less like we're getting rated and more like we're getting pressured to buy another product.").

⁹⁹ See Joann S. Lublin, *Turning the Tables; RiskMetric's Head Faces His Day of Shareholder Judgment*, WALL ST. J., June 2, 2008, at C1.

affected share price around the time a takeover bid was made, and ignores evidence that anti-takeover defenses can enhance share performance measured over longer periods.¹⁰⁰

Despite these concerns about the quality of ISS' services, ISS continues to be the preferred choice for mutual funds, ostensibly because ISS is the largest and most established player in the proxy industry. Hiring ISS provides a sense of security as most mutual funds use ISS, and ISS offers the largest scope of company coverage.

Vice Chancellor Strine summed up the issue as follows: "Following ISS constitutes a form of insurance against regulatory criticism, and results in ISS having a large sway in the affairs of American corporations."¹⁰¹

II. The Agency Problem

A. Agency Costs and Corporate Law Myopia

The agency problem arises when one party uses another party to act on his behalf and the parties' incentives are misaligned. In corporate law the problem of agency is often expressed as the problem of the separation of ownership and control. In their seminal piece, Adolf Berle and Gardiner Means conceptualized the shareholders of the corporation as the property "owners" of the corporation and noted that the corporate form created a separation of ownership and control.¹⁰² Corporate law scholarship has remained heavily focused on agency problems created by the separation of ownership and control in the context of the manager/shareholder relationship in the "open corporation".¹⁰³

The modern corporate landscape is comprised of several layers of agency relationships, which muddle the traditional Berle-Means conception of the corporation. For example, shareholders rely on company management to make decisions and generate attractive returns; company management relies on third-party agents such as auditors and lawyers to help them make sound decisions; individual shareholders rely on institutional clients to invest their money and make

¹⁰⁰ See Stout, *supra* note 10.

¹⁰¹ 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, at 688.

¹⁰² See BERLE & MEANS, *supra* note 17.

¹⁰³ See, e.g., Fama & Jensen, *supra* note 19.

financial decisions that impact their future; and institutional clients in turn rely on agents like ISS to provide proxy voting recommendations and other services.

Despite (i) this transition from the traditional bicameral Berle and Means agency model to a multicameral model of agency, and (ii) the increasing centrality of third-party advisors and mutual funds in corporate decision making, very little scholarship has been dedicated to analyzing the agency costs associated with these other forms of agency.¹⁰⁴ The outsourcing of decision-making by mutual funds to ISS and other proxy advisors presents a rich opportunity to examine the problem of agency in today's corporate landscape in a more expansive form than originally conceptualized by Berle and Means.

B. Conceptualizing ISS Agency Cost

1. A Brief Overview of Agency Theory

Leading agency theorists, Professors Eugene Fama and Michael Jensen, characterize the problem of agency as the problem that arises whenever there is a "separation of decision and risk bearing functions".¹⁰⁵ Agency theory holds that the principal's goals and the agent's incentives do not perfectly align and without appropriate incentives and restraints the agent could act to the detriment of the

¹⁰⁴ Vice Chancellor Strine aptly summed up the issue in a series of articles. Strine noted that "[a]s much as corporate law scholars fetishize the agency costs that flow from the separation of ownership and control in operating companies, they have been amazingly quiet about the 'separation of ownership from ownership.'" See Strine, *supra* note 20, at 6; See also Strine, *supra* note 20, at 7 (stating that as much as "the corporate law scholarship of the last 25 years obsesses over the agency costs of operating company boards ... [l]ittle of it considers that the 'empowerment' of stockholders does not empower end-user investors so much as it empowers intermediaries.") In another article, Strine further noted that "[t]hese institutional intermediaries have interests that are not perfectly aligned, to state it mildly, with those of their own stockholders," and that "these institutions have their own agency costs." See Strine, *infra* note 123, at 687. Finally, Strine noted that although much of the focus of corporate lawyers "remains directed at the management of operating corporations,"... "the traditional Berle-Means paradigm has fundamentally changed in favor of stockholders." See Strine, *supra* note 20, at 8. An example of an exception to the general tendency in the literature to focus on the agency costs of operating company managers and shareholders, is a research paper by Larry Ribstein examining the mechanisms utilized by private equity firms to control for managerial agency costs. See Larry E. Ribstein, Research Papers Series, *Uncorporating the Large Firm*, Ill. L. & Econ., Research Paper LE 08-016, (May 28, 2008), http://papers.ssrn.com/pape.tar?abstract_id=1138092.

¹⁰⁵ Fama & Jensen, *supra* note 17, at 301.

principal. Agency theory also recognizes, however, that certain incentives or restraints help reconcile divergent interests between principal and agent.

In their widely cited work on the problem of agency - *Separation of Ownership and Control* - Fama and Jensen note:

Control of agency problems in the decision process is important when the decision managers who initiate and implement important decisions are not the major residual claimants and therefore do not bear a major share of the wealth effects of their decisions. Without effective control procedures, such decision managers are more likely to take actions that deviate from the interests of residual claimants.¹⁰⁶

Fama and Jensen argue that agency problems can be controlled "by decision systems that separate the management (initiation and implementation) and control (ratification and monitoring) of important decisions at all levels of the organization."¹⁰⁷ According to Fama and Jensen, "[a]n effective system for decision control implies, almost by definition, that the control (ratification and monitoring) of decisions is to some extent separate from the management (initiation and implementation) of decisions."¹⁰⁸

2. Examples of Systems of Decision-Control

In the corporate context, agency costs resulting from the bifurcation of ownership and control between "managers" (executive officers and corporate directors) of a corporation on one hand, and the shareholders of a corporation on the other, are curtailed by a combination of forces, such as express legal rules, "best practice" type corporate governance norms and standards, market discipline and fiduciary duties.¹⁰⁹ Concrete examples of systems of decision control that target the agency problem in the context of the modern corporation include Sarbanes-Oxley,

¹⁰⁶ Fama & Jensen, *supra* note 17, at 303.

¹⁰⁷ Fama & Jensen, *supra* note 19, at 332.

¹⁰⁸ Fama & Jensen, *supra* note 17, at 303.

¹⁰⁹ See generally LEWIS D. SOLOMON, DONALD E. SCHWARTZ, JEFFREY D. BAUMAN & ELLIOTT J. WEISS, CORPORATIONS LAW AND POLICY 36, 658 (Thompson West 1998). See also ROBERT C. CLARK, CORPORATE LAW 123-262 (1986) (providing a detailed discussion of the duties of company officers and directors).

which emphasizes the need for transparency, CEO pay-tied-to-performance mechanisms, the use of independent expert boards, a shareholder's right to vote, fiduciary duties owed by company managers to company shareholders, the stock market and the takeover market.¹¹⁰

3. Application of Theory to ISS

From an agency theory perspective, ISS presents a lethal combination – significant power and virtually no accountability. In Fama and Jensen's construct, the outsourcing of proxy voting and monitoring functions by mutual funds to ISS presents the classic agency problem of "separation of decision and risk."¹¹¹ ISS decides on, and instructs, how mutual funds should vote, but it is the mutual fund (and ultimately the fund shareholder) that bears the risk of a poor voting decision by ISS.¹¹²

Under classic agency theory, this separation of decision and risk should not be tolerated without effective control procedures.¹¹³ As Fama and Jensen noted, "[w]ithout effective control procedures . . . decision [makers] are more likely to take actions that *deviate from the interests* of residual claimants."¹¹⁴ [emphasis added]

Mutual funds' primary interest in hiring ISS to monitor corporate ballots and vote proxies is to receive advice that they can rely on to satisfy their fiduciary obligations in the most cost effective and efficient manner.¹¹⁵ Mutual funds are required to vote shares held in their portfolio in the "best interest" of their clients. To satisfy this requirement, the mutual fund must in turn have some system in place for monitoring companies in which they own stock and for voting this stock in an informed manner. ISS has become this system.¹¹⁶

¹¹⁰ See generally Fama & Jensen, *supra* note 17 (discussing generally the stock market, the market for takeovers and the use of expert boards as examples of agency cost control mechanisms in corporations).

¹¹¹ Fama & Jensen, *supra* note 17, at 301.

¹¹² See Strine, *supra* note 44, at 11 ("[U]nlike the individual investors whose capital they use to wield influence, institutional investors and their advisors bear far less of the residual risk of poor voting decisions, as their compensation turns more on short-term factors than long-term growth.").

¹¹³ See generally Fama & Jensen, *supra* note 17.

¹¹⁴ *Id.* at 5.

¹¹⁵ See *infra* Part III.A.1.

¹¹⁶ See Strine, *supra* note 103 ("Following ISS constitutes a form of insurance against regulatory criticism, and results in ISS having a large sway in the affairs of American corporations.")

As a public company, ISS' primary interest in providing proxy voting services to mutual funds is to maximize profits. While ISS as advisor should rationally have an interest in ensuring that the advice it provides is consistently sound, anecdotal evidence suggests otherwise.¹¹⁷

How then do we control ISS' agency costs? Are there, in the words of Professors Fama and Jensen, "effective control procedures" that provide checks on these agency costs?¹¹⁸ Given that (i) ISS has been entrusted by its institutional clients to make decisions that have a tremendous effect on corporations and their activities; and (ii) the market relies on ISS to produce sound corporate governance ratings, a thorough examination of this question merits attention.

III. The Absence of Agency Cost Control Mechanisms

In Part III, I analyze aspects of the proxy advisory and corporate governance market, ISS' decision-making methodology, and aspects of its legal obligations and regulatory environment to make the case that currently no "effective control procedures" exist that incentivize ISS to provide consistently sound advice and control its agency costs. First, I examine the market in which ISS operates and I argue that the market offers weak constraints over ISS agency costs. I posit that this result is due to the following factors - (i) ISS' mutual fund clients have very little economic incentive to monitor ISS; (ii) ISS has a "first mover" advantage; and (iii) the proxy advisory industry has limited competition and high barriers to entry.

Second, I analyze the process through which ISS develops its proxy voting policies and corporate governance ratings. I argue that this process lacks transparency and that ISS is not subject to sufficient external procedural checks. The lack of transparency in ISS' decision-making process results in significant agency costs as it (i) handicaps a third-party's ability to monitor ISS; (ii) creates a system that relies on ISS to self-monitor; and (iii) results in a lack of separation of decision-making from decision-control. The lack of separation of decision-making from decision-control is sharply at odds with traditional agency theory, particularly when it is accompanied by a separation of decision and risk, as in ISS' case.¹¹⁹

Third, I highlight that unlike operating company managers, ISS does not owe fiduciary duties to the companies (or the companies' shareholders) on which ISS

¹¹⁷ See *supra* notes 92-95.

¹¹⁸ Fama & Jensen, *supra* note 17, at 301.

¹¹⁹ Fama & Jensen, *supra* note 17.

issues proxy advice and corporate governance ratings.¹²⁰ I explore the implications of this and argue that this lack of fiduciary duties furthers the problem of ISS unaccountability, primarily because ISS bears minimal residual risk of a poor voting decision vis-à-vis company shareholders.¹²¹

Fourth, I analyze the cumulative effect, from an agency theory perspective, of inadequate market discipline and the lack of transparency in decision-making processes, on ISS' accountability. I argue that the combined effect on ISS' clients is a weakened incentive to utilize "exit" or "voice" as measures to control for agency costs.

A. Lack of Market Check

The free market can act as a powerful check on agency costs.¹²² Embedded in the assumption that markets may serve as a potential check on agency costs is the assumption that markets are rational and efficient. At a minimum, markets should be aware of the relevant information needed to make a rational decision and the market should be pricing this information and corresponding risks appropriately.

For the proxy advisory and corporate governance industry, potential sources of market check could come from the market for clients, intra-market competition, and the stock market. So far, however, the proxy advisory and corporate governance market does not seem to be serving as a robust check on ISS agency costs. The following sub-section explores possible reasons for this market failure.

1. Market Check from Mutual Fund Clients?

For mutual funds, the most economical and least risky way to demonstrate compliance with the 2003 SEC Rule is to hire and follow the advice of a proxy advisor. In terms of monitoring ISS and being active in corporate governance affairs, mutual funds cannot be expected to serve as a substantial market check on ISS. This

¹²⁰ For the sake of simplicity, this argument assumes that the operating company shareholders are direct shareholders in the operating company and not indirect shareholders through institutional investors, like mutual funds.

¹²¹ As a registered investment adviser, ISS does owe fiduciary duties to its mutual fund clients. See discussion *infra* Part III.C.

¹²² See generally Fama & Jensen, *supra* note 17 (discussing the role of the stock market and takeover market as examples of agency cost control systems).

is because mutual funds are generally rationally apathetic and suffer from the classic free-rider problem.¹²³

This result is due to the economic realities of mutual funds. First, mutual funds do not have the necessary internal manpower required to effectively monitor and vote proxies in the multitude of portfolio companies in which mutual funds own shares.¹²⁴ Second, mutual funds generally hold a given stock for a short-period of time and on average a mutual fund owns less than one percent of a given company's stock. This in turn means that with the exception of significant events, such as a merger, mutual funds have very little incentive to expend resources to monitor a company's day to day activities, and instead find it much more economical to hire a proxy advisor to do the job.¹²⁵ Third, because a fund manager is rewarded for the economic performance of his/her fund and not for making corporate governance better for the world at large, fund managers have very little immediate economic incentive to monitor company management and instead find it more efficient (both economically and logistically) to outsource proxy voting decisions and vote execution to third-party services like ISS. From the mutual funds' perspective it makes much more economic and business sense to outsource proxy monitoring and voting functions to third-party advisor firms like ISS. As Vice Chancellor Strine noted, "[m]any institutional investors have . . . little desire to do any thinking of their own, particularly about investments that they often hold for nanoseconds."¹²⁶

This sentiment was reiterated in a post on CorporateCounsel.net:

¹²³ See Strine, *supra* note 101, at 687 ("A mutual fund family knows that whatever benefits its activism generates for the operating company will not be exclusively or primarily theirs, but will be spread among the operating company's diverse investor base, including the mutual fund's own industry competitors. For that reason, the huge institutions that manage an enormous amount of equity for many Americans- like Vanguard, Fidelity, and Barclay's- have been relatively docile stockholders in the United States.").

¹²⁴ Broc Romanek, GAO Report on Proxy Advisors: No Smoking Guns, The Harvard Law School Corp. Gov. Forum, Aug. 3, 2007, <http://blogs.law.harvard.edu/corpgov/2007/08/03/gao-report-on-proxy-advisors-no-smoking-gun> ("The reality is that institutional investors are trying to keep their expense ratio down - and even the larger institutions typically have only a few employees dedicated to vetting voting issues.").

¹²⁵ See Strine, *supra* note 101, at 687 (discussing the fact that "[m]utual funds make money through fees, and do not have a profit motive to undertake efforts at shareholder activism at the operating level").

¹²⁶ Strine, *supra* note 101, at 688.

[Mutual funds] hold positions in thousands of companies; it would be a monumental task to conduct independent research about each item for each issuer's ballot. To do so, [a mutual fund] would have to have a staff along the lines of a proxy advisor to adequately do the job. The reality is that [mutual funds] are trying to keep their expense ratios down – and even the large [mutual funds] typically have only a few employees dedicated to vetting voting issues.¹²⁷

Similarly, the sentiments expressed by the chief operating officer of CPR Asset Management (CPR-AM), a wholly owned subsidiary of Crédit Agricole SA, further underscore this point: "By using ISS's voting expertise and technologically advanced platform, we can better exercise our fiduciary responsibilities without having to add costly internal resources . . . [ISS' system] makes it easy to vote. It's a systematic approach that removes the nightmare of the masses of paper involved in handling proxies."¹²⁸

In addition, ISS' mutual fund clients' "Statements of Additional Information" (SAI)¹²⁹ show that several mutual funds do indeed adopt a "Follow ISS" approach as their default. For example, Goldman Sachs' SAI for its "Absolute Return Tracker Fund" indicates that the fund's proxy voting policy for public equity investments is "generally to follow the Guidelines and recommendations from ISS."¹³⁰ While Goldman's portfolio managers retain the authority to vote differently from ISS' recommendations, should a manager decide to diverge from ISS' recommendations, such a decision is subject to an internal "review and approval process."¹³¹ Similarly, Janus Capital's SAI states that Janus' voting policy is to "vote all proxies on behalf of client's accounts in accordance with the ISS

¹²⁷ See, e.g., Romanek, *supra* note 124.

¹²⁸ CPR Asset Management selects Institutional Shareholder Services for Proxy Voting solution, Bobsguide, Oct. 14, 2002, available at http://www.bobsguide.com/guide/news/2002/Oct/14/CPR_Asset_Management_selectsInstitutional_Shareholder_Services_for_Proxy_Voting_solution.html.

¹²⁹ Mutual funds are required to disclose their proxy voting policies in their Statement of Additional Information (SAI). SAIs can be accessed through the SEC's EDGAR system or in many cases on a mutual fund's website.

¹³⁰ See Goldman Sachs Absolute Return Tracker Fund, *Statement of Additional Information*, at B-48, May 23, 2008, http://www2.goldmansachs.com/client_services/asset_management/mutual_funds/u_s_funds/pdf/prospectuses/new_funds/SAI_ART_Inst_AC.pdf.

¹³¹ *Id.*

Recommendations ... unless otherwise directed by the client.”¹³² Finally, Oberweis Funds’ proxy voting policy states that “[i]n general, based on [our] review of [ISS’] proxy voting recommendations, it is anticipated that [we] will be in agreement with [ISS] recommendations and no other action will be required by [us].”¹³³

The economics of the relationship between ISS and mutual funds provide no real incentives for the funds or ISS to control and resolve any agency cost problems that may exist. In fact, one may argue that this result is necessitated by a mutual fund’s guiding principle to act in the “best interest” of its clients, which dictates that a mutual fund focus its energies and resources on maximizing fund profits and minimizing fund losses, not on corporate ballot monitoring and proxy voting execution. At base, the reality is that for mutual funds proxy issues are often just a function of timing rather than conviction.

2. Market Check from Intra-Market Competition?

ISS is the dominant player in the proxy advisory and corporate governance industry.¹³⁴ The industry is characterized by a limited number of players and ISS currently operates without significant competitive pressure.¹³⁵ Even though Glass Lewis has made some inroads into ISS’ market share, the current gap between ISS’ and Glass Lewis’ proxy coverage makes it unlikely that Glass Lewis will pose a significant threat to ISS’ market share in the near future.¹³⁶

The anemic level of competition currently present in the proxy advisory and corporate governance industry is not sufficient to serve as an adequate check on ISS agency costs. A key reason for this lack of competition is that ISS has been able to successfully cement its position in the market as the first player in town and, as a result, has reaped significant benefits (the so-called “first mover advantage”). A second reason, which is intimately tied to the first, is that the proxy advisory and corporate governance industry has significant barriers to entry.

a. “First Mover” Advantage

¹³² See Janus Investment Fund, *Janus Equity and Bond Funds, Statement of Additional Information*, at 81 Feb. 28, 2008, available at <http://www.janus.com>.

¹³³ See Oberweis Funds, *Proxy Vote Policies and Procedures*, available at http://www.oberweisfunds.com/account_services.asp?page=proxyvote.

¹³⁴ See U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 4.

¹³⁵ See, U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 4.

¹³⁶ See Part I.C.1 *supra* (discussing the current gap in proxy coverage between ISS and Glass-Lewis).

ISS has what economists and marketers term a “first mover” advantage. First mover advantage theory states that first movers into a new industry will gain an advantage, creating very high or insurmountable barriers for new entrants.¹³⁷ Professors Lieberman’s and Montgomery’s 1998 seminal paper on the topic of first mover advantage provides a helpful conceptual framework for examining the first mover advantage of ISS.¹³⁸ Lieberman and Montgomery attribute the advantages of being a first-mover to the following: (i) network effects; (ii) consumer switching costs; (iii) acquisition of resources; and (iv) technology preemption.¹³⁹

i. Network Effects

Network effects are typically more important in industries where technology plays a central role.¹⁴⁰ Network effects apply to industries where the value of a good or service to a given user increases with the number of users. According to Professor Lieberman, “[t]he positive feedback that is generated causes the market to tip in favor of the firm that emerges as the standard, potentially leading to a winner-take-all market structure...In markets with network effects, the leading firm is likely to capture disproportionate returns.”¹⁴¹

A classic example of a network effect is the adoption of the “QWERTY” keyboard as the industry standard in the telecommunications industry. The initial adoption of the QWERTY keyboard eventually lead to widespread adoption of this configuration. Manufacturers were keen to produce keyboards with the configuration that was more popularly known and users wanted to learn to type on

¹³⁷ See generally Marvin B. Lieberman & David B. Montgomery, *First-Mover Advantages*, 9 STRATEGIC MGMT. J., (SPECIAL ISSUE: STRATEGY CONTENT RESEARCH) 41 (Summer 1988); Roger A. Kerin, P. Rajan Varadarajan & Robert A. Peterson, *First-Mover Advantage: A Synthesis, Conceptual Framework, and Research Propositions*, 56 J. Marketing 33 (1992); Gurumurthy Kalyanaram, William Robinson & Glen Urban, *Order of Market Entry: Established Empirical Generalizations, Emerging Empirical Generalizations, and Future Research*, 14 MARKETING SCI. G212 (1995); David Szymanski, Lisa Troy & Sundar Bharadwaj, *Order of Entry and Business Performance: An Empirical Synthesis and Reexamination*, 59J. Marketing 17 (1995); Pieter VanderWerf & John. F. Mahon, *Meta-Analysis of the Impact of Research Methods on Findings of First-Mover Advantage*, 43 Mgmt. Sci. 1510 (1997).

¹³⁸ See Lieberman & Montgomery, *supra* note 137.

¹³⁹ *Id.* See also Marvin B. Lieberman, *Did First-Mover Advantage Survive the Dot-Com Crash?*, Dec. 2007, available at <http://www.smith.umd.edu/seminars/Papers/Lieberman-InternetFirstMoverAdvantages.pdf> (describing the types of mechanisms that help sustain a first-mover advantage).

¹⁴⁰ *Id.*

¹⁴¹ *Id.* at 8.

the configuration which was more popularly produced. By the time alternative keyboard configurations emerged, QWERTY had already achieved market dominance and was embedded in the collective psyche of consumers. QWERTY still remains the standard today.

ISS is unquestionably the leading firm in the proxy advisory industry, and the industry exhibits network effects from which ISS has reaped the benefits. On the institutional client side, the more mutual funds that use ISS' services, the more a mutual fund can feel secure in relying on ISS' advice because it is assured that its voting practices are in line with the industry.¹⁴² Similarly on the operating company side, the more institutional investors vote according to ISS recommendations, the more it behooves companies to ensure that they fall in line with ISS' CGQ ratings, and the best way to achieve this is to hire ISS for its corporate governance expertise. ISS was able to effectively dominate the proxy advisory and corporate governance market early on and it continues to benefit from significant network effects that reinforce its prominence in the industry.

ii. Consumer Switching Costs

The economic and psychological costs to consumers of switching brands may benefit a first mover if the first mover is able to effectively capture market share early on.¹⁴³ If a consumer has made a substantial investment in a product, by the time a late mover enters the market, the late mover will have to expend more resources than the first mover and offer a superior product in order to compel the consumer to switch brands.

As the first mover in the proxy advisory industry, ISS benefits handsomely from consumer switching costs. In terms of the proxy advisory industry, the costs of switching proxy advisors entail the hassle of getting up to speed with a new rating and proxy voting system, *and* the immense task of switching voting platforms. As noted by the founder of CorporateCounsel.net, "[n]o sane institutional investor is going to assume the risk inherent in moving thousands of accounts and ballots from ISS to another provider. The chance that accounts would be lost, not voted, or voted incorrectly is far too great. An ISS competitor has a rough road ahead to try to

¹⁴² See Strine, *supra* note 101, at 688 ("Following ISS constitutes a form of insurance against regulatory criticism, and results in ISS having a large sway in the affairs of American corporations.").

¹⁴³ See Lieberman & Montgomery, *supra* note 137.

duplicate the sophisticated vote execution platform that ISS has built over the years.”¹⁴⁴ Similarly, the GAO Report noted that “[s]everal of the institutional investors [the GAO] spoke with that subscribe to ISS’s services explained that they do so because they have relied on ISS for many years and trust it to provide reliable, efficient services.”¹⁴⁵

iii. Acquisition of Resources and Assets

A first-mover may also gain an advantage by establishing positions in geographic or product space such that new entrants find it unprofitable to enter the market – the theory of spatial preemption.¹⁴⁶ Generally, a given market will only have space for a limited number of profitable firms.¹⁴⁷ A first-mover can acquire an advantage by selecting the most attractive niches and by employing strategies that limit the amount of space remaining for subsequent entrants.¹⁴⁸ Spatial preemption may include the preemption of both geographic space and “shelf” space, which allows for brand positioning in the eyes of consumers.¹⁴⁹

ISS has unquestionably been able to acquire prime shelf space and has created a premier brand. Twenty-four of the top 25 institutional investors use ISS, ISS advises funds controlling approximately half the world’s common stock and ISS is commonly referred to as, and acknowledged to be, the industry leader.¹⁵⁰

iv. Technology Preemption

Early product development and knowledge creation often means that the first mover will have the first bite at obtaining intellectual property protection for its

¹⁴⁴ Broc Romanek, *GAO Report on Proxy Advisors: No Smoking Guns*, TheCorporateCounsel.net Blog, Aug. 1, 2007, <http://www.thecorporatecounsel.net/blog/archive/001460.html> (discussing that even though the GAO Report found that ISS adequately disclosed potential conflicts, the report was deficient in a number of ways, including that the report underestimated ISS’ influence).

¹⁴⁵ U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 4, at 13.

¹⁴⁶ See Lieberman & Montgomery, *supra* note 137. See also Edward C. Prescott & Michael Visscher, *Sequential Location Among Firms with Foresight*, 8 BELL J. ECON. 378 (1977); Ram C. Rao and David P. Rutenberg, *Pre-empting An Alert Rival: Strategic Timing of the First Plant by Analysis of Sophisticated Rival*, 10 BELL J. ECON. 412 (1979); B. Curtis Eaton and Richard G. Lipsey, *Capital Commitment and Entry Equilibrium*, 12 BELL J. ECON. 593 (1981).

¹⁴⁷ See Lieberman & Montgomery, *supra* note 137.

¹⁴⁸ See Lieberman & Montgomery, *supra* note 137.

¹⁴⁹ See Lieberman & Montgomery, *supra* note 137.

¹⁵⁰ See Part I.2., *supra* (discussing ISS’ business and market share).

creations.¹⁵¹ ISS has been successful in developing and acquiring proprietary platforms, such as the Governance Analytics platform and the Straight-Through-Processing System,¹⁵² which allow ISS to offer superior coverage of ballots and vote execution capabilities.

ISS has a clear first mover advantage. For mutual funds, for whom it makes more economic sense to outsource proxy voting services and not actively monitor, ISS' first mover advantage points strongly in favor of a mutual fund choosing ISS. The lack of competition and high barriers to entry in the proxy advisory industry continue to entrench ISS' first mover advantage and result in a weak market check on ISS' agency costs. In addition, ISS has not fallen prey to what Lieberman and Montgomery term the first mover *dis*advantage, which typically results from an inability by a first mover to maintain continued mastery and dominance of a given product space.¹⁵³ First mover disadvantages include shifts in technological or consumer needs, incumbent inertia, resolution of technological or market uncertainty in favor of a competitor's product, and free-rider effects.¹⁵⁴ ISS continuously revamps its products to match its client's needs, it enjoys a high renewal rate, and it continues to attract new clients.

b. Lack of Competition and Significant Barriers to Entry

Limited competition and high barriers to entry in the proxy advisory industry allow ISS to maintain its first mover advantage and continue to operate with little pressure to control potential agency costs.¹⁵⁵

The GAO Report identifies the ability to offer "comprehensive coverage of corporate proxies" and to "implement sophisticated technologies" as the main barriers to entry in the proxy advisory industry.¹⁵⁶ In addition, the presence of

¹⁵¹ See Lieberman & Montgomery, *supra* note 137.

¹⁵² The "Straight Through Processing" system is the proprietary platform that ISS uses for vote execution. See *infra* notes 157 and 161.

¹⁵³ See Marvin B. Lieberman & David B. Montgomery, *First-Mover (Dis)Advantages: Retrospective and Link With The Resource-Based View*, 19 STRATEGIC MGMT. J. 1111 (1998).

¹⁵⁴ *Id.*

¹⁵⁵ See U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 4 (ISS is the dominant player in the advisory industry with over 1,700 clients, which is more than the other four major proxy advisors combined). See also 2007 Annual Report, *supra* note 8, at 17 ("[t]he competitive landscape for multi-asset class risk management and corporate governance and financial research and analysis products and services is characterized by a *limited* number of external third party competitors." [emphasis added]).

¹⁵⁶ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 4, at 13.

switching costs associated with vote execution also presents an additional barrier to entry in the proxy advisory industry.

i. Comprehensive Coverage as a Barrier

Any firm wishing to effectively compete with ISS for its proxy advice and corporate governance business would have to *at a minimum* offer the same scope of coverage as ISS. Considering that ISS offers coverage “for more than 45,000 shareholder meetings across 110 countries,”¹⁵⁷ this is no small feat. As previously discussed, ISS has a first mover advantage in developing products and is much further along the learning curve than its competitors. Institutional clients will incur significant economic and psychological switching costs should they decide to switch proxy advisors. Merely providing *the same* coverage as ISS may not be enough to attract clients. Instead any new entrant would have to offer coverage *that exceeds* ISS’ or be able to offer a superior product in terms of other attributes, such as price or improved decision-making methodologies.

Furthermore, while much of the information that is needed to provide “coverage” is public, it is the *gathering and processing* of this information that poses the real barrier. Much of this gathering and processing function rests on the sophistication and capabilities of the underlying technology.

ii. Sophisticated Technology as a Barrier

According to the GAO Report, “[t]he initial investment required to develop and implement [the needed] technology can be a significant expense . . .”¹⁵⁸ In addition, the GAO Report notes that developing and implementing the necessary technology to provide research and voting services can be “challenging.”¹⁵⁹ According to the GAO Report, however, “once a firm has done so, the marginal cost of providing services to additional clients and of updating and maintaining such technology is relatively low.”¹⁶⁰

The development, implementation, updating and maintenance of the technology necessary to effectively compete in the proxy advisor industry is in the aggregate a significant barrier to entry, which limits competition and preserves ISS’ first mover advantage.

¹⁵⁷ See 2008 Annual Report, *supra* note 7, at 11.

¹⁵⁸ U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 4, at 14.

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*

iii. Vote Execution Switching Costs

Another barrier to entry that has been identified in the proxy advisor industry is the switching cost associated with vote execution. ISS utilizes a "Straight Through Processing System" (STP) for vote execution of U.S. and global ballots.¹⁶¹ According to ISS, the STP "allows for ballots to be received and proxy votes to be made electronically, minimizing the manual aspects of the proxy voting process and limiting the risk of error inherent in manual processes."¹⁶² Being able to provide efficient and reliable vote execution lessens an institutional client's need to be involved in the process.

The lack of competitive vigor in the proxy advisory industry shows no signs of being alleviated and the current economics of the industry are not enough to control for ISS agency costs. Despite persistent concerns about the quality and reliability of ISS' recommendations and ratings, ISS has seen relatively little defection from its institutional clients.¹⁶³

3. Market Check from Stock Markets?

In January 2008, ISS' parent, RiskMetrics became a public company, and its stock is traded on the New York Stock Exchange. As is the case with any publicly traded company, investors are now able to use the stock market as a direct way of rewarding or disciplining RiskMetrics for its actions and decisions.¹⁶⁴ For example, when Moody's Investor Service came under fire in 2008 for errors in its ratings of

¹⁶¹ According to the 2007 Annual Report, ISS administers the STP through an arrangement it has with Broadridge. See 2007 Annual Report, *supra* note 8.

¹⁶² 2007 Annual Report, *supra* note 8, at 10.

¹⁶³ One notable exception to the unwillingness of institutional clients to switch from ISS to an ISS competitor is the Colorado Public Employees' Retirement Association ("CPERA"). In November 2006, after 16 years of using ISS, CPERA terminated its contract with ISS and hired Glass-Lewis. See Starkman, *supra* note 78. However, this is the exception to the rule. In 2006, ISS' president and chief executive noted that "despite 30 defections, ISS had a 94 percent renewal rate by its customers [in 2005] and added 424 [new] clients." See Starkman, *supra* note 78. See also 2008 Annual Report, *supra* note 7, at 3 ("[D]uring the year ended December 31, 2008, [ISS] had a renewal rate of approximately 86.3%.").

¹⁶⁴ As a result of RiskMetrics becoming a public company, RiskMetrics is now subject to the SEC's disclosure rules, which will allow for enhanced transparency of its operations. ISS is also subject to other regulations, such as the insider trading prohibitions, the general anti-fraud prohibitions, and the Investment Adviser Act. However, like the reporting and disclosure obligations, it is doubtful that these regulations will result in increased transparency in ISS decision methodology, which is a key part of the ISS agency cost problem.

complex debt instruments, the market responded by registering a 16% drop in Moody's share price.¹⁶⁵

While market discipline of RiskMetrics could reduce some ISS agency costs, it is questionable whether stock price discipline directed at ISS' parent will in turn serve as an effective control device that targets ISS agency costs. ISS has already established itself as the market leader and during the critical period when ISS cemented its first-mover advantage,¹⁶⁶ ISS was not subject to market discipline vis-à-vis a public stock price. On the other hand, because ISS accounts for approximately 50% of RiskMetrics' earnings,¹⁶⁷ widespread concerns by the market about errors in ISS' judgment, ratings or advice may result in a sell off of RiskMetric stock.

Currently, it is hard to predict whether the market for RiskMetrics stock will emerge as a meaningful check on ISS agency costs. At present, however, stock market discipline of ISS does not act as a significant check on ISS agency costs.

B. Lack of Transparency & Controls in Decision-Making Process

Transparency is recognized as a critical component of sound corporate governance.¹⁶⁸ In the wake of recent corporate malfeasance, there has been an increased focus on enhanced transparency as a way to control for agency costs. For example, Sarbanes-Oxley aims to increase accurate and timely disclosure; the OECD Principles of Corporate Governance call for the "timely and accurate disclosure . . . [of] all material matters regarding the corporation,"¹⁶⁹ SEC's Regulation FD aims to correct information asymmetry and requires registered public companies to disseminate information to all constituents simultaneously;¹⁷⁰ and the Business

¹⁶⁵ See Aaron Lucchetti & Kara Scannell, *New Debt Products Test Moody's Method*, WALL ST. J., May 22, 2008, at 2.

¹⁶⁶ See Part III.A.2.a. for a discussion of ISS' first mover advantage.

¹⁶⁷ This is based on RiskMetrics' and ISS' "Earnings Before Interest Tax Depreciation and Amortization" for the year ended December 31, 2008, as reported on RiskMetrics' Form 10-K for the year ended December 31, 2008. See *supra* note 7.

¹⁶⁸ See Sarbanes-Oxley, *supra* note 22; ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, OECD PRINCIPLES OF CORPORATE GOVERNANCE (2004), OECD Publication Service, 2 Rue Andre-Pascal, 75775 Paris Cedex, 16, France [hereinafter OECD Principles]; Business Round Table, *Principles of Corporate Governance*, (white paper, Nov. 2005) available at <http://www.businessroundtable.org/initiatives/leadership/governance> (follow "Principles of Corporate Governance" hyperlink to download pdf).

¹⁶⁹ See OECD Principles, *supra* note 168, at 22.

¹⁷⁰ SEC Regulation FD, 17 C.F.R. § 243.100-03 (2000).

Roundtable directs companies to consider the need for candor and timely disclosure in their communications with stockholders and other investors.¹⁷¹

Transparency offers an effective way to control agency costs because it incentivizes the agent to control its agency costs and it places the principal in a better position to monitor and exert control over the agent's actions. Lack of transparency enables the agent to act without fear of public sanction, increases the risk of residual loss to the principal, provides fertile ground for opportunistic and self-regarding behavior, results in information asymmetry, creates opportunity for the agent to make decisions based on unfounded assumptions and/or unprincipled arguments, and limits the principal's ability to monitor the agent.¹⁷²

ISS strives to achieve transparency in the development of its proxy voting policies by soliciting input from its institutional clients and providing an opportunity for clients to comment on proposed proxy voting policies before they are implemented.¹⁷³ Although the *development* of its proxy voting policies is not opaque, precisely how those policies are *implemented* remains unclear.¹⁷⁴ Even more unclear is how ISS determines a company's CGQ score. Because the CGQ is comprised of proprietary variables, and the methodologies, assumptions and totality of qualitative factors that are determinative of a company's CGQ score are all unknown, in the area of corporate governance ratings ISS operates in a black hole free from market or regulatory check.¹⁷⁵

From an agency theory perspective, the lack of transparency in the implementation of ISS' proxy voting policies and, in particular, in the generation of its corporate governance ratings is unsettling for several reasons. First, without transparency, third parties are unable to adequately monitor ISS. Second, this creates a de facto regime in which ISS is left to self-monitor, even though ISS has no real

¹⁷¹ See Bus. Roundtable, *supra* note 168, at 32-33.

¹⁷² See, e.g., Note, *Mechanisms of Secrecy*, 121 HARV. L. REV. 1556 (2008) (discussing the interplay among secrecy, transparency and agency costs).

¹⁷³ See RiskMetrics Policy Gateway, available at <http://www.riskmetrics.com/policy> (last visited, Apr. 3, 2009).

¹⁷⁴ A December 2008 memorandum published by the law firm of Wachtell, Lipton, Rosen & Katz referenced this broader point in its discussion of how ISS would implement its new proxy voting policies regarding executive compensation practices, with a focus on what ISS refers to as "poor pay practices." The memorandum noted that "[c]ircumstances under which one or more 'poor pay practices' will trigger a withhold recommendation remain unclear, and likely will be determined by [ISS] on a case-by-case basis." See Katz & McIntosh, *supra* note 86.

¹⁷⁵ See *supra* Part I, (discussing generally the opaque nature of the CGQ).

incentive to aggressively control for potential agency costs. Third, acceptance of a system which permits ISS to decide how voting policies should be implemented and corporate governance ratings determined without simultaneous checks *ex ante* to control for decision missteps, presents the classic Fama and Jensen agency problem of “the lack of separation of decision-making from decision control.”¹⁷⁶

1. External Monitoring Handicap

The lack of transparency in ISS’ decision-making process significantly hampers any attempt by mutual funds or the market to monitor ISS’ methodologies and resulting advice. A principal’s ability to monitor the agent is generally recognized as a powerful way to curtail agency costs.¹⁷⁷ For ISS’ clients any attempt to monitor the substance of and process by which ISS reaches decisions is significantly handicapped by the inability to obtain all relevant information. Similarly, while the market is generally regarded as an effective monitoring tool that can help reduce agency costs,¹⁷⁸ in ISS’ case the market’s ability to monitor is also significantly compromised because ISS’ decisions are cloaked in a veil of secrecy.¹⁷⁹

2. Reliance on ISS to Self-Monitor

The secret nature of ISS’ decision-making process provides no incentive for ISS to correct any deficiencies in its analysis and resulting advice. In fact it does just the opposite—it provides a black box into which ISS can disappear to perform its decision-making and from which it can emerge with decisions in the form of CGQ scores that are essentially immune from scrutiny.

No one except ISS knows precisely how the CGQ score is derived and no one except ISS can ensure that the CGQ score serves its intended purpose of providing an accurate measure of a company’s corporate governance. The quality of the CGQ is dependent on the trustworthiness of ISS to objectively do its job.¹⁸⁰ To trust the CGQ one must trust that when faced with the temptation of pursuing its interest over those of its clients, ISS will always act selflessly and put the best interest

¹⁷⁶ See *supra* Part II, (discussing generally the deficiencies that arise from lack of separation of decision making from decision control).

¹⁷⁷ *Id.*

¹⁷⁸ See Part II, *supra* (discussing market discipline as a measure for controlling agency costs).

¹⁷⁹ See Part I.C.2., *supra*.

¹⁸⁰ *Id.*

of its clients first. In contrast, the anecdotal evidence suggests that there is good reason to doubt whether ISS is a reliable self-monitor.¹⁸¹ Furthermore, as argued above, the economics of ISS' relationship with its mutual fund clients and the lack of competition in the proxy advisory industry do not adequately incentivize ISS to aggressively self-monitor its decision-making process.

3. Centralization of Decision-Making and Decision-Control

The secret nature of ISS' decision process significantly handicaps the ability of mutual fund clients and the market to monitor ISS' decisions, which by extension leaves ISS as the *de facto* monitor. In the Fama-Jensen paradigm, ISS' decision system combines "decision management" and "decision control" in the hands of the agent.¹⁸²

A combination of "decision management" and "decision control" is not by itself offensive to agency theory, however, agency concerns are at their height when both functions are centralized in the hands of an agent. Agency theory tempers this problem by instructing that the agent bears a commensurate amount of residual risk.¹⁸³ ISS, however, bears relatively little residual risk of issuing poor voting advice.¹⁸⁴

4. Contrast to Other Policy Makers

ISS is arguably one of the most influential policy makers in the corporate governance space.¹⁸⁵ Unlike other policy makers such as the SEC and NYSE, who are constrained in their policy making by various procedural checks and balances, ISS is free to produce its policies *carte blanche*. For example, the Administrative Procedure Act (APA) and its companion rule-making procedures establish standards for the SEC's decisions and provide a point of reference for SEC decision-monitoring by

¹⁸¹ See Part I.C.2., *supra*.

¹⁸² Fama & Jensen, *supra* note 17.

¹⁸³ *Id.* at 7 ("A feasible solution to the agency problem that arises when the same agents manage and control important decisions is to restrict residual claims to the important decision agents. In effect, restriction of residual claims to decision agents substitutes for costly control devices to limit the discretion of decision agents.").

¹⁸⁴ See Part II, *supra*. See also Strine, *supra* note 44, at 11 ("[U]nlike the individual investors whose capital they use to wield influence, institutional investors and their advisors bear far less of the residual risk of poor voting decisions, as their compensation turns more on short-term factors than long-term growth.").

¹⁸⁵ See Rose, *supra* note 28 (discussing ISS' role as policy maker in setting corporate governance standards). See also text accompanying *supra* note 11.

third parties.¹⁸⁶ Similarly, the NYSE is constrained by external controls on its rule-making process in the form of Section 19(b)1 of the United States Securities Exchange Act of 1934 (the "Exchange Act")¹⁸⁷ and corresponding Rule 19b-4,¹⁸⁸ which requires the NYSE to file a notice of any proposed rule change with the SEC. The SEC and NYSE rule-making procedural requirements all are meant to encourage transparency in the decision-making process and to engender well thought out and principled policies. In contrast, ISS' decisions and resulting policy and advice are not curtailed by any similar procedural checks. Thus, although ISS advises institutional clients that manage the largest share of the world's equity, ISS is not subject to similar external procedural checks on its decision making. The absence of similar procedural checks provides yet another example of a systematic deficiency in monitoring and controlling ISS agency costs.¹⁸⁹

C. Lack of Fiduciary Duties Restraints

Although ISS has significant sway over the affairs of corporations, unlike corporate managers, it does not owe fiduciary duties to the corporations (or the corporations' stockholders) on which it makes recommendations that have been estimated to sway up to 20% of shareholder votes.¹⁹⁰

For corporate managers, the fiduciary duty of care and the duty of loyalty are meant to restrain company managers from abusing their position as decision-makers and overseers of the corporation's affairs. In contrast, ISS is free from such fiduciary restraints and is free to advance recommendations, which may or may not be in the best interest of the corporations, with minimal risk of repercussion should its recommendations prove wrong. Vice Chancellor Strine acknowledged this disconnect, stating:

¹⁸⁶ Administrative Procedure Act, 5 U.S.C. § 551 (2000).

¹⁸⁷ Securities Exchange Act of 1934, 15 U.S.C. § 78a-III.

¹⁸⁸ 17 C.F.R. 240.19b-4 (2008).

¹⁸⁹ While it is acknowledged that ISS is a private entity and thus should be treated differently than a public administrative agency, in the corporate governance space, ISS is an influential policy maker and corresponding restraints should attach. *See supra* note 185.

¹⁹⁰ *See Bethel & Gillan, supra* note 12. *See also* Strine, *supra* note 101, at 688 ("Following ISS constitutes a form of insurance against regulatory criticism, and results in ISS having a large sway in the affairs of American corporations."). *Contra* Stephen J. Choi et al., Director Elections and the Influence of Proxy Advisors 52 (NYU Ctr. for Law, Econ. & Org., Working Paper No. 08-22, 2008), available at <http://ssrn.com/abstract=223729> (arguing that ISS' influence is overstated).

Unlike corporate managers, neither institutional investors, as stockholders, nor ISS, as a voting advisor, owe fiduciary duties to the corporations whose policies they seek to influence. And unlike the individual investors whose capital they use to wield influence, institutional investors and [ISS] bear far less of the residual risk of poor voting decisions, as their compensation turns more on short-term factors than long-run growth.¹⁹¹

The trend of substituting ISS' recommendations for those of company managers means that mutual funds are replacing agents who are constrained by relatively strong fiduciary duties with agents who have relatively weak fiduciary duties.

1. Traditional Fiduciary Duties of Operating Company Managers

Company managers owe fiduciary duties of care and loyalty to the corporation and its shareholders.¹⁹² Taken together, the duty of care and the duty of loyalty provide incentives and restraints to curtail agency problems created by the separation of ownership from control between managers and shareholders.

The duty of loyalty addresses the heart of the agency problem: the divergence of interests between the principal and the agent, looking both to substance and procedure. The duty of loyalty requires corporate officers and directors to act only in the best interests of the shareholders with potentially serious legal consequences if a court finds that the duty has been breached. Both in theory and in fact, the duty of loyalty provides incentives and restraints on corporate managers that address problems of agency.

The duty of care lends support to the duty of loyalty by providing restraints against grossly negligent acts by managers of a corporation. The duty of care incentivizes management to establish decision control systems *ex ante* to guard against claims of a breach. In addition, the duty of care provides a normative framework for addressing agency problems related both to the *substance* of management's decisions and the *process* from which these decisions derived. Also, because as a practical matter courts often blur the distinction between the duty of

¹⁹¹ Strine, *supra* note 44, at 11.

¹⁹² See generally SOLOMON ET AL., *supra* note 109. See also CLARK, *supra* note 109.

care and the duty of loyalty, together both fiduciary duties address managerial agency costs whether or not they stem from a conflict of interests.¹⁹³

Together, the managerial fiduciary duties of care and loyalty (i) reach a wide range of (mis)conduct, (ii) are aimed at addressing both problems in the *substance* of the decision and the *process* by which the decision was made, (iii) incentivize managers to establish *ex ante* monitoring systems, information systems and decision control systems that target a wide range of ills, (iv) provide a best practice framework within which managers are expected to operate and (v) provide a framework for courts to assess whether managers have held up their end of the bargain or exploited their positions as agents.

In contrast to the fiduciary duty checks on agency costs to which company managers are subject, ISS is free to make decisions that could potentially affect corporate vote outcomes without fiduciary duty restraint.

2. ISS' Fiduciary Duties under the Adviser Act

As an investment adviser under the Investment Adviser Act of 1940 (Adviser Act),¹⁹⁴ ISS does owe fiduciary duties to its mutual fund clients.¹⁹⁵ These fiduciary duties have been articulated as a requirement that advisers act in the best interest of their clients by fully disclosing all potential conflicts of interest. In *SEC v. Capital Gains Research Bureau, Inc.*, the United States Supreme Court held that the Adviser Act imposes a fiduciary duty on investment advisers to act in the best interest of their clients by fully disclosing all potential conflicts of interest.¹⁹⁶ The Court noted that advisers have a duty of utmost good faith and are required to provide full and fair disclosure of all material facts. The Court also noted that in enacting these provisions Congress intended to "eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested."¹⁹⁷ The SEC has

¹⁹³ See, e.g., SOLOMON ET AL., *supra* note 109, at 658 (stating that historically the duty of care and the duty of loyalty were thought to be "discrete and separate," but recently courts "have begun to blur the distinction between the two so that it is sometimes difficult to tell when one duty ends and another duty begins").

¹⁹⁴ The Investment Advisers Act of 1940, 15 U.S.C. § 80a-1 et seq. (2006).

¹⁹⁵ See TAMAR FRANKEL, *THE REGULATION OF MONEY MANAGERS, MUTUAL FUNDS AND ADVISERS*, (2nd Ed., Aspen Law & Business) (providing an overview of the fiduciary duties of investment advisers).

¹⁹⁶ *SEC v. Capital Gains Research Bureau Inc.*, 375 U.S. 180 (1963).

¹⁹⁷ *Id.* at 191-92.

consistently confirmed the Supreme Court's articulation of an adviser's fiduciary duty in no-action letters.¹⁹⁸

ISS' fiduciary duties under the Adviser Act do not, however, extend to the corporations or the shareholders of the corporations that are affected by its decisions and advice.

D. Between a Rock and a Hard Place – Weakened Exit; Diluted Voice; Historic Loyalty

The twin strategies of "exit" and "voice" operate in tandem to incentivize agents to act in the best interests of the principal, and are powerful monitoring and sanctioning devices that target agency costs.¹⁹⁹ "Exit" refers to a person's ability to sever his or her ties with an organization with whom that person is dissatisfied. In the context of the publicly traded company, the sale of stock is the chief form of exit. "Voice" refers to a person's ability to remain with the organization and attempt to remedy the situation creating the dissatisfaction. The right to vote afforded common stock is an example of voice in the corporate context. One's willingness to exit or voice often depends on the strength of one's loyalty to the organization.

The extent to which a principal can readily employ exit and/or voice in signaling dissatisfaction to an agent impacts the relevance of exit and voice as monitoring and sanctioning tools. In ISS' case, the combination of weak market constraints and the lack of decision process transparency, results in a dual weakening of exit and voice for mutual fund clients.

1. Weakened Exit

Holders of a corporation's common stock are generally free to sell their stock without management's concurrence or involvement and with relatively little hassle.²⁰⁰ The ability to freely transfer stock provides an economic source of constraint on management's discretion and it provides the basis for a functioning takeover market.²⁰¹ In addition, the more liquid the market for a corporation's common stock, the easier it should be for a shareholder to employ a strategy of exit.

¹⁹⁸ See, e.g., Institutional Shareholder Services, Inc., SEC No-Action Letter, *supra* note 87.

¹⁹⁹ See HIRSCHMAN, *supra* note 27.

²⁰⁰ This assumes that the common stock is unrestricted and not subject to transfer restrictions, as is the case with most publicly held common stock.

²⁰¹ See SOLOMON ET AL., *supra* note 109.

In contrast, a dissatisfied ISS mutual fund client who wants to employ a strategy of exit is constrained by, *inter alia*, switching costs, the lack of vigorous competition and by the need to involve ISS in transferring proxy voting data from its voting platform to that of an ISS competitor.²⁰² Unlike stock which is a relatively liquid investment for common shareholders, the employment of ISS is a highly illiquid investment for ISS' mutual fund clients. Thus, although exit is generally thought to provide a powerful monitoring and sanctioning device, in the case of ISS, exit poses significant costs to a mutual fund, which in turn weakens its efficiency as an agency cost control tool.

2. Diluted Voice

Stockholders of a corporation may express dissatisfaction with company management in several ways, such as by exercising their right to vote, by presenting proposals for inclusion in a company's proxy, or by meeting with management to voice concerns.²⁰³ A stockholder's willingness to use his or her voice is contingent on the stockholder's estimate of success. Even if a stockholder ultimately decides not to voice dissatisfaction, the stockholder may still utilize exit as a way to signal disapproval and sanction management.

In contrast, ISS' clients face significant obstacles in employing an "exit" strategy, making exit an unrealistic tool for monitoring and sanctioning ISS for agency missteps. In addition, voice is also an unrealistic sanctioning tool for ISS' mutual fund clients because mutual funds typically own a *de minimis* amount of any company's stock and have very little incentive to expend resources to exercise voice. Furthermore, while a dissatisfied stockholder who may also be rationally apathetic and not incentivized to employ a strategy of voice may instead readily employ a strategy of exit, because exit poses significant costs for a mutual fund client they are left between a rock and a hard place. Mutual funds have little incentive to actively monitor and voice concerns, and they will be hard pressed to undertake a strategy of exit barring exigent circumstances.

²⁰² See Part III.2.a. and Part III.2.b. *supra* for a discussion of switching costs and the lack of competition in the proxy advisory and corporate governance industry.

²⁰³ A recent example of the exercise of voice is the campaign by members of the Rockefeller family to pressure executives at Exxon to change aspects of Exxon's business strategy. See Leslie Eaton and Russell Gold, *Rockefeller Rebellion Turns Up Heat on Exxon*, WALL ST. J., May 24, 2008, at A12.

3. Historic Loyalty

The choice between exit and voice may also be influenced by the intangible factor of loyalty.²⁰⁴ The more attached a person is to an organization, all things remaining equal, the more reluctant he or she will be to sever ties with the organization by employing a strategy of exit.

ISS has a first-mover advantage and enjoys historic brand loyalty, which shows no signs of eroding.²⁰⁵ This suggests that ISS clients would favor a strategy of voice over exit. Because ISS' clients are rationally apathetic, however, it is unrealistic to expect them to expend the necessary resources to effectively monitor ISS and control for agency costs, and the more realistic expectation is that mutual funds will not do anything absent a seismic shift in the status quo.

IV. Potential Arguments in Favor of the Status Quo

Having outlined the agency costs of ISS and, to a large extent the proxy advisory industry and corporate governance rating industry, as well as why ISS has no real incentives or restraints that ensure that these agency costs are controlled, Part IV addresses the primary objections likely to be raised in response to this article. First, some may argue that ISS' influence is overstated and that currently there is no need to expend resources to address any potential agency costs. Second, because ISS' institutional clients are theoretically free to vote the underlying shares in their portfolio however they see fit, it may be argued that this controls for agency costs and that there is no need to implement additional monitoring devices. A third potential critique is that ISS is constrained by reputational risk and other market forces, which minimizes the need for additional monitoring strictures.

A. ISS' Influence is Overstated

The urgency one attaches to controlling for ISS agency costs may be tied to the degree of influence that one perceives ISS to have. For example, in a 2008

²⁰⁴ See generally HIRSCHMAN, *supra* note 27.

²⁰⁵ The historic brand loyalty that ISS enjoys is intimately linked to its first mover advantage. See generally Section III.A.2.a., *supra* (discussing ISS' first mover advantage). See also text accompanying *supra* note 145 ("...the GAO Report noted that '[s]everal of the institutional investors [the GAO] spoke with that subscribe to ISS' services explained that they do so because they have relied on ISS for many years and trust it to provide reliable, efficient services'.").

working paper Professors Choi, Fisch and Kahan argue that “the reported influence of ISS is substantially overstated [and]...that proxy advisors act primarily as agents or intermediaries which aggregate information that investors find important in determining how to vote in director elections rather than as independent power centers.”²⁰⁶ In conducting their study, Professors Choi, Fisch and Kahan used a data set of proxy recommendations and voting results for uncontested director elections from 2005 and 2006 at S&P 1500 companies, with the aim of examining *inter alia* how proxy advisors’ recommendations affect shareholder vote. After performing various analyses, they concluded that while there is some correlation between ISS’ recommendations and how shareholders vote, the correlation is not as strong as one would expect to see given ISS’ perceived role of “exercising ‘tremendous clout,’ wielding ‘extraordinary’ influence, [and] getting ‘whatever [it] wants’ . . . ”²⁰⁷

The Choi/Fisch/Kahan study is valuable in attempting to quantify ISS’ influence; however, the study does not deny that ISS has influence and it does not address the agency costs that this influence comes with, which is the focus of this article. In fact Choi/Fisch/Kahan note that proxy advisor firms “follow significantly different factors in determining their recommendations” and that “[t]hese differences may support increased disclosure by proxy advisors in their approach . . . ” This sentiment is in keeping with this article’s call for increased transparency in ISS’ decision-making process, which would be an important step towards controlling ISS agency costs.

Furthermore, while ISS may not be an “independent power center,” the anecdotal evidence suggests that institutional investors and corporations do ascribe significant weight to its recommendations. For example, Vice Chancellor Strine’s perception is that:

ISS [has] a large sway in the affairs of American corporations. Moreover, powerful CEOs come on bended knee to Rockville, Maryland, where ISS resides, to persuade the managers of ISS of the merits of their views They do so because the CEOs recognize that some institutional investors will simply follow ISS’s advice rather than do any thinking of their own.²⁰⁸

²⁰⁶ See Choi et al., *supra* note 190.

²⁰⁷ *Id.* at 4.

²⁰⁸ See Strine, *supra* note 101, at 688.

Similarly, according to the former General Counsel of CALPERS, “[a]nyone voting against ISS better have a very good reason to do so.” In a 2003 report, the Wall Street Journal described ISS as follows: “[ISS] has built . . . a near-monopoly on advising institutional investors, such as mutual funds and pension funds, on how to vote on resolutions put before shareholders. A black mark from ISS could be very harmful to a company...”²⁰⁹

B. ISS’ Institutional Clients Have Final Say

ISS and its institutional clients are quick to point out that its clients are free to vote their shares however they choose and that they are not contractually obligated to follow ISS’ advice. In theory, this sounds like an effective way to control for potential ISS’ agency costs, however, as discussed, many of ISS’ mutual fund clients such as Goldman Sachs and Janus Capital have instituted a default policy that in effect encourages fund managers’ to rubber-stamp ISS’ recommendations. Should a fund manager choose to vote shares contrary to ISS’ recommendations the fund manager must explain this decision and jump through several additional hoops before he or she can do so. The default “opt-in” policy all but ensures that “follow ISS” is the rule and not the exception. Moreover, approximately 15-20% of ISS’ clients have relinquished control of their proxy voting to ISS and have authorized ISS to automatically vote their proxies however it sees fit.²¹⁰

C. ISS is Constrained by the Market

A final objection that some might raise to the need to implement measures to control for ISS agency costs is that market forces can already control for ISS agency costs and that the value ISS places on its reputation as the go-to player in the industry will provide incentive for ISS to conduct itself and perform its analyses in a sound and reasonable manner.

The difficulties with this argument are several. First, the lack of competition and high barriers to entry in the proxy advisory industry do not provide adequate incentives or restraints for ISS to control agency costs.²¹¹ Second, ISS continues to

²⁰⁹ Monica Langley, *Want to Lift Your Company’s Ranking on Corporate Governance? Buy the Test*, WALL ST. J., June 6, 2003, at A1.

²¹⁰ See 2007 Annual Report, *supra* note 8.

²¹¹ See *supra* Part III.A.

enjoy a significant first-mover advantage that provides a significant buffer against market checks. Third and finally, because mutual funds have no real economic incentive to police ISS and its advice, realistically mutual funds cannot be expected to exert any real pressure on ISS to control for agency costs.

V. Potential Solutions

The following section examines potential solutions to this agency cost problem. ISS is not accountable to the public, any regulatory body,²¹² the corporations on which it provides CGQ ratings and proxy voting advice, the shareholders of these corporations, or the market.²¹³ Furthermore, several of ISS' mutual fund clients have adopted a "Follow ISS" rule as the default and these mutual fund clients currently have limited incentive to expend resources to exert meaningful checks on potential agency costs.²¹⁴ To be effective, any solution targeted at addressing ISS agency costs must be designed to meaningfully increase accountability, with real consequences to ISS for failing to deliver on its promise to provide sound proxy voting advice and reliable CGQ ratings.

Two solutions that have already been proposed are to have: (i) the SEC clarify its 2003 proxy voting rules and affirmatively state that mere reliance by mutual funds on a proxy advisor is not enough to satisfy a mutual fund's fiduciary duties and (ii) the SEC directly regulate the proxy advisory industry.²¹⁵ The drawbacks to the first solution are that (a) it would probably amount to mere form over substance and (b) increasing the monitoring requirements of a mutual fund may simply result in the fund passing any increased costs on to the fund shareholders in the form of increased fees. On balance, however, this solution requires a relatively simple act on the part of the SEC and at a minimum it would reduce a mutual fund's comfort in relying on ISS without an increase in the fund's monitoring of ISS' decision process. Similarly, the second solution raises several practical and philosophical concerns, such as (i) whether the SEC would be able to

²¹² While ISS does have some accountability to the SEC as a registered investment adviser under the Adviser, its CGQ methodology and proxy voting decisions are currently outside the scope of SEC regulation. *See supra* Part III.C. (discussing ISS' fiduciary duties under the Investment Adviser Act).

²¹³ *See supra* Part III.A., (discussing why ISS operates virtually free from market discipline).

²¹⁴ *See* text accompanying notes 130-33 (discussing examples of mutual funds which have adopted a "Follow ISS" as their default proxy voting policy).

²¹⁵ *See* Rose, *supra* note 28.

regulate ISS' methodologies since this would look very much like "merit review," which is facially not part of the SEC's function; and (ii) regulating ISS and its competitors may actually serve as additional barriers to entry.²¹⁶

This article proposes three additional solutions to the ISS agency cost problem. The first solution builds on the general call for direct regulation of the proxy advisory and corporate governance rating industry and offers a specific blueprint for constructing such a regulatory framework. The solution urges the SEC to consider regulating the proxy advisory and corporate governance industry, similar to the regulation it is currently contemplating for registered credit rating agencies.

The second solution contemplates establishing an oversight board for the proxy advisory and corporate governance industry similar in objective and mandate to the Public Company Accounting Oversight Board (PCAOB) that was established for auditors in the wake of the Enron and WorldCom scandals. The intended goal of this second proposal would be to implement systematic accountability and checks on the proxy advisory and corporate governance rating industries.

The third solution focuses on incentivizing mutual funds to exercise their right to vote on behalf of their underlying fund shareholders in a more meaningful and diligent way. The objective of this third solution would be to encourage mutual fund clients to pay more attention to the quality of ISS' and other proxy advisor's decisions and not simply follow the vote recommendations of these advisors.

A. SEC Oversight and Regulation

The proxy advisory and corporate governance industry is analogous to the credit rating agency industry in several ways. First, both are in the business of reducing complex information down to a single number or rating (in the case of ISS the "CGQ," in the case of Moody's and Standard & Poors a debt rating such as "AAA" or "BB"), which is derived from a combination of the application of proprietary models or algorithms,²¹⁷ and the input of qualitative factors and certain assumptions that both types of rating firms include at their discretion.

²¹⁶ *Id.* (discussing the drawbacks to having the SEC regulate the proxy advisory industry).

²¹⁷ In ISS' case, the primary proprietary model that is used is the Governance Analytics Platform. An example of a model frequently used by credit rating agencies is a quantitative expected loss model. See SEC NRSRO Proposed Rule, *supra* note 29.

Second, corporate governance ratings like debt ratings merely represent the ratings company's view of the soundness of a company's corporate governance or creditworthiness, as the case may be. To varying degrees investors and the market rely on these ratings in making decisions about the company that is being rated. Simplistically speaking, in the case of credit ratings, it is a decision of whether to purchase that company's debt; in the case of corporate governance ratings, it is a decision about whether to buy or sell the particular company's stock, or whether to pressure the company to change its practices in terms of management, the board, governing documents or other operational directives.

Third, in the case of credit rating agencies, investors typically only look to the credit ratings of the three largest firms in the industry – Fitch, Moody's and Standard & Poors.²¹⁸ This in turn causes the arrangers of debt issuances to overly use these three credit rating agencies to obtain credit ratings for the securities that they are bringing to market. Of course, in the proxy advisory and corporate governance industry the over-reliance by the market on a particular firm is even more pronounced – the market looks predominantly to ISS. Corporate boards know this so they in turn feel an enormous amount of pressure to shape their business practices and operations in a way that is pleasing to ISS, and which will hopefully result in a high CGQ score.²¹⁹

Fourth, the methodologies and resulting ratings of both ISS and the credit rating agencies have been roundly criticized as being flawed and misleading. For example, Moody's has been cited for including erroneous data in their ratings of some complex debt instruments and the ratings process of several NRSROs has been critiqued for suffering from inherent conflicts of interests.²²⁰ Both of these concerns have raised the specter that credit ratings may not be as reliable as the market would like to believe. Similarly, as previously discussed, ISS' corporate governance ratings

²¹⁸ See SEC NRSRO Proposed Rule, *supra* note 29.

²¹⁹ This sentiment was summed up by noted securities lawyer Ira Millstein: "If [a company's] governance is not getting a good grade, you go see them [referring to ISS] and they tell you how to get a good grade."... "If that's not a conflict, I don't know what is." Starkman, *supra* note 78.

²²⁰ See Lucchetti & Scannell, *supra* note 165 ("The Financial Times reported that data errors were discovered after some of the early [complex debt instruments] were rated by Moody's, and those errors went unreported.") See also SEC NRSRO Proposed Rule, *supra* note 29, at 35 ("...the NRSROs that rated subprime [debt instruments] have come under intense criticism and scrutiny. It has been suggested that changes may be needed to address the conflicts of interest inherent in the process of rating [these debt instruments].")

have been cited as being tainted by conflicts of interests, being based on flawed methodologies and assumptions, and being based on data that included errors, mistakes and/or omissions.²²¹

One key difference between the credit rating agencies and corporate governance rating services is that in the case of credit rating agencies it is the arranger or underwriter of the debt that *seeks out and initiates* the rating process.²²² In contrast, in the case of corporate governance rating services it is the rating service that initiates and produces the rating without prompting. This difference arguably weighs more heavily in favor of regulating the proxy advisory and corporate governance industry. Nevertheless, while the public and the SEC are now focused on making the credit rating agencies more accountable, ISS and the proxy advisory industry still operate virtually unfettered and free from restraint.

An examination of some features of the current proposed SEC credit rating agency rules offers a guide for how effective SEC regulation of the proxy advisory and corporate governance industry could be achieved.

On June 11, 2008, the SEC formally voted to propose "a comprehensive series of credit rating agency reforms to bring increased transparency to the ratings process and curb practices that contributed to recent turmoil in the credit markets."²²³ These proposals are a continuation of the initial authority the SEC received from Congress in September 2007 allowing the SEC to oversee credit rating agencies.²²⁴ The SEC released a series of three proposals (the "SEC NRSRO Proposals") targeted at enhancing the accountability and soundness of the ratings of NRSROs. The SEC NRSRO Proposals are designed to "address concerns about the

²²¹ See text accompanying notes 95-96.

²²² Another difference is that the anecdotal evidence seems to suggest that the credit rating analysts employed by the NRSROs are more highly trained and sophisticated in expertise than the analysts who ISS employs to generate its proxy voting advice and CGQ scores.

²²³ SEC Proposed Comprehensive Reforms to Bring Increased Transparency to Credit Rating Process, <http://sec.gov/news/press/2008/2008-110.htm> [hereinafter SEC NRSRO Press Release].

²²⁴ The SEC's authority to regulate NRSROs comes from the Credit Rating Agency Reform Act of 2006 (The "Rating Agency Act"). The Rating Agency Act was enacted on September 29, 2006 is to "improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry." Report of the Senate Committee on Banking, Housing, and Urban Affairs to Accompany S. 3850, Credit Rating Agency Reform Act of 2006, S. report No. 109-326, 109th Cong., 2d Sess. (Sept. 6, 2006), at 1.

integrity of [the] credit rating procedures and methodologies of [NRSROs] in... light of the role they played in determining credit ratings for securities collateralized by or linked to subprime residential mortgages.”²²⁵

Several features of the SEC NRSRO Proposals are useful by analogy for designing a regulatory framework for the proxy advisory and corporate governance industry.

First, the SEC NRSRO Proposals would require that credit rating agencies disclose the underlying information furnished by the issuer, underwriter or arranger, which the agency uses in determining the rating.²²⁶ This proposal is aimed at increasing transparency in the credit rating process, which in turn will hopefully lead to more informed investors and greater competition in the credit rating agency industry. By analogy, regulation aimed at increasing transparency in the proxy advisory and corporate governance industry could require disclosure of the underlying information and data used by the proxy advisor in generating its advice and/or corporate governance rating.

Second, the SEC NRSRO Proposals “require enhanced disclosures about the procedures and methodologies”²²⁷ used by a credit rating agency in determining credit ratings. The proposals are designed with the intent of enhancing disclosure of the credit rating agency’s methodologies “without intruding into the processes and methodologies by which NRSROs determine credit ratings.”²²⁸ Currently, the SEC requires that a NRSRO provide general descriptions of its procedures and methodologies for determining credit ratings.²²⁹ These descriptions must be “sufficiently detailed to provide users of credit ratings with an understanding of the procedures and methodologies”²³⁰ used by the NRSRO. The SEC NRSRO Proposals would augment the current required disclosure, by requiring specific disclosure of substantive factors such as (i) a description of how assessments of the quality of originators of assets underlying the debt instrument affect the resulting credit

²²⁵ See SEC NRSRO Proposed Rule, *supra* note 29.

²²⁶ See *id.*

²²⁷ *Id.* at 88.

²²⁸ *Id.* at 83.

²²⁹ See Instructions to Form NRSRO. The Instructions to Form NRSRO implements the requirements of Section 15E(a)(1)(B)(ii) of the U.S. Securities Exchange Act of 1934, 15 U.S.C. §78o-7(a)(1)(B)(ii) (requiring that an application for registration as an NRSRO contain information regarding the procedures and methodologies used by the credit rating agency to determine credit ratings).

²³⁰ SEC NRSRO Proposed Rule, *supra* note 29, at 88.

information and (ii) how frequently credit ratings are reviewed and how changes made to models and criteria affect resulting credit ratings.²³¹ Taken together, the current required disclosure and the proposed enhanced disclosure aim to provide greater clarity for investors as to how credit ratings are derived.

It is easy to see how a similar regime of methodology demystification would be helpful for the proxy advisory and corporate governance rating industry. Requiring disclosure of the methodology underlying the CGQ and other corporate governance ratings²³² would provide greater clarity of the rating process to shareholders, corporations, the public, and regulators, which would in turn lead to better informed investors and an enhanced ability to assess the trustworthiness and reliability of proxy voting advice and corporate governance ratings.

A third feature of the SEC NRSRO Proposals that could be replicated in a regulatory regime for the proxy advisory and corporate governance rating industry is the proposed requirement that NRSROs keep a record of all their ratings actions and a record of the rationale for any material difference between the credit rating implied by the NRSRO's rating model and the resulting credit rating issued by the NRSRO. The intended purpose of this proposed requirement is to enhance accountability, foster competition, and allow the SEC to independently examine and "reconstruct the analytical process by which a credit rating was determined."²³³ In terms of the proxy advisory and corporate governance industry, requiring the maintenance of records, which allow for independent reconstruction and critique of resulting ratings and advice, would be a powerful antidote to the current problems of unaccountability, obscurity, and flawed ratings and advice, which are present in the industry.

While it is premature to predict the effects of the new SEC NRSRO Proposals, the SEC's proposed rules offer a model on which to base potential SEC oversight of the proxy advisory and corporate governance industry. In addition, it shows that a Congressional grant of regulatory authority to the SEC to oversee the proxy advisory industry is not a dramatic leap. Any kind of SEC oversight specifically targeted at transparency, accountability, and competition in the proxy advisory industry would be a significant improvement over the void in which ISS and its competitors currently operate.

²³¹ *Id.* at 89.

²³² See discussion of other corporate governance ratings in Part I.A. *supra*.

²³³ SEC NRSRO Proposed Rule, *supra* note 29, at 75.

In addition, separate SEC regulation specifically directed at the proxy advisory industry would be preferable to relying on regulation vis-à-vis the Advisers Act because (i) not all proxy advisors and corporate governance rating providers are required to register as an investment adviser under the Adviser Act; and (ii) even if they were to register, as currently drafted and interpreted, the Adviser Act and corresponding rules would not require disclosure of ratings methodologies and procedures, which is a key element of the agency cost problem.

B. Creation of Oversight Board

A central part of the Enron and WorldCom scandals was the role that auditors played in the financial chicanery that eventually resulted in widespread market turmoil and lack of investor confidence. Auditors came under fire for their role in vouching for companies and transactions as above board, when the information that came out after the fact indicated that these companies and transactions were less than legitimate. Investors relied on auditor opinions in making investment decisions.

The Enron and WorldCom scandals resulted in a period of reckoning and reassessment of the role of auditors in relation to operating companies and whether more oversight and accountability of auditors were required to restore investor confidence and prevent a recurrence of the accounting frauds perpetrated in Enron and WorldCom. Out of this unease, the Public Company Accounting Oversight Board (the "PCAOB") was born.

The Sarbanes-Oxley Act created the PCAOB to "oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair and independent audit reports."²³⁴

The sentiments underlying the creation of the PCAOB are similar in contour and substance to the sentiments expressed by those concerned about the current landscape in the proxy advisory and corporate governance industry. Like auditors, ISS and other proxy advisors hold positions of significant perceived authority and expertise on which the market relies. And like auditors in the wake of Enron and WorldCom, there is a growing sentiment that an unrestrained and unaccountable proxy advisory industry is a disaster waiting to happen.

²³⁴ Public Company Accounting Oversight Board, Our Mission, <http://www.pcaod.com> (last visited Apr. 7, 2009).

Creation of an oversight board like the PCAOB, which would be designed to provide systematic accountability of proxy advisors, could help alleviate several of the concerns discussed in this article. General features of the PCAOB's mandate and role, which could be replicated in designing an oversight board for the proxy advisory and corporate governance industry, are (i) the creation of auditing and ethics standards; (ii) the authority to conduct a continuing program of inspections; (iii) a requirement that audit firms register with the PCAOB; and (iv) the grant of enforcement action to the PCAOB to investigate and discipline registered public accounting firms.²³⁵

C. Re-examining Mutual Funds' Exercise of Voting Authority

A mutual fund's authority to vote on behalf of its fund shareholders is not a requirement of any legal rule, statute, case law, regulatory action or policy. The requirement comes about as a result of the contractual agreement between mutual funds and fund shareholders. In their contractual agreement, fund shareholders grant mutual funds the authority to vote portfolio shares on the fund shareholder's behalf.

While the law does not require mutual funds to vote portfolio shares on behalf of fund shareholders, once mutual funds have acquired voting authority the SEC does require that they exercise their voting authority in the "best interest" of the fund shareholders.²³⁶ This "best interest" requirement includes a requirement that the mutual fund disclose to its clients information about the fund's voting policies and procedures, and that the fund disclose to its clients how the clients may obtain information on how the fund has voted their proxies. The SEC has also implicitly blessed the prevalent practice by mutual funds of using proxy advisors as keeping with the "best interest" standard so long as the mutual funds perform some due diligence and satisfy themselves that the proxy advisor is not conflicted.²³⁷

²³⁵ Information about the PCAOB is available on their website, <http://www.pcaob.com>.

²³⁶ See SEC 2003 Rule, *supra* note 22.

²³⁷ While the SEC has mentioned in broad strokes that mutual funds should undertake some diligence of their own rather than merely rely on the advice of proxy advisors, so far the SEC has not articulated precisely what this diligence would entail, nor has the SEC specifically required that this diligence go beyond a conflict of interest check. For example, diligence which focuses on how the proxy advisor determines the implementation of its proxy voting policies or diligence on the soundness of the advisor's computational methodologies are not explicitly required by the SEC's current line of no-action letters.

While the impetus for enacting the SEC 2003 Rule was a concern that mutual funds were voting portfolio shares in blind accordance with company management's recommendations, so far the SEC has not taken any action to address the widespread reliance by mutual funds on these third-party proxy advisors, even though these proxy advisors are significantly less accountable and arguably more problematic than their company management counterparts. This begs the question of what is more in the "best interest" of fund shareholders: Is it follow accountable agents such as company managers? Or is it follow unaccountable agents such as ISS and the other proxy advisors? It also begs the question of whether the "best interest" standard as currently interpreted is too lax in light of the fact that mutual funds have imposed the duty to vote portfolio shares on themselves in contrast to this duty having been imposed by operation of law. The SEC should reexamine its interpretation of what satisfies the "best interest" standard and impose specific diligence requirements, beyond conflict of interest checks, on the mutual fund industry.²³⁸

In sum, designing viable standards and rules to address the problem of ISS agency costs, and by extension that of the proxy advisory industry and corporate governance rating industry, is a complex task. However, as leading corporate law scholar, Professor Victor Brudney, aptly noted, "[t]hat agency costs are inevitable does not preclude efforts to reduce them."²³⁹

Conclusion

This article makes the case that ISS generates significant agency costs and that the traditional monitoring and control devices of market constraints, transparency, fiduciary duties, and exit and voice, are absent in the case of ISS. Furthermore, currently no effective control procedures exist for curtailing ISS agency costs.

This result is troubling given the influence and centrality of ISS in corporate elections and corporate governance affairs. It also has implications for several issues currently being tackled in corporate law scholarship, such as concerns about shareholder voting interests being decoupled from their economic interests; balancing the push for greater shareholder rights with the concern that traditional

²³⁸ *Id.*

²³⁹ Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 617 (1997).

board functions are increasingly being hijacked by institutional and activist investors; and the challenge of defining and measuring what “good” corporate governance looks like.

Finally, the current system in which an unaccountable and unregulated agent wields such power and influence in corporate elections and corporate governance standards is both conceptually at odds with corporate law agency theory and practically perilous for the corporate enterprise. At the end of the day, should ISS’ proxy voting advice and corporate governance ratings prove woefully flawed, it will not be ISS or the mutual funds that will have to bear the price; instead it will be public companies, their long-term shareholders, and our corporate system.

