PROXY

WHO IS OVERSEEING THE PROXY ADVISORS?

*By Colin Diamond and Irina Yevmenenko**

Proxy advisors are perceived as wielding significant power over shareholder meetings. In 2002, Institutional Shareholder Services' (ISS) endorsement of the Hewlett-Packard/Compaq merger was widely viewed as a decisive factor in the 51.4% vote in favor of the merger.[1] Companies whose proposals are supported by proxy advisors often issue press releases trumpeting this fact.[2] Conversely, those whose proposals are challenged by proxy advisors often issue detailed explanations as to why the proxy advisors' positions are incorrect.[3] In light of this perceived influence, companies go to significant lengths to avoid conflicts with proxy advisors by seeking their guidance in advance on management proposals and by conforming proposals to the proxy advisor's published guidelines.

Opinions differ on the benefits that proxy advisors bring to shareholder democracy, and limited empirical research exists on proxy advi-

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1. *See, e.g.,* Eleanor Laise, *Is This the Most Influential Man on Wall Street?*, SMARTMONEY MAGAZINE, Oct. 16, 2002, *available at* http://www.smartmoney.com/smartmoney-magazine/index.cfm?story=Oct02-influential.

2. *See, e.g.,* Press Release, Washington Mutual, Inc., Three Proxy Advisory Firms Support WaMu Proposals at Upcoming Special Shareholders' Meeting (June 12, 2008), *available at* http://newsroom.wamu.com/phoenix.zhtml?c=189529&p=irol-newsArticle&ID=1165405&highlight=; Press Release, Restoration Hardware, Inc., Proxy Governance Recommends that Restoration Hardware Stockholders Vote "For" The Merger: Proxy Governance Joins RiskMetrics (ISS) and Glass Lewis in recommending that Restoration Hardware stockholders vote "FOR" the Merger: Special Meeting of Stockholders is Scheduled for June 12, 2008 (June 12, 2008), *available at* http://phx.corporate-ir.net/phoenix.zhtml?c=79100&p=irol-newsArticle&ID=1162211&highlight=.

3. *See, e.g.,* Polo Ralph Lauren Corp., Proxy Statement (Schedule 14A) (July 24, 2008) (containing talking points regarding ISS's recommendation to withhold votes from three board nominees); EMC Corp., Proxy Statement (Schedule 14A) (May 8, 2008) (seeking shareholder support for a board member who was subject to a withhold recommendation from ISS); *see also* Johnson & Johnson, Proxy Statement (Schedule 14A) (Apr. 15, 2008) (seeking shareholder support for four board members subject to a withhold recommendation from ISS).

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sors' impact on shareholder meetings. In June 2007, the U.S. Government Accountability Office (GAO) issued a report questioning the "overall influence" that proxy advisors have on the shareholder voting.[4] Notwithstanding industry perception that proxy advisors significantly impact shareholder votes, express regulation of proxy advisors no longer appears to be a priority for either the U.S. Congress or regulatory agencies. Indeed, regulation of compensation consultants to address their conflicts of interests is currently a higher priority (and a more politically rewarding) agenda item.[5] Nevertheless, outside the Washington beltway, ISS and other proxy advisors continue to draw significant attention from boards and their advisors. It is therefore worthwhile to understand how proxy advisors' guidelines differ significantly from those of the SEC and the stock exchanges, and to consider whether any form of oversight is desirable.

The Advent of the Proxy Advisor

Proxy advisors for shareholder voting are a relatively recent phenomenon. A combination of regulatory and market developments prompted their rise. In 1988, the U.S. Department of Labor issued a letter indicating that shareholder voting rights are plan assets under the Employee Retirement Income Security Act of 1974 and, accordingly, pension plan fiduciaries must consider plan beneficiaries' best interests when voting stock held by the plan.[6] While this led to the initial growth of proxy advisors, the most significant development occurred in 2003, when the SEC adopted Rule 206(4)-6 under the Investment Advisers Act of 1940, requiring investment advisers to vote proxies in the best interests of clients,[7] and Rule 30b1-4 under the Investment Company Act of 1940, requiring investment funds to disclose annually their proxy voting record and the policies and procedures used by the fund to determine how to vote proxies.[8] These additional legal responsibilities created a need for managers

4. U.S. Government Accountability Office, *Corporate Shareholder Meetings: Issues Relating to Firms That Advise Institutional Investors on Proxy Voting*, at 6 (June 2007), *available at* http://www.gao.gov/new.items/d07765.pdf.

5. *See* Letters from Henry A. Waxman, Chairman, Committee on Oversight and Government Reform, House of Representatives, to Executive Compensation Consults (May 8, 2007), *available at* http://oversight.house.gov/story.asp?ID=1302.

6. Letter from Alan D. Lebowtiz, Deputy Assistant Secretary, Department of Labor, to Helmuth Fandl, Chairman of the Retirement Board, Avon Products, Inc. (Feb. 23, 1988).

7. Proxy Voting by Investment Advisers, Investment Advisers Act Release No. IA-2106, 79 S.E.C. Docket 1673 (Jan. 31, 2003).

8. Annual Report of Proxy Voting Record or Registered Management Investment Company (Form N-PX); Registration Statement Under the Investment Company Act of 1940 (Form N-1A), Item 13, 16; Registration Statement Under the Investment Company Act of 1940 (Form N-2); Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Securities Act Release No. 33-8188, Securities Exchange Act Release No. 34-47304, Investment Company Act Release No. IC-25922 (Jan. 31, 2003).

to point to the retention of a proxy advisor as proof that they were taking their voting responsibilities seriously.

Demand for proxy advisors also increased with the growing influence of institutional stockholders. Over the last thirty years, institutional investors, such as mutual funds, pension funds, hedge funds, investment managers, investment banks and insurance companies, have become increasingly dominant as stockholders in the United States and globally. According to The Conference Board, institutional investors held 37.2% of total U.S. equities in 1980, 51.4% in 2000 and 61.2% in 2005.[9] Many institutional investors – particularly smaller ones – focus on deciding which companies to invest in rather than on how to vote shareholder proxies. Recent corporate scandals, such as those involving Enron and WorldCom, also contributed to the rise of proxy advisor activism, particularly among state and local pension funds, which have been at the forefront of demanding governance changes.

The Proxy Advisor Market

ISS dominates the proxy advisor market. ISS began its operations in 1985 and grew to dominance in the 1990s and early 2000s. It was purchased in January 2007 by RiskMetrics Group, a financial risk management company that completed an IPO in January 2008. According to its website, ISS delivers complete vote recommendations for more than 38,000 meetings in over 100 markets globally, and as of December 31, 2007, it served approximately 1,200 financial institutions with an estimated $20.0 trillion of assets under management.[10] Because of its size and reach, ISS's recommendations and general policies are perceived to be weighty. Other significant players in the proxy advisory market include Egan-Jones and Glass Lewis, both of which commenced offering proxy recommendations in 2003, and Proxy Governance Inc., which did so starting in 2005.

The four proxy advisors described above differ in a number of important ways. First, in addition to proxy recommendations, ISS also provides corporate governance consulting services. By contrast, the other three proxy advisors do not provide consulting services and thereby claim to avoid conflicts of interest (although all proxy advisors provide vote execution, record-keeping and reporting services). Second, ISS, Glass Lewis and Egan-Jones publish voting policy guidelines upon which they base their recommendations. Proxy Governance does not publish guidelines, noting explicitly its belief that recommendations must be tailored on an issue-by-company basis. Third, ISS and Egan-Jones provide quantitative

9. *See* Press Release, The Conference Board, U.S. Institutional Investors Continue to Boost Ownership of U.S. Corporations (Jan. 22, 2007), *available at* http://www.conference-board.org/utilities/pressDetail.cfm?press_ID=3046.

10. *See* RiskMetrics Group, Inc., Annual Report (Form 10-K), at 3, 10, 11 (Mar. 31, 2008).

measures of companies' corporate governance practices in the form of quotients or grades.

Many institutional investors subscribe to one or more proxy advisors. Typically, proxy advisors make their proxy voting recommendations available publicly, but provide only subscribers with the underlying report containing their analysis and research.

Proxy Advisors' Approaches to Key Proposals

The agenda of proxy advisors is generally activist, shareholder-friendly and protective of shareholder voting rights. In the discussion below, we analyze several topics that proxy advisors focus on, comparing ISS, the proxy advisor with the most detailed policies, to the other major players in the industry.

Director Independence

It has long been accepted that independent directors are key to ensuring that the interests of public shareholders are adequately represented on the board of a public company. Director independence is regulated under Rule 10A-3 of the Exchange Act (with respect to audit committee membership) and by the rules of the New York Stock Exchange and Nasdaq Stock Market (with respect to the majority-independence requirements of those exchanges, and compensation and nominating committee membership).

Notwithstanding these standards, ISS counsels a "withhold vote" from directors if a majority of a company's board or any member of the audit, compensation or nominating committee does not satisfy its own definition of independence. ISS's definition is notably stricter than the NYSE or Nasdaq. For example, ISS deems directors to be non-independent if they (or their family, or others close to them) had certain relationships with the company within the past *five* years.[11] The stock exchanges, by comparison, only look back *three* years. ISS considers a director to be non-independent if such director (or a relative) provides professional services for payments in excess of *$10,000* per year.[12] The stock exchanges, by comparison, use a *$120,000* threshold. The result for many companies is the imposition of a higher director independence standard than was envisaged by the SEC, the NYSE, Nasdaq and companies themselves when originally listing. Glass Lewis similarly has a five-year look-back, and, among other things, considers a director to be non-independent if the director "owns or controls 25% or more of the company's voting stock" (notwithstanding the fact that both the NYSE and Nasdaq indicate that ownership of a significant amount of stock does not, in their view, impair

11. *See ISS Governance Services: U.S. Corporate Governance Policy: 2008 Updates, at* 8-9 (RiskMetrics Group, Inc. ed., Nov. 19, 2007), *available at* http://www.riskmetrics.com/pdf/2008ISS_USPolicyUpdates.pdf.

12. *Id.*

independence *per se*). Glass Lewis and Egan-Jones both state that at least two-thirds of a board's members should be independent, contrasting with the majority standard required by the NYSE and Nasdaq (and adopted by ISS).

The approach of ISS and Glass Lewis contrasts with that of Proxy Governance, which states in its guidelines: "PROXY Governance does not propose to adopt or apply a definition of director independence that is more stringent than that imposed by the self-regulatory organizations (SROs). If shareholders feel that the independence standards set out in the listing rules are too weak, or that their interpretation has been inconsistent, we believe they should reopen the debate with the SROs or the SEC rather than overlay additional and inconsistent criteria for director independence."

Company Performance

Company performance represents one of the more challenging aspects of proxy advisors' roles. Unlike other areas, such as those that relate to governance, company performance is an area where institutional investors *are* likely to be more expert than proxy advisors. After all, company performance relates directly to the decision to buy or sell stock. Accordingly, proxy advisors have generally trodden carefully around this issue.

Prior to the 2008 proxy season, ISS's policy was to recommend a vote against or to withhold a vote from directors of companies that underperformed relative to their industry peers based on a performance metric determined by ISS. The policy resulted in ISS advising shareholders to vote against or withhold a vote for an incumbent board if the company languished for two consecutive years in the bottom five percent of the company's Global Industry Classification Standard group (a Standard & Poor classification system) based on ISS's performance metric, without showing improvement in the second year. The performance metric is based fifty percent on operational performance and fifty percent on five-year stock performance. Operational performance, in turn, is an aggregate of five-year sales growth, average pre-tax return on invested capital, and EBITDA growth, weighted equally. Forty percent of each individual five-year measurement is based on the preceding year, while sixty percent is based on the combined four years prior to the preceding year. ISS changed this policy in its update for the 2008 proxy season, stating that it would evaluate a company's "overall performance relative to its peers on a case-by case basis," taking into account the performance metric, but also considering other factors, such as year-to-date performance, situational circumstances, changes in management or the board, and overall governance practices.[13]

No other proxy advisor publishes a predetermined metric for recommending a vote against or withholding a vote from an incumbent board.

13. *Id.* at 6-7.

Each uses a case-by-case review of board and company performance. Glass Lewis provides a comparison of the subject company's performance metrics to at least three other companies in the same Global Industry Classification Standard group having similar market capitalization and revenue characteristics.

Executive Compensation

In recent years, executive compensation has become a focus of investors and politicians, and the SEC's comprehensive 2006 amendments to Item 402 of Regulation S-K have enhanced significantly the disclosure required from companies. Both Presidential candidates have expressed their views on executive pay. As reported by the *Wall Street Journal*, Sen. McCain described compensation received by Bear Stearns and Countrywide Financial executives as "unconscionable" and "outrageous."[14] It is against this background of enhanced scrutiny that proxy advisors have developed policies on various aspects of executive compensation.

Equity Compensation Plans

ISS leads in the application of predetermined formulae in order to determine whether to recommend a vote for or against an equity compensation plan. ISS will recommend a vote against an equity compensation plan if any of the following conditions exist:

- *Total cost of the company's equity plans is unreasonable*. This test analyzes the dollar and percentage amounts of shareholders' equity transferred to employees and directors under a company's equity compensation plan.
- *Plan expressly permits the repricing of stock options without prior shareholder approval.*
- *Disconnect between CEO pay and company performance*. ISS will generally recommend a vote against an equity plan if more than one-half of a CEO's increased pay is equity-based at a time when there have been negative one- and three-year shareholder returns.
- *Excessive burn rate*. ISS will generally recommend a vote against an equity plan if the company's three year "burn rate" (the rate at which it depletes shares reserved under the plan) exceeds the greater of two percent and the mean plus one standard deviation of its industry group, unless the company commits in a public filing to satisfy this test in the future.
- *Poor pay practices*. ISS has a long list of practices that may result in a recommendation to vote against a plan.[15]

In its update for the 2008 proxy season, ISS amended its policies to focus on clear disclosure, "fair, competitive, reasonable, and appropriate"

14. *See* Laura Meckler, *McCain, In Populist Turn, Slams Executives' Pay*, WALL ST. J., Apr. 7, 2008, *available at* http://online.wsj.com/article/SB120752535331093607.html?mod=special_page_campaign2008_leftbox.

15. *ISS Governance Services*, *supra* note 11, at 13-15.

pay practices with pay for performance being "a central tenet in executive compensation philosophy." ISS also added more precision to its policy relating to excessive burn rates to require use of the weighted average common shares outstanding rather than the fiscal year-end figure to better account for the impact on a company that has significantly changed its outstanding shares during the year. Finally, ISS now allows companies with sustained positive stock performance and high overhang costs attributable to in-the-money options outstanding in excess of six years to receive, on a case-by-case basis, a carve-out from a portion of the cost attributable to the overhang.

No other proxy advisor publishes predetermined metrics for recommending a vote against, or withholding a vote for, an equity compensation plan. Each uses a case-by-case review of board and company performance. Glass Lewis provides a list of nine principles that it applies, including, among other things, a prohibition on repricing, a requirement that the number of shares allocated to a plan be small enough that companies will need shareholder approval every three to four years (or more frequently) and a requirement that the annual net share count and voting power dilution be reasonable.

Say-On-Pay

Companies have recently been subject to an increased number of "say-on-pay" proposals from shareholders which would give shareholders an annual, non-binding vote on the prior year's compensation of named executive officers. Annual say-on-pay requirements have been adopted in a number of jurisdictions, such as the United Kingdom where it is mandatory for companies listed on the London Stock Exchange.[16] Sen. Obama proposed a bill in the Senate requiring annual advisory shareholder votes on executive pay by public corporations. A measure similar to Obama's, the "Shareholder Vote on Executive Compensation Act," was approved by the House of Representatives last year. In the absence of binding legislation in the United States, the position of proxy advisors is helping to determine whether shareholders approve say-on-pay proposals.

The guidelines of ISS and Glass Lewis both state that they will generally support say-on-pay shareholder proposals. Egan-Jones and Proxy Governance both make the determination on a case-by-base basis. The result is that different firms can come up with different recommendations on the same resolution. For example, at Cisco's November 2007 annual shareholder meeting, Glass Lewis and Egan-Jones supported a say-on-pay resolution while Proxy Governance stated that "Executive pay (at Cisco) is in line with peers, while the company is outperforming its peer group. If we don't find a problem at a company, we typically feel it's best to leave well-enough alone. We don't support an annual advisory vote on (executive) pay for the sake of having it just in case there is a problem."

16. Companies Act, 2006, ch. 46, pt. 15, ch. 9, § 439 (U.K.).

It is important to note that say-on-pay resolutions, if adopted, subject the entire array of a company's executive pay policies and procedures to proxy advisor scrutiny resulting in the practical effect of requiring companies to comply with ISS guidelines or run the risk of ISS recommending that shareholders vote against executive pay. Such a vote, while only advisory, would likely result in an ISS recommendation to vote against or withhold votes from the compensation committee or the entire board of directors unless the company conformed its compensation practices to ISS guidelines. On a practical level, proxy advisors have this power in any event, but a specific vote on compensation has enhanced their power as demonstrated by the revisions that ISS made to its guidelines for voting on management compensation in the 2008 proxy season. ISS will now evaluate pay programs on a case-by-case basis using five global principles and additional guidelines specifically for the U.S. markets. The global principles are as follows:

- First, an appropriate alignment between pay and performance, with emphasis on long-term shareholder value, should permeate overall executive pay practices;
- Second, pay arrangements should avoid making payment for failure by not guaranteeing compensation or providing excessively long contracts or severance packages;
- Third, an independent and effective compensation committee is required;
- Fourth, shareholders must receive clear, comprehensive compensation disclosure;
- Fifth, non-executive directors should not receive compensation compromising their independence.

ISS also identifies additional criteria specific to U.S. companies, including relative considerations (i.e., assessment of performance metrics, comparison to pay policies of peer companies, alignment of corporate performance and executive pay trends, and internal pay equity between the CEO and other executives), design considerations (i.e., balance between fixed and performance-based pay, perquisite practices, and severance and retirement pay packages) and communication considerations (i.e., the quality of the Compensation Discussion and Analysis disclosure consistent with the requirements of Item 402 of Regulation S-K and related SEC guidance).[17]

It is interesting to note that the 2008 proxy statement of RiskMetrics Group, which acquired ISS, includes three separate resolutions for shareholder approval: (1) the company's overall executive compensation philosophy; (2) whether the board executed these principles appropriately in making its 2007 compensation decisions; and (3) the board's application of its compensation philosophy and policies to the company's 2008 performance objectives.

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17. *ISS Governance Services*, *supra* note 11, at 13-15.

Proxy Governance's guidelines do not differ significantly: the firm takes a "holistic" approach to executive pay, with emphasis mostly on performance. It considers compensation "one of the best indicators of a board's ability to oversee management. Poor compensation practices that fail to adequately tie pay to performance for executives point to a weak, ineffective or detached board."

Corporate Social Responsibility

ISS's policies relating to social issues are varied. ISS generally recommends voting for enhanced disclosure and reporting proposals, and takes a case-by-case approach to proposals requiring action restraining the company's activities. For example, it generally advises voting for enhanced disclosure of policies related to toxic materials, against resolutions requiring that the companies reformulate their products, and takes a case-by-case approach to resolutions requiring disclosure of implementation of Internet privacy and censorship policies, energy efficiency, community impact assessments and operations in terrorism-sponsoring states. Proxy Governance's support for social issue proposals depends on "whether enacting them or failure to enact them will, respectively, enhance or harm long-term corporate and shareholder value, broadly speaking." Proxy Governance requires inquiry into financial risk, cost and activities of the company's peer group before advocating a social responsibility resolution.

By contrast, instead of adopting a case-by-case approach to corporate social responsibility matters, Egan-Jones outlines specific voting recommendations either for or against proposals relating to various social issues, including, among others, energy and environment, military business, product integrity and marketing, and equal opportunity and discrimination. Glass Lewis, in an attempt to distinguish itself further from the other proxy advisors, in October 2006, added voting guidelines from KLD Research & Analytics, a company providing recommendations to shareholders on how to vote to enhance corporate environmental and social responsibility, to its regular package.[18]

Conflicts of Interest and Proxy Advisor Reform

One of the primary concerns raised by advocates of proxy advisor reform is the potential for conflicts of interest that arises when a proxy advisor advises a company how to structure management proposals to improve their chances of shareholder approval, while at the same time advising institutional investors how to vote their proxies for that proposal. This concern arises in particular with respect to ISS, which is the only proxy

18. Press Release, KLD Research & Analytics, Inc., *SRI Proxy Voting Guidelines Available for Institutional Investors Globally: KLD and Glass Lewis to Partner to Provide Investors Best-In-Class SRI Proxy Voting Solution* (Oct. 26, 2006), *available at* http://www.kld.com/newsletter/archive/press/pdf/SRIProxy_voting_Glass_lewis.pdf.

advisor to provide both voting advisor and consulting services. In addition, because of ISS's dominance, there is a concern that companies may feel compelled to retain ISS's services in order to obtain a favorable recommendation.

For its part, ISS has stated that it has "instituted multiple safeguards to mitigate any real or perceived conflicts of interests."[19] ISS maintains separate buildings, staff and technology functions for its advisory and consulting functions.[20] The June 2007 GAO report found that ISS's voluntary disclosure and corporate practice were adequate and cited as a potential deterrent the substantial reputational risks to ISS of exploiting conflicts. The GAO also noted that several proxy advisors, including ISS, are registered with the SEC under the Investment Advisers Act of 1940 and that the SEC had not identified any major violations or initiated any enforcement actions.[21] In addition, as a separate matter, Rule 206(4)-6 under the Investment Advisers Act requires a registered investment adviser exercising proxy voting authority on behalf of a client (e.g., a fund manager voting on behalf of a mutual fund) to adopt policies and procedures designed to mitigate conflicts of interest. The SEC has clarified that an investment adviser can demonstrate its vote was not the product of a conflict of interest if the advisor votes proxies in accordance with a predetermined policy based on the recommendations of an independent third party.[22] In response to a query from Egan-Jones (clearly targeted at rival ISS), the SEC clarified that the fact that a proxy advisor advises on corporate governance issues and receives compensation from an *issuer* does not affect the proxy advisor's independence from the *investment adviser* under Rule 206(4)-6. The SEC did, however, go on to state that an investment adviser should obtain information concerning a proxy advisor's relationship with an issuer in order to determine whether the proxy advisor could make voting recommendations in an impartial manner.[23] The SEC then clarified its position in a subsequent letter to ISS stating that an impartiality determination need not be made on an issuer-by-issuer basis and that the implementation of general conflict procedures could be sufficient.[24]

Notwithstanding the GAO report and SEC's clarification, whether the current regime provides sufficient safeguards against conflicts of in-

19. RiskMetrics Group, Inc., Annual Report (Form 10-K), *supra* note 10, at 15.

20. *See* Institutional Shareholder Services, Inc., SEC No-Action Letter, 2004 WL 2093360 (Sep. 15, 2004), *also available at* http://www.sec.gov/divisions/investment/noaction/iss091504.htm.

21. U.S. Government Accountability Office, *Corporate Shareholder Meetings*, *supra* note 4, at 19.

22. Proxy Voting by Investment Advisers, Investment Advisers Act Release No. IA-2106, 79 S.E.C. Docket 1673 (Jan. 31, 2003).

23. *See* Egan-Jones Proxy Services, SEC No-Action Letter, 2004 WL 1201240 (May 27, 2004), *also available at* http://www.sec.gov/divisions/investment/noaction/egan052704.htm.

24. *See* Institutional Shareholder Services, Inc., SEC No-Action Letter, 2004 WL 2093360, *available at* http://www.sec.gov/divisions/investment/noaction/iss091504.htm.

terest remains an open question. Addressing the concerns raised by proxy advisory services requires action on two fronts:

(1) *Voluntary Action by Proxy Advisors*

In the absence of substantive regulation, there have been calls for proxy advisors to adopt a voluntary code of conduct. Yale's Millstein Center for Corporate Governance and Performance noted in a 2008 draft report (the Voting Integrity Report) that the adoption of an industry-wide code of professional ethics, similar to those used in other industries, could anchor the practice of meaningful conflicts disclosure.[25] Among other things, the draft code requires that "disclosures of conflicts of interest should be complete, timely, clear, concise, specific and prominent." The draft code also addresses topics such as the quality and integrity of the recommendation process, separation of advisory and consulting functions, advisor independence and advisor responsibilities to clients and issuers. While the Voting Integrity Report does not call for regulation, some of the recommendations embodied in the code are similar to the requirements of NASD Rule 2711 regarding avoidance of conflicts of interest in connection with research reports issued by investment bank analysts. Indeed, the draft code could have gone further and adopted some of the requirements applicable to analysts, such as requiring that the compensation of individual employees involved in proxy advice is not tied in any way to consulting services or the adoption of particular management proposals, and requiring a certification similar to that provided by research analysts under Regulation AC.

In an initial response, Proxy Governance generally endorsed the Millstein Report's recommendations and indicated current voluntarily compliance with many of the recommended practices.[26] Not surprisingly, however, it went on to call for a complete and total separation of proxy advisory and corporate consulting businesses – a move that is antithetical to ISS's business model. Discussion on the Voting Integrity Report will continue over the coming months.

(2) *Institutional Investors' Approach to Proxy Advisors*

Before ISS updated its guidelines for the 2008 proxy season, ISS placed heavy reliance on the application of predetermined formulas to determine its voting advice on a number of key issues, such as those described above. Other proxy advisory services rejected this approach, in one case characterizing the formula approach as a "check the box" ap-

25. Meagan Thompson-Mann, *Policy Briefing No. 2: Voting Integrity: Practices for Investors and the Proxy Industry, Working Draft — For Public Comment* (Millstein Ctr. for Corporate Governance and Performance, Yale School of Mgmt., 2008), *available at* http://millstein.som.yale.edu/2008%2006%2005%20voting%20integrity2.pdf.

26. Letter from Michael J. Ryan, Jr., President & Chief Operating Officer, Proxy Governance, Inc., to Meagan Thompson-Mann, Visiting Rearch Fellow, Millstein Center for Corporate Governance and Performance, Yale School of Management (July 23, 2008), *available at* https://www.proxygovernance.com/content/pgi/img/2008MillsteinResponse.pdf.

proach, instead advocating an approach tailored to the facts and circumstances of individual companies. ISS's updated 2008 guidelines have started to move away from a pure formulaic approach and, instead, use formulas as one factor in determining proxy advice.

It is not without irony that proxy advisors' businesses grew most rapidly because institutional investors perceived that engaging a proxy advisor was the best way to comply with their fiduciary duties to vote proxies for the benefit of their investors and to comply with disclosure obligations imposed by regulators. It is questionable whether blindly following the recommendation of a proxy advisor fulfills such fiduciary duty, particularly if the recommendation is heavily dependent on a formula determined by that firm. In this regard, it is noteworthy that one of the conclusions in the GAO report is that the influence of proxy advisors is overstated with respect to the largest institutional investors because those investors do, in fact, rely on their own in-house research and only supplement it with recommendations from proxy advisors. The clear general trend in the proxy advisory industry – evidenced by ISS's updated 2008 guidelines and the practices of other firms – is to move towards a principles-based approach. Such an approach raises the question of whether institutional investors should rely on proxy advisors primarily to aggregate data in a concise and user-friendly format so that the investor can make its own independent voting decision. The SEC could assist this process by clarifying that an investment adviser's fiduciary duties under Rule 206(4)-6 are not satisfied merely by following the recommendations of a proxy advisor. One method of enabling multiple voting decisions to be made efficiently is for an institution to adopt a proxy voting policy. All proxy advisors offer a service to assist their clients in developing such a policy. Depending on the resources of the investor, the policy could contain general guidelines that require judgment in their application or more detailed guidelines that could be implemented without significant judgment.

Conclusion

The precise extent to which proxy advisors influence shareholder votes remains open to debate and ongoing empirical study. However, little doubt exists that proxy advisors, at a minimum, have had a meaningful impact on some shareholder votes, particularly those in connection with closely fought proposals. Moreover, if most directors believe that ISS has power – as their actions indicate – boards may do what they believe ISS wants them to in order to keep their seats, whether or not their belief is justified. Similarly, if most institutional investors follow the same proxy advice closely, the impact of that advice on U.S. corporate governance could be very significant. For these reasons, it is incumbent on proxy advisors to operate with full transparency, ideally pursuant to self-imposed, industry-wide standards that result in clear disclosure to institutional and retail investors alike in connection with voting recommendations. In ad-

dition, institutional investors who are fiduciaries should continue to consider carefully how the use of proxy advisory services best serves their fiduciary duties. In some cases, a proxy advisor can assist the institution in constructing a tailored proxy voting policy. The institution then votes its shares in accordance with that policy. In other cases, proxy advisor research could supplement the individual research of that institution.