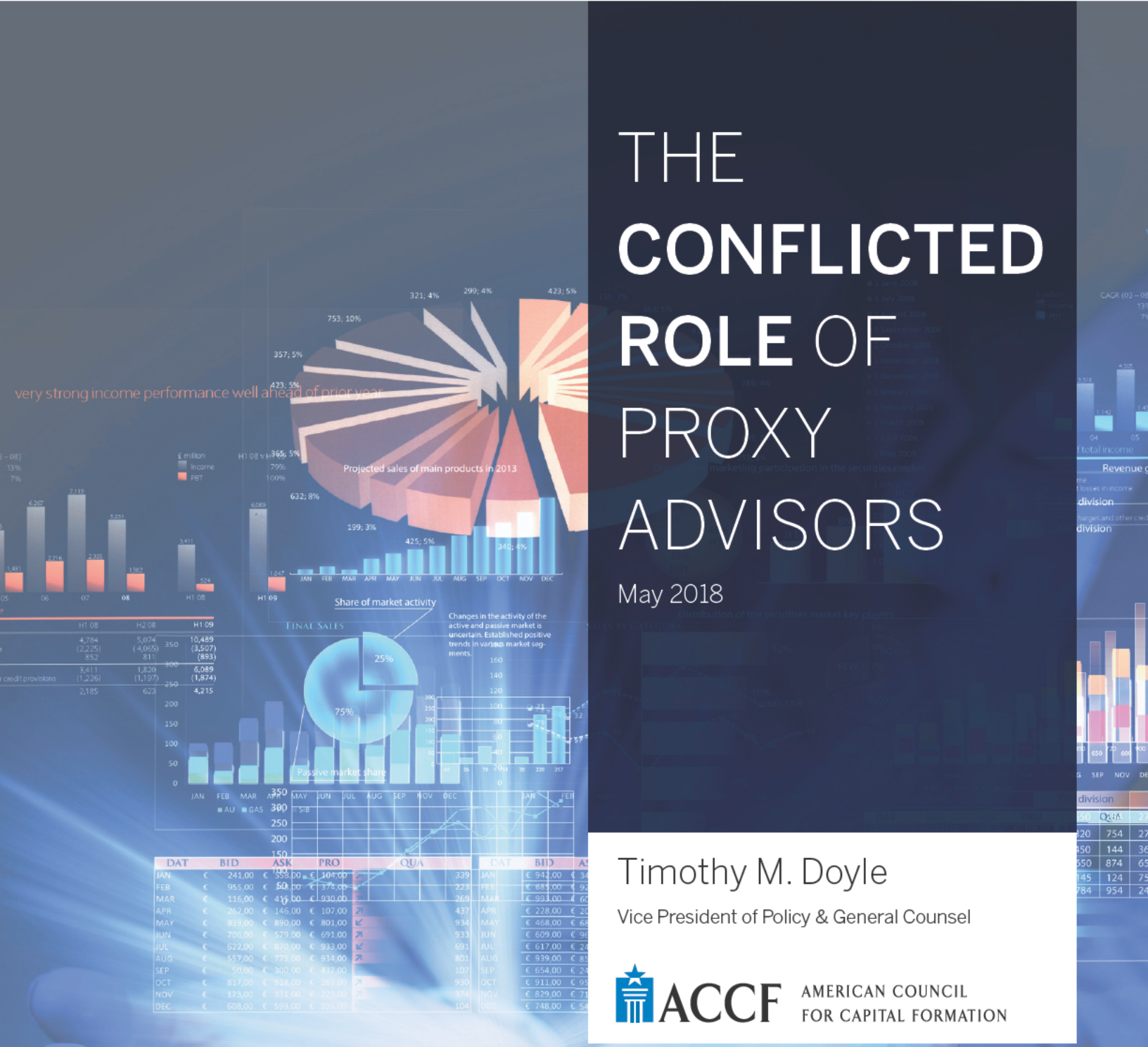

THE **CONFLICTED ROLE** OF PROXY ADVISORS

May 2018

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Vice President of Policy & General Counsel

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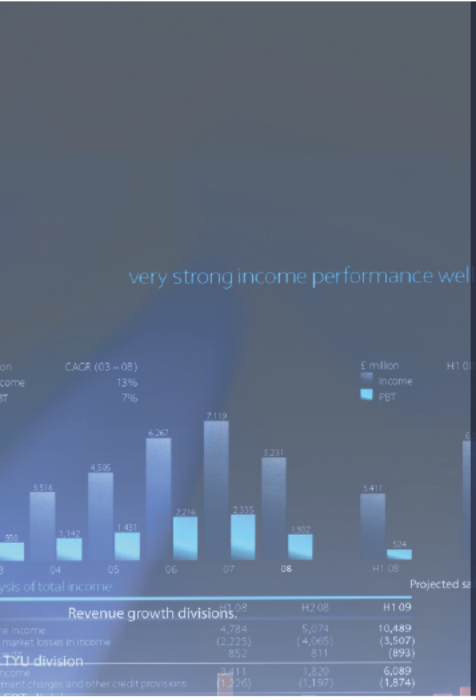
Timothy Doyle brings a diverse policy and legal background in multiple areas including energy, environment, science, and technology. Tim manages ACCF's broad portfolio of issue areas including economic, energy, environment, regulatory, and corporate governance.

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

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



THE **CONFLICTED ROLE** OF PROXY ADVISORS

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THE **CONFLICTED ROLE** OF PROXY ADVISORS

EXECUTIVE SUMMARY

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

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

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

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

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

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

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

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

KEY CONCLUSIONS:

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

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

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

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

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

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

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

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

WHAT ARE ISS AND GLASS LEWIS?

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

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

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

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

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

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

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

ISS (INSTITUTIONAL SHAREHOLDER SERVICES)

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

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

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

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

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

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

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

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

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

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

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

in March 2018, oekom will be renamed ISS-oekom and will complement the work of ISS's existing responsible investment teams.

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

GLASS, LEWIS & CO.

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

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

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

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

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

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

POLICY GUIDELINES

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

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

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

Similar to ISS, Glass Lewis develops an annual set of Proxy Guidelines that outline how the company comes

to its recommendations. These guidelines are updated annually and are intended to reflect Glass Lewis's analysis of proposals, yet Glass Lewis provides no information as to what factors influence their consistently evolving analysis.[40]

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

CONFLICTS OF INTEREST

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

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

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

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

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

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

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

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

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

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

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

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

PART II: THE PROXY ADVISOR AS AN ACTIVIST

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

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

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

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

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

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

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

Large Institutional Alignment with ISS & Glass Lewis Recommendations

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

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

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

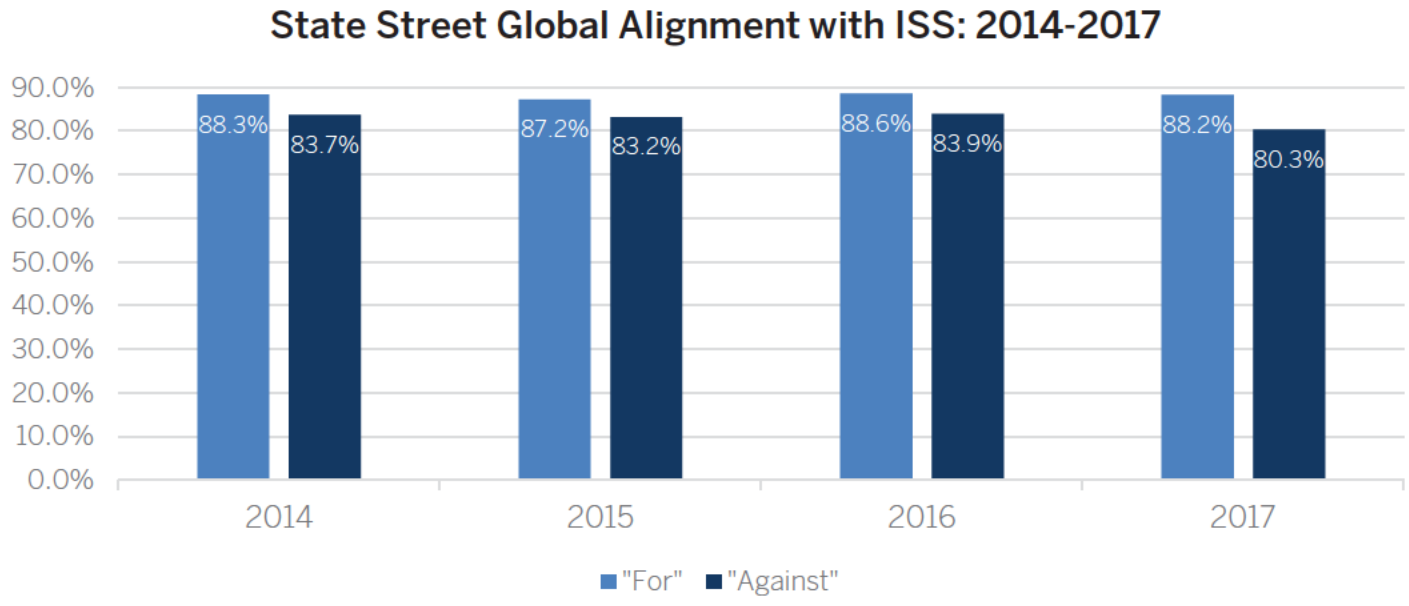
The SEC further amended their previous proxy voting rules to state: "An investment adviser that exercises voting authority over client proxies [must] adopt policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interests of clients, to disclose to clients' information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

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

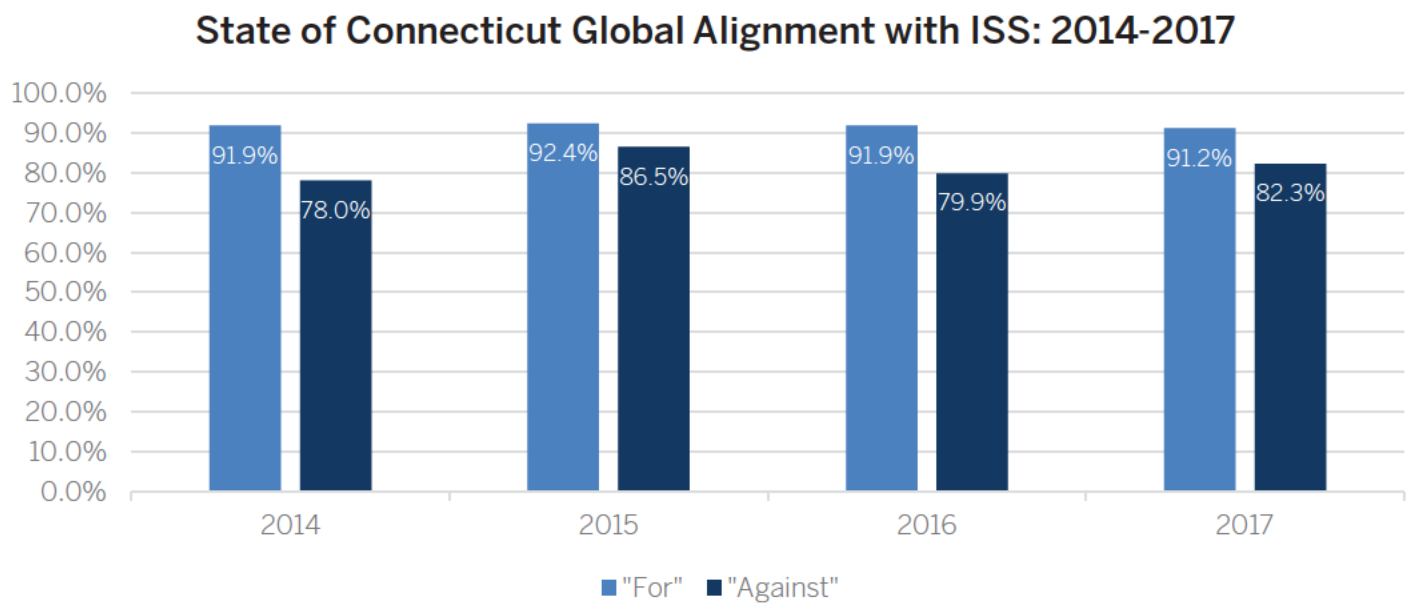
- Johnathan Feigelson, former Senior Vice President, General Counsel and Head of Corporate Governance for TIAA-CREF notes, "Some critics contend that proxy advisors are controlling or significantly influencing voting outcomes without appropriate oversight. However, we believe these concerns are somewhat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

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

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

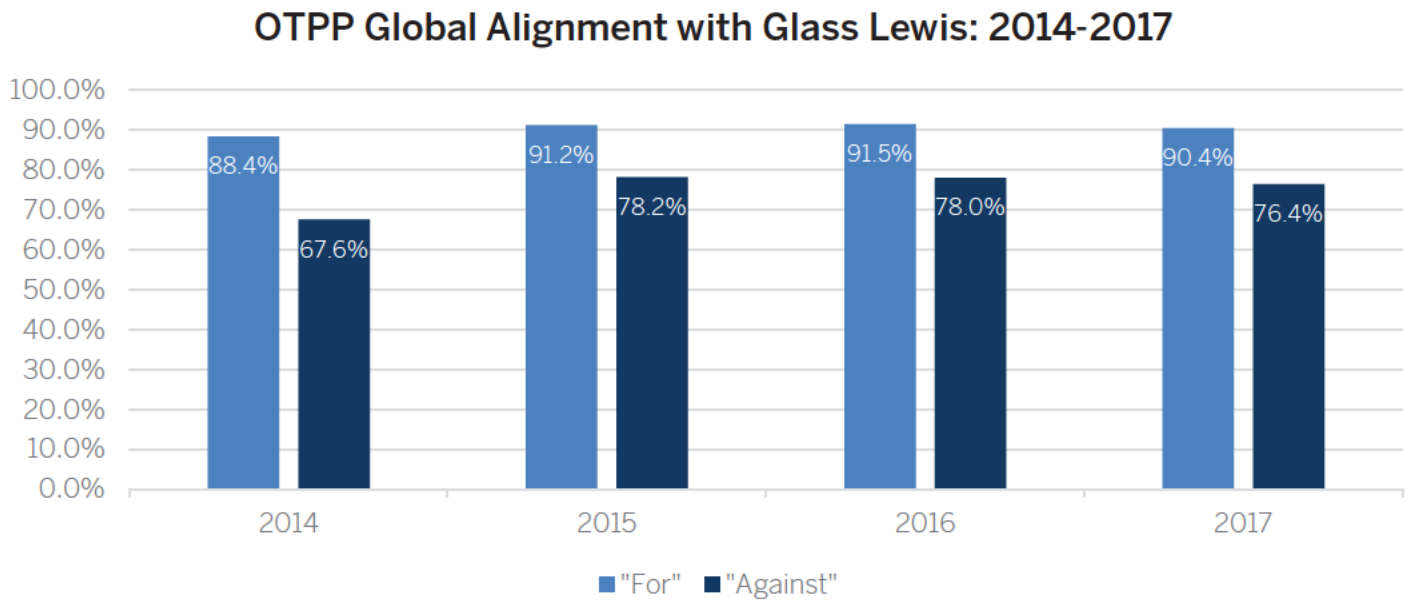


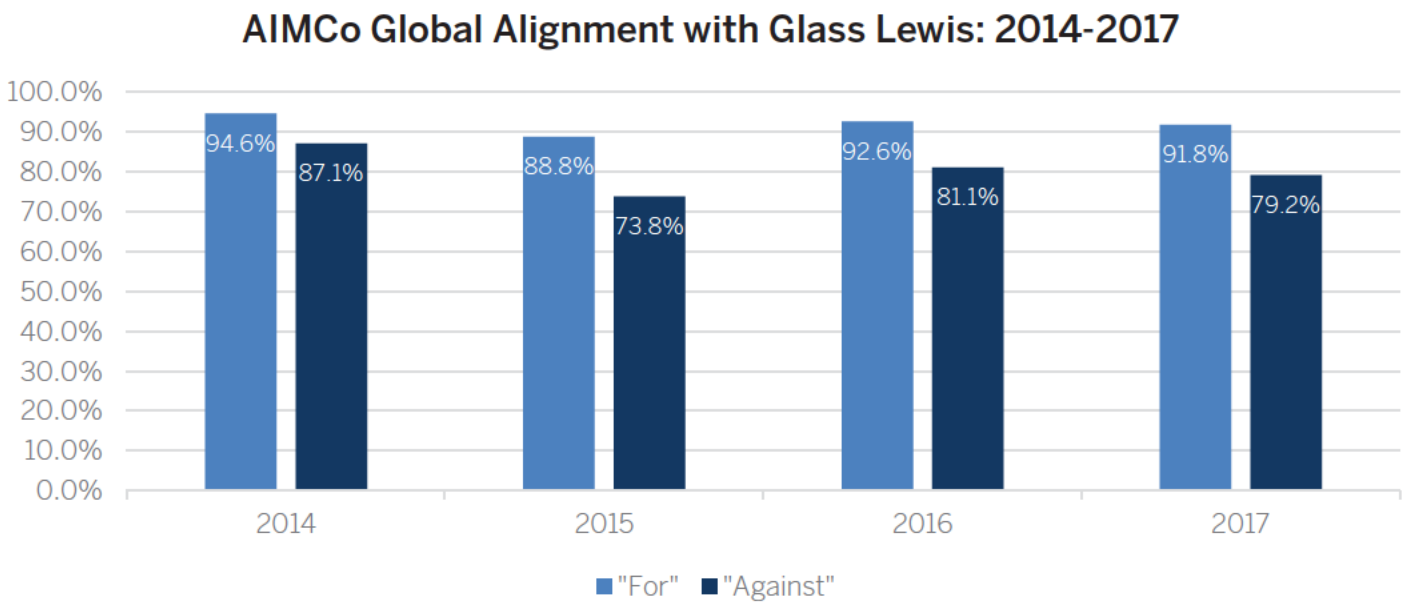
While less so than State Street, BlackRock and Vanguard still overwhelmingly vote in alignment with ISS, as do many large pension funds. Take for example the State of Connecticut Retirement Plans & Trust Funds:



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

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



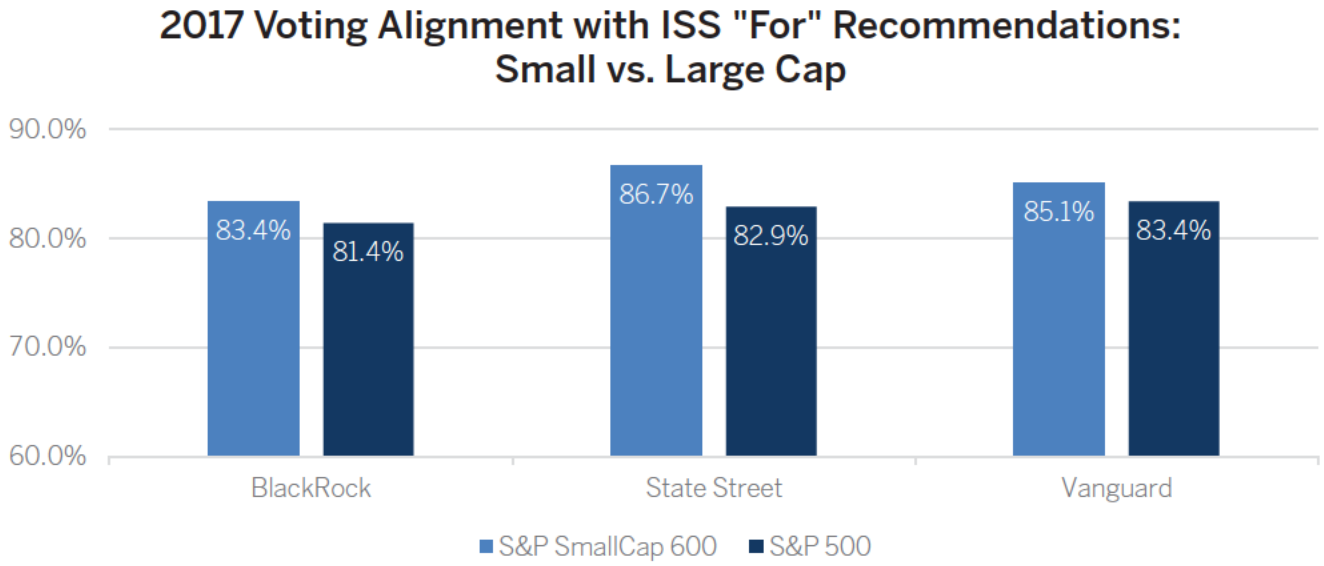


In addition, many of the other pension funds examined are more aligned with Glass Lewis generally than their mutual fund peers. CalSTRS and the Illinois State Board of Investment are both more aligned with Glass Lewis than ISS – well over 80 percent of the time on both "for" and "against" recommendations.

IMPACT ON SMALL COMPANIES

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

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



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

ROBO-VOTING

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

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

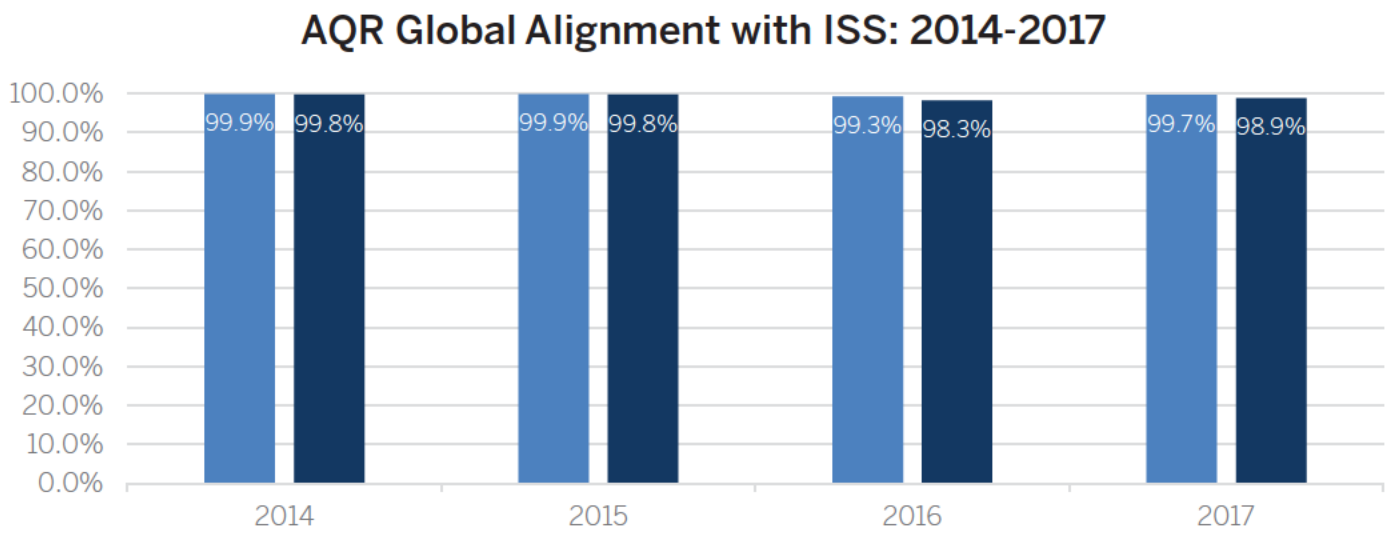
Commissioner Gallagher's concern is well-placed. Certainly not all institutions yield to the advice of proxy advisors, but many of them do – "particularly small and medium-size institutions that don't have their own corporate governance staffs."[63]

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

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

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

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



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

THE IMPACT OF PROXY ADVISOR ACTIVISM

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

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

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

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

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

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

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

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

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

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

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

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

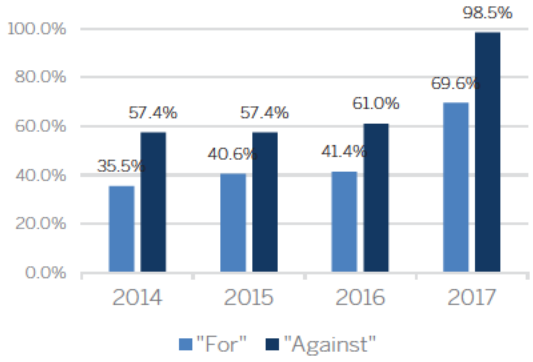
While this paper can't assert for sure who is pressing ISS and Glass Lewis into this more activist direction (third parties, their customers, etc.), the changes in their overall E&S policies has brought them closer in line with large passive institutions. Take, for instance, the fact that Vanguard's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

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

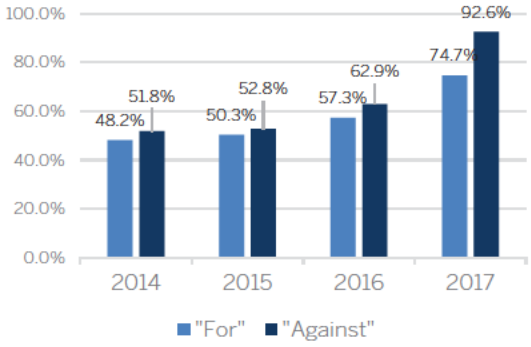
> "The updates to our voting guidelines on environmental and social issues are intended to better articulate the types of proposals we will consider supporting…For a number of years, we have abstained on most of the environmental and social proposals that we didn't support, though we'd vote against proposals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

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

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



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



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

ENVIRONMENTAL POLICIES

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

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

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

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

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

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

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

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

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

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

However, the reality of their changing E&S policies tells a different story. The proxy advisors have increasingly moved

to the left on environmental issues – while in some cases it may be warranted for investors to pressure companies for further disclosure (thus the case-by-case application), a blanket reliance on disclosure to decide whether a company ought to disclose creates a regime where such disclosures are essentially mandatory for companies, regardless of their costs or business implications.

GENDER PAY GAP & BOARDROOM DIVERSITY

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

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

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

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

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

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

CORPORATE BURDEN

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

ISS Evolving Policy Guidelines on Cost vs. Burden

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

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

POLITICAL CONTRIBUTIONS & LOBBYING

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

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

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

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

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

ANIMAL WELFARE

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

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

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

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

REVISITING SMALL COMPANY BIAS

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

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

ISS ENVIRONMENTAL & SOCIAL QUALITYSCORE

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

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

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

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

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

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

CONCLUSION & RECOMMENDATIONS

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

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

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

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

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

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

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

RECOMMENDATIONS

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

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

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

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

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

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