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Soapbox

The GAO's Proxy Advisory Firm Report: Another Missed Opportunity

By Michael J. Ryan

Concern that proxy advisory firms unduly influence institutional investor proxy voting decisions can be measured in decades – at least three – not just years. Exacerbating this situation is that advisory firm influence increasingly extends beyond institutional voting and permeates boardroom decision-making.

In 2007, the Government Accountability Office (GAO) released a cursory report on proxy advisory firms. Last June, Senator Dean Heller (R-NV) requested that GAO conduct another examination of proxy advisory firms. Based on this evaluation, last November, GAO released its latest report with the following principal conclusions:

- Institutional investors' degree of reliance on proxy advisory firms varies among institutions;
- Proxy advisory firms' influence on shareholder voting and corporate governance practices has increased, but there are mixed views about the extent of that influence; and
- The two primary proxy advisory firms have, to some degree, increased their operational transparency and company engagement.

Though more comprehensive than GAO's 2007 report, the latest report has several shortcomings, and it fails to draw any conclusions as to whether regulatory action is needed. Further, while the report identifies most of the generally known concerns, it does little to raise an alarm over them, and it understates or overlooks some important problems.

Influence, but little oversight

Commenting on GAO's report warrants a quick review of the root of proxy advisory firm influence. Generally speaking, neither state incorporation laws nor the federal securities laws codify corporate governance standards. Rather, in part to avoid a one-size-fits-all approach, it is widely agreed that company boards are best suited to determine their individual corporate governance standards and policies.

Ironically, this lack of prescription creates the unfortunate opportunity for proxy advisory firms to intervene as de facto standard-setters. These firms operate devoid of rigorous administrative process, in stark contrast to most US standard-setting bodies. Their policies are not subject to public notice and comment, SEC approval, or judicial review. It's worth noting that proxy advisory firms impose more stringent independence standards on directors than those required under stock exchange rules—rules subjected to public notice and comment and SEC approval. Further, the barriers to entry are significant, leaving little room for meaningful competition.

Since inception of the business model in the 1980s, proxy advisory firms have escaped meaningful oversight, although the SEC has not completely ignored the issue. In 2003, the SEC adopted rules concerning proxy voting by investment advisers. Most recently, in 2010 the SEC issued a Concept Release on the US Proxy System, including a meaningful section and 19 sets of questions concerning proxy advisory firms. Generally, the SEC uses concept releases to seek public input in

advance of possible rulemaking. Notwithstanding all the effort expended surrounding the 2010 concept release, the SEC took only two relatively inconsequential steps.

First, in December 2013, it held a Proxy Advisory Services Roundtable. The public roundtable lasted three hours and comprised 18 market participants representing various perspectives, including the author of this article. The roundtable addressed the most commonly expressed concerns: institutional investor reliance, work product quality, and conflicts of interest. No conclusions were reached and no formal report was issued, though a transcript is available on the SEC's website.

Second, in June 2014, SEC staff issued Staff Legal Bulletin No. 20 (SLB 20) providing guidance to investment advisers on their proxy voting responsibilities. SLB 20 clarifies that "an investment adviser should ascertain, among other things, whether the proxy advisory firm has the capacity and competency to adequately analyze proxy issues."

None of these recent initiatives resulted in any regulatory or legislative reform. Worse, these steps create a pretense that the SEC has done something, but in reality, it has just kicked the can down the road.

2016 GAO report – limited usefulness

Though a marked improvement over GAO's 2010 Report, the recent report is presented in a "he said – she said" fashion and essentially covers the same issues as the SEC's 2010 concept release. GAO's analysis stems principally from interviewing various market participants and reviewing some recent literature, including the 2010 concept release; European reports on firm best practices; a report by market participants concerning institutional ownership of public company shares; and academic studies published in finance and law journals.

In fairness, corporate governance is complex and inherently qualitative—this is precisely why a one-size-fits-all approach is bad policy. Even so, GAO could have better leveraged the 2010 concept release and related comments to provide policymakers greater information for assessing the need for reform.

In addition, there are three critical problems that GAO gave insufficient or no attention: the "two-dimensional impact" problem, the "CliffsNotes" problem, and the "partial leak" problem.

In the first instance, it's important to note that most debates over proxy advisors focus exclusively on their impact on institutional investor voting. This, however, addresses one dimension of a two-dimensional problem. GAO acknowledges that these firms do impact voting but then neutralizes this finding by recognizing that institutions are not monolithic and the degree of influence varies among institutions. While there's little doubt this is true, stating it in such a nonchalant manner obfuscates the fundamental problem: Proxy advisory firms are unregulated, de facto, public policy standard-setters.

GAO's cursory review of the second dimension understates the gravity of this problem. Often overlooked – but likely more significant – is the impact proxy advisory firms have on boardroom decision making. Proxy advisors necessarily issue reports very close to the time shareholder meetings are held, causing companies often proactively to change their governance policies simply to "fall in line" and minimize the possibility of a negative vote recommendation. The influence of

proxy advisory firms is like an iceberg – most of the potential for damage is below the surface and completely out of public view.

Next, there is the “CliffsNotes” problem. For many years, investors, issuers, public-policy makers, and others have engaged in spirited debates over the content of an ever-expanding proxy statement. The SEC has expended extraordinary resources delving into the content of the proxy statement. Each year, hundreds of thousands of hours and millions of dollars are spent preparing and reviewing corporate proxies.

The open secret is that almost no one reads the proxy statements. These massive documents are distributed during a compressed proxy season. Institutional investors voting hundreds if not thousands of proxies push the proxy statement aside in favor of a “CliffsNotes” version prepared by a proxy advisory firm. On a pragmatic level, these abbreviated reports provide a valuable service by efficiently summarizing and standardizing the information from proxy statements, and institutional investors should not be deprived of the benefit these research reports. However, the SEC needs to address this very weak link in the chain—the chasm between the heavily regulated, seldom-read proxy statement and the unregulated proxy advisory research report on which most proxy voting decisions are based.

In his letter, Senator Heller enquires about the benefits of publicly releasing advisory firm reports sometime after the shareholder meeting. This idea strikes a healthy balance between a firm’s proprietary interests and the need for quality improvement. Creating transparency would place meaningful quality-control pressure on proxy advisory firms. Academics and others could better analyze proxy voting and corporate governance trends, including the extent to which institutions rely on proxy advisory firms.

Finally, another problem GAO fails to address is the selective release of a proxy advisory firm reports in close votes. For example, a shareholder proponent nominates two alternative directors to a board. The side that receives a favorable vote recommendation often issues a press statement, selectively quoting the report. Clearly, the objective is to influence other voting decisions and, therefore, is a proxy solicitation. This selective release might sway investors without access to the report, meanwhile the report may include other information that could have caused the investor to vote differently. The only remedy is immediate public release of the entire report so all shareholders have equal access to relevant voting information.

Where to go from here?

The basic problem is the US allows privately owned, for-profit companies to exercise an outsized and unregulated role in establishing corporate governance public policy outside well-established policymaking procedures. Unfortunately, the role and influence of proxy advisory firms lacks the intrigue of many other public policy issues. Further, it is inextricably bound to a proxy voting system that could win a Rube Goldberg national competition. Still, the SEC, Congress, and perhaps the state of Delaware – the state whose corporate governance judgments are being most tread upon – ought to challenge the entrenched interests to create a modern system for establishing corporate governance policy.

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