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Proxy Advisors Find Themselves in the Spotlight

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by **James Hyatt**

Proxy advisory services -- the firms that handle the chore of voting shareholder proxies for institutional investors, and at the same time provide stiff appraisals of corporate conduct -- may be about to start receiving their own report cards for a change.

A lot of Corporate America thinks it's about time.

The services' influence has certainly been growing in the wake of corporate scandals and ever more heated debates over ethical behavior and attention to social responsibility issues.



The proxy services play a key role because institutional holders of billions of shares turn to them for advice when voting billions of shares at annual meetings. The services get paid to help manage the actual proxy voting process and they also weigh in on management-vs-shareholder debates over such hot button issues as compensation, the makeup of boards of directors, and proposals on corporate disclosures and behaviors.

For almost a decade, academics, corporate officials, regulators and shareholder activists have kicked around the issues of proxy advisory service behavior and performance: do they exercise too much influence; does their advisory business influence their voting recommendations; is more formal oversight needed?

The Advisory Industry

A lot of the conversation, of course, is aimed either in a veiled way or implicitly at the 800-pound gorilla in the room, **RiskMetrics Group** and its influential proxy advisory unit ISS Governance -- which, by some estimates, advises half the world's common stock. RiskMetrics had \$303 million of revenues in 2009; of that, almost half or \$145 million came from the ISS segment. The company last year issued proxy and vote recommendations for more than 37,000 shareholder meetings in 108 countries and voted 7.6 million ballots representing over 1.3 trillion shares.

RiskMetrics in 2009 had 3,500 clients in 53 countries, including 70 of the 100 largest investment managers, 43 of the 50 largest mutual fund companies, and 42 of the 50 largest hedge funds.

(RiskMetrics in March said it would be acquired by **MSCI Inc.** for about \$1.55 billion in cash and stock, subject to various approvals. MSCI calculates more than 120,000 indices daily and its Barra unit provides risk models and portfolio analytics.)

In addition to RiskMetrics, other major proxy advisors include **Glass Lewis & Co.; Egan-Jones Proxy Services; Marco Consulting Group; Proxy Governance, Inc.; Governance Metrics International;** and **CtW Investment Group.** (RiskMetrics, Marco Consulting and Proxy Governance are also registered with the SEC as investment advisers.)

New Scrutiny

Questions about proxy advisors have been raised in the past. The Government Accountability Office, the audit arm of the U.S. Congress, **took a look at proxy service providers in 2007** and an **SEC Compliance Alert in mid-2008** addressed some proxy voting issues as well.

Nonetheless, questions about the performance and role of proxy advisory services continue to simmer. **SEC Chair Mary Schapiro told the Practising Law Institute last November:**

“...we'll be asking about the role of proxy advisory firms in corporate voting. Given the influence that these firms' recommendations have on corporate voting outcomes, we'll probe the need for rules to ensure that advisory firms are basing their research and recommendations on accurate and reliable information. And, that they are providing adequate disclosure of any conflicts of interest they may have in providing voting recommendations. “

Given the pressures surrounding the new financial services legislation, the SEC may find such steps pretty far down on its agenda. But regulators are being pressed for action by members of the **"Shareholder Communications Coalition,"** comprised of the Business Roundtable, the National Association of Corporate Directors, the Society of Corporate Secretaries and Governance Professionals, the National Investor Relations Institute, and the Securities Transfer Association, whose members often find themselves the object of proxy service criticism.

In March 2010, the Coalition distributed a “discussion draft” on” proxy advisory services: **“The Need for More Regulatory Oversight and Transparency”.** Among its criticisms: institutional investors that hire third-party proxy advisory firms often find that firm guidelines “do not evaluate the facts and circumstances of each public company with respect to the matters to be voted on; instead, these guidelines encourage a “one-size-fits-all” or “check the box” methodology.”

RiskMetrics, it notes, provides corporate governance and executive compensation consulting services as well as voting recommendations on proposals at shareholder elections – which, the study suggests, “may create conflicts of interest”. Moreover, all proxy advisory firms may face conflicts when an institutional client is backing a specific ballot proposal or has instigated a “vote no” campaign against directors. The SEC, the draft suggests, should examine such situations for conflicts.

The draft report recommends that proxy advisory firms:

- be subject to more robust oversight by the SEC
- be required to register as investment advisers
- be subject to conflicts of interest disclosure.
- have “a complete and total separation” of the proxy advisory business from all other business including consulting and research services.

It also calls for public disclosure of procedures, guidelines and assumptions for making voting recommendations and voting decisions, calls for institutional investors to exercise more due diligence concerning delegation of decisions to proxy advisory firms, and calls on the firms to maintain a public record of all their voting recommendations and voting decisions.

The report concludes: "We believe that proxy advisory services have an oversized impact on the proxy process. Despite their large role, proxy advisory firms generally remain unregulated and unsupervised and often are not transparent with regard to their standards, procedures, methodologies, and conflicts of interest."

Dual Roles

RiskMetrics' 2009 annual report acknowledges the "perceived conflict of interest between the services we provide to institutional clients and the services, including our Compensation Advisory Services, provided to certain corporate clients." It concedes that "in the event that we fail to adequately manage these perceived conflicts of interest, we could incur reputational damage." RiskMetrics spells out its policies regarding conflicts and disclosures [here](#).

Asked for comment on the recent proxy advisory discussions, a RiskMetrics spokesman said the company is awaiting the substance of the SEC's concept draft "and will refrain from making any comment before it is available."

One of the testier critics, Tamara C. Belinfanti, an associate professor at the New York Law School, in a legal studies research paper in 2009 argued "**The Case for Increased Oversight and Control**" over the proxy advisory and corporate governance industry.

She builds her argument around "agency theory," or situations where one party uses another party to act on his behalf but where the parties' "incentives are misaligned" – classically, in the case of corporations, the separation of ownership and control.

Ms. Belinfanti declares: "From an agency theory perspective, ISS presents a lethal combination – significant power and virtually no accountability." And, she says, "ISS bears minimal residual risk of a poor voting decision vis-à-vis company shareholders."

She argues for the SEC to regulate the proxy advisory industry "similar to the regulation it is currently contemplating for registered credit rating agencies," for an oversight board for the industry similar to the Public Company Accounting Oversight Board, and for the mutual fund industry to pay more attention to proxy advisor decisions "and not simply follow the vote recommendations of these advisors."

In March this year, Ms. Belinfanti posted **a more acerbic comment about RiskMetrics on The Huffington Post**, prompted by the MSCI acquisition announcement: "ISS is incompetent and it is only a matter of time before markets and regulators realize ISS... is a ticking time bomb waiting to explode." She noted that ISS had given high governance ratings to Lehman Brothers and AIG before their financial woes. And she said MSCI's governance rating was "in the bottom 2.5% of all S&P 400 companies in terms of corporate governance," declaring the merger agreement "belies the reliability of its own corporate governance ratings system."

"Prudent Man" Standards

A recent posting at the **Harvard Law School Forum on Corporate Governance and Financial Regulation** by attorneys at Latham & Watkins LLP raises other issues, commenting on "**The Parallel Universes of Institutional Investing and Institutional Voting**".

SEC and Labor Department ERISA rulings, they note, require that institutional investors vote portfolio shares under "prudent man" standards, which often has resulted in outsourcing voting

mechanics and recommendations to the proxy advisory firms. (The burden is huge; there are more than 10,000 public U.S. companies.) Other investment managers have created an internal “corporate governance” staff to vote portfolio shares.

The result, the authors argue, is that voting policies are often applied in a one-size-fits-all fashion that doesn’t take into account a company’s particular circumstances. And, they declare, “economic ownership and economic decision making have been effectively decoupled from voting decisions throughout most of the investment management world.”

The separate interests of the investment community and the governance community, they argue, mean that public companies “need to engage in constructive and separate dialogues with each constituency. “Too often, corporate governance issues are seen as a distraction from a company’s goal of creating economic value for its shareowners. Although this may be true, it is also somewhat beside the point because voting decision makers at the company’s institutional shareowners demand otherwise.”

James Hyatt, a retired reporter and editor for The Wall Street Journal, has been writing about business ethics and social responsibility issues since 2005.

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