

*PROXY ADVISORY FIRMS\* (ON THE OPPORTUNITY  
FOR AN INTERNATIONAL CONVENTION)*

AGENCIAS DE CONSEJO DE VOTACIÓN (SOBRE  
LA OPORTUNIDAD DE UNA CONVENCIÓN INTERNACIONAL)

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*ABSTRACT: Proxy advisory firms are relatively new entities in the corporate landscape particularly in the general context of shareholders' voting devices. Firms of the kind were established with the aim of assisting investors/shareholders with their expertise in how to vote their shares. These third-party consultants are not regulated by any government agency in most of the countries and not even required to disclose the methodology used to render their recommendations. The lack of accountability of proxy advisors but also the possible conflict of interests spotted in their activities have been constant concerns since the kinetic force of international commerce will certainly spread firms of the type all over the world. In this context it may be appropriate to start considering an international convention on the matter.*

RESUMEN: Las agencias de consejo de votación son entidades relativamente nuevas en el panorama corporativo, especialmente en el contexto de los mecanismos de voto de los accionistas. Las agencias de este tipo fueron creadas con el ánimo de asistir a los inversionistas/accionistas con su consejo en cómo votar sus acciones. Este tipo de consultores no se encuentran regulados por agencia alguna en la mayoría de los países ni se les requiere informar sobre la metodología utilizada para llevar a cabo sus recomendaciones. La falta de imputabilidad de las agencias de consejo de votación, así como los posibles conflictos de intereses que han sido identificados en el desarrollo de sus actividades son preocupaciones constantes, puesto que la fuerza cinética del comercio internacional dispersará a empresas de este tipo en todo el mundo. En este contexto, parece apropiado comenzar a considerar una convención internacional en la materia.

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\* Artículo recibido el 27 de diciembre de 2015 y aceptado para su publicación el 12 de junio de 2016.

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**Keywords:** *proxy, shareholder's right, accountability, regulation, conflict of interest, institutional investors.*

**Palabras clave:** *proxy, derecho de accionista, responsabilidad, regulación, conflicto de intereses, inversores institucionales*

SUMMARY: I. *Introduction.* II. *Current landscape of proxy advisors.* III. *Problems issued from proxy voting system.* IV. *Problems issued from proxy advisory industry.* V. *Current regulatory measures.* VI. *Conclusion.* VII. *Bibliography.*

## I. INTRODUCTION

The participation of shareholders in corporations is derived from their contribution to the corporation assets; in publicly held corporations, this contribution is made by the acquisition of shares, where the share is basically “a unit of interest in the corporation based on a contribution to the corporate capital”.<sup>1</sup> This share, as derived from a contract, implies rights and obligations for both the shareholders and the corporation. As owners of shares, shareholders hold rights against their corporation;<sup>2</sup> among those, the rights to control and management<sup>3</sup> include the right to vote.

Nonetheless, shareholders influence over the corporation cannot be wielded directly; the management faculties of shareholders may be expressed only throughout the decisions taken at shareholders meetings. Therefore, the proper way for stockholders to exercise power over the corporation is to vote on decisions in general meetings. The vote in general meetings is used for various purposes such as the election and eventual removal of directors or the making of amendments to the charter of the corporation or its bylaws. But more important, holding a share implies the right “to have the corporation managed honestly and prudently for the benefit and profit of the shareholders within the scope of the authorized business”.<sup>4</sup>

<sup>1</sup> Cox, James *et al.*, *Corporations*, New York, Aspen Law & Business, 1997, p. 306.

<sup>2</sup> Those may be rights: as to control and management, proprietary rights and remedial rights.

<sup>3</sup> Other kinds of rights arise by holding shares in a corporation, as for example: proprietary rights including the right to participate in dividends distribution or the right to participate in distribution in case of liquidation and remedial rights, for example the right to information and inspection of corporate records. This paper focuses only on the rights of control and management specifically the voting rights.

<sup>4</sup> Cox, James, *op. cit.*, p. 306.

This cursory thought recalls the massive importance of voting processes in the corporate scenario, particularly in publicly held companies.

All legal owners of voting shares in a stock corporation have a right to be present and vote at all corporate meetings, normally, on the basis of one share one vote.<sup>5</sup> The particular voting provisions are established by the corporate bylaws, but some legislations establishes the general rule; for instance, the Model Business Corporation Act (MBCA) has recognized the common practice in the United States<sup>6</sup> and in Mexico the provisions concerning the voting shares are established by the Ley General de Sociedades Mercantiles (LGSME).<sup>7</sup>

At the early ages of industrialization when companies were consolidated, the physical presence of shareholders was the best and almost the only effective way to manage the corporation. However, nowadays it seems extremely difficult to compel all stockholders to attend personally to shareholders' meetings especially in publicly held corporations. This would be not just unpractical but almost impossible for various reasons: firstly because nowadays stockholders may acquire shares through stock markets of a company without having a minimum contact with the corporation and secondly because share markets are open for buyers around the world making a difficult matter the geographical dispersion. Furthermore, in public corporations the amount of shares issued implies a large number of holders and it is a hard and expensive task to gather all shareholders<sup>8</sup> of a public corporation at least once a year to discuss corporate matters.

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<sup>5</sup> Notwithstanding, it may be the case that corporations' shares may be classified in different series of shares with specific characteristics, some of them with preference rights over others, no further analysis at this respect was considered necessary for the aim of this paper.

<sup>6</sup> Model Business Corporation Act, published by the American Bar Association, 3<sup>rd</sup> Edition, 2003. Section 7.21: (a) Except as provided in subsections (b) and (d) or unless the articles of incorporation provide otherwise, each outstanding share, regardless of class, is entitled to one vote on each matter voted on at a shareholders' meeting. Only shares are entitled to vote.

<sup>7</sup> The provisions concerning voting rights change for the different types of 'corporations' recognized under Mexican law. For the sake of this paper, sole account for the provisions concerning the '*Sociedad Anónima*' will be made (Chapter V, LGSME).

<sup>8</sup> In this sense see; Cary, L. William and Eisenberg, Melvin Aron, *Cases and Materials on Corporations*, 7<sup>th</sup> ed., New York, The Foundation Press, 1995, p. 300: "Physical attendance at a shareholders' meetings is normally an uneconomical use of a shareholder's time when he can vote by proxy".

For meetings to be held and other operations to be transacted, shareholders unable to attend personally appointed agents to represent them in meetings. Today the activity of voting in behalf of absent shareholders has become common practice worldwide; this representation is ensured by a specific document called proxy.<sup>9</sup> In a wide definition of the term, a proxy may be understood as a person appointed in place of another to represent him. This concept applied in US corporate law has a narrower meaning; it is generally understood as the person appointed by the stockholder in order to vote in his behalf at the shareholders' meetings.<sup>10</sup>

Legislation in various countries allows shareholders to exercise their vote through a third person, by mail or online, depending on the case granted by the corporations' bylaws. This process is known as proxy voting<sup>11</sup>. Granting of proxies may be issued for a specific meeting or as a general unrestricted proxy.<sup>12</sup> In both cases the proxy granted is revocable

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<sup>9</sup> As defined by the *Black's Law dictionary*: PROXY (Contracted from procuracy). A person who is substituted or deputed by another to represent him and act for him, particularly in some meeting or public body. An agent representing and acting for principal. Also the instrument containing the appointment of such person. *Manson v. Curtis*, 223 N. Y. 313, 119 N.E. 559, 561, Ann. Cas. 1918E, 247; *Cliffs Corporation v. United States*, C.C.A. Ohio, 103, F.2d 77, 80. *Black's Law Dictionary*, Definitions of the Terms and Phrases of American and English Jurisprudence, Ancient and Modern, 4<sup>th</sup> edition, West Publishing Co., 1968.

<sup>10</sup> It is important to bare in mind, in order to avoid any confusion, that proxy may be also used to refer to the instrument that empowers the appointed person or even the agent himself.

<sup>11</sup> In the United States the MBCA establishes at section 7. 22, the legal framework for proxies: § 7.22. PROXIES (a) A shareholder may vote his shares in person or by proxy. (b) A shareholder or his agent or attorney-in-fact may appoint a proxy to vote or otherwise act for the shareholder by signing an appointment form, or by an electronic transmission. An electronic transmission must contain or be accompanied by information from which one can determine that the shareholder, the shareholder's agent, or the shareholder's attorney-in-fact authorized the transmission. Nevertheless proxy voting is a global common practice, some examples of it can be found in the United Kingdom, the Companies Act 2006 recognizes in its section 324 that "a member of a company is entitled to appoint another person as his proxy to exercise all or any of his rights to attend and to speak and vote at a meeting of the company". In France there is also the possibility for shareholders to be represented at shareholders' meetings in the basis of article L225-106 of the Commercial Code and so forth among diverse countries with different legal systems. It is possible to say that casting voting rights is a common practice, widely recognized in regulation around the world.

<sup>12</sup> A general proxy may be understood as general power of attorney to vote on ordinary matters of the corporation.

(as agency in general) if it is not coupled with an interest. Thus, the possibility for shareholders to appoint agents in order to vote in their behalf at corporate meetings is the ground over which a system has been created, *the proxy system of voting*; scheme which is nowadays common practice in publicly held corporations worldwide.

Without any doubt, the shareholders' possibility to delegate their voting rights to agents has simplified the management of corporations. Furthermore, it is possible to say that based on proxy voting process some devices<sup>13</sup> have been created to enhance corporate governance. Usually, the proxy voting process in large corporations is usually triggered when the Board of Directors mails the shareholders the notice for the meeting to be held and an attached document containing a *proxy request* for the signature of shareholders. It is certainly a pragmatic practice in order to allow the Board to gather the quorum required for binding decisions. This method would seem accurate when there is a general consensus among shareholders and between them and the board; nevertheless, we must acknowledge that this is not a normal scenario in huge corporations where the real situations are fulfilled with strong disagreements in general meetings.<sup>14</sup>

In recent times, the mechanics of voting systems in corporations have suffered an interesting evolution with the rise of new entities offering consulting services and creating new products in the corporate market service's. In the scenario drafted by proxy voting and voting devices, some specialists sought a possibility to intervene and develop a new form of business aiming the advice to shareholders in how to vote their shares.

Since most of shareholders lacked the expertise and adequate information that would enable them to make the better decision for their own interest, these new entities emerged when shareholders of large corporations sought for information and a pertinent advice about the corporate governance at their companies. In this context some entrepreneurs proposed an answer to this technical demand of stockholders by creating specialized firms. These firms were incorporated with different purposes,

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<sup>13</sup> Among these instruments there are the pools of voting shares, voting trusts, and more recently the voting through proxy firms. No deeper analysis shall be conducted in order to avoid failing out of the main objective in this paper that is to acute the study of proxy advisory firms.

<sup>14</sup> Consequently, the above-mentioned practice presents some problems, especially for minority stockholders because it leaves the holders of a small number of shares without choice but to delegate his or her vote to an agent.

but in particular with the aim of voting shares in behalf of shareholders and providing research and advise as how they may vote in their meetings. Such entities are known today as *Proxy Advisors* or *Proxy Firms* and are considered as independent advisors for the corporate governance, becoming in recent years a high lucrative activity, they are “third-party consultants that charge institutional investors for advice about a specific company, and provide ‘for’ or ‘against’ recommendations on shareholder voting issues”.<sup>15</sup> In this paper, the scrutiny will be devoted to the advising role of proxy firms since it has been the target of criticism and controversy.

It is important to say that these firms have been favored by a phenomenon of shareholders’ activism that has manifested with greater force after situations involving unscrupulous corporate governance in publicly held corporations. After the drama performed by Boards of Directors the past decade, the general meetings have turned on to corporate arenas where fights for control take place, encouraging the stockholders to take an active role in the meetings. In this situation proxy firms have the merit to have accurately realized that for minority shareholders it was difficult to appraise the importance of corporate decisions; furthermore, that it takes time and money to study and analyze the best option to vote in public held corporations.

It must be noticed that the aim of proxy firms is in essence, to give voting counsel for shareholders but not take away the right of vote. Proxy firms are hired by shareholders to cast proxy statement votes on their behalf on the diverse matters that require shareholder’s approval at publicly held corporations. Also, it is important to consider that proxy advisors have no authority to raise issues on their own; their activity is limited to the counsel and advice for others. Normally, proxy advisors have no power to vote if they are not expressly authorized to do so by the stockholders. Their basic activity is compelled to provide information to shareholders or institutional investors<sup>16</sup> as the case may be, which have the possibility to hire this kind of services or not.

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<sup>15</sup> Choi, Stephen J. and Fisch, Jill E., “How to fix Wall Street: a voucher financing proposal for securities intermediaries”, 113 *Yale L. J.* 269, 294 (2003), taken from Slaght, Jodi, “Whatever Happened to the Prudent Man? The Case for Limiting the Influence of Proxy Advisors Through Fiduciary Duty Law”, 9 *Rutgers Bus. L. Rev.* 1 2012.

<sup>16</sup> Institutional investors are entities with large amounts to invest, such as investment companies, mutual funds, brokerages, insurance companies, pension funds and investment

Having sketched the main idea behind proxy voting and proxy advisors a deeper analysis of the current landscape of the latter is of capital importance in order to grasp the real dimension of this issue.

## II. CURRENT LANDSCAPE OF PROXY ADVISORS

Within the industry of proxy advisors a short group of corporations have acquired a strong worldwide presence and dominated the greater part of this market. In the United States two main firms appropriated the leading role in the proxy advisory business, *Institutional Shareholder Services* (ISS)<sup>17</sup> and *Glass Lewis & Co.* In Europe, the most important proxy advisor was established since 1995 and is known under the name of *Manifest*,<sup>18</sup> in France the entity incorporated under the name of *Proxinvest* develop the proxy advisory industry as part of the European Corporate Governance Services (ECGS) which provides the analysis over six hundred of the most important listed corporations in Europe.

It is important to take into account the fact that institutional investors spend in thousands of companies, making a huge task to conduct an independent research on each one of them every time corporate matters

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banks; they account for a majority of overall volume of shares and are the biggest participants in securities trading. The share of stock market volumes of institutional investors has consistently grown over the years and so their participation in public held corporations. Institutional investors are considered as a unit while acquiring shares, nevertheless they represent the interests of hundreds of investors, with which the institution holds fiduciary duties. In recent corporate history they have gained great strength in the business landscape.

<sup>17</sup> The statistics of the corporations advised by ISS are quite impressive. Offering services for 25 years, ISS has been the leading provider of proxy research to institutional investors. From information published in its public web site, ISS cover more than 39,000 companies in over 115 countries worldwide. The offer of services includes standard benchmark policies but also policy solutions whereby ISS implements voting recommendations based on shareholders' specific corporate governance guidelines. Available on <http://www.issgovernance.com/proxy/advisory>.

<sup>18</sup> From the public web site: [www.manifest.co.uk](http://www.manifest.co.uk). *Manifest* proxy firm, is presented as an independent, global proxy voting and corporate governance support service. Their mission is "To Make Things Clear", with the aim to empower shareholders to support their stewardship responsibilities with comprehensive research and voting services, which enable informed decision-making. They make the point over the independent and conflict-free proxy governance support services, offering an analysis consistent and impartial.

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*Boletín Mexicano de Derecho Comparado*, núm. 148, pp. 337-359.

are to be voted in shareholders meetings. That would amount institutional investors paying a lot of money to get the job dully done. Notwithstanding, the reality points-out to corporations trying to keep expenses low and opting instead for proxy advisors' services. At this respect there is also a conflictive opinion, mostly from the professionals at proxy advisory firms who state that their only "crime" is to represent a threat to the autocracy of the CEO and incumbent boards through advice to shareholders in voting on the particular matters.

It is precisely the participation of institutional investors that have favored the rise of the advisory industry and increased exponentially the influence of proxy advisers. The need of services provided by corporations such as ISS or Glass Lewis to institutional investors that manage huge portfolios with thousands of corporations is the origin of the great incomes of proxy advisory firms and for which the use of proxy advisory firms represents savings of time and effort.

The services provided by proxy advisors represent a fundamental role in the activities carried on by institutional investors since the latter look for an advice when voting billions of ballots at annual meetings in thousands of corporations. It would be a hard and a very expensive work for institutional investors to prepare research about the corporate status of every entity in which they hold titles in order to be able to offer a conscious propositions at shareholders' meetings; therefore, outsourcing this activity to proxy firms implies enormous savings for investors.

Furthermore, a recent trend of shareholders activism<sup>19</sup> has also a huge influence over institutional investors, which seem nowadays more

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<sup>19</sup> Which differs from the 'shareholders activism' of the early 1970's, when the political and social conditions in the United States exerted a great influence over corporations. In the activism of the 70's shareholders of publicly held corporations sought to enforce political pressure over companies involved in social confrontations by mean of shareholders decisions in general meetings. The pressure came through derivate or class actions by shareholders who intended to affect the management of corporations. Shareholders activism led to decisions on social and political shareholders proposals, cases such as *Medical Committee for Human Rights v. Securities and Exchange Commission* 432 F.2d 659 (D.C. Cir. 1970) involving a motion to amend the corporation's charter to forbid it to make napalm without several limitations on its use while the apogee of Vietnam War or *Peck v. Greyhound Corp.* 97 F. Supp. 679 (S.D.N.Y. 1951) regarding a shareholder proposal requesting reconsideration of segregated seating in the hardest time of American segregation were cases in which a real activism was enhanced by shareholders. On the contrary the "activism" in our days



conscious about social and governance considerations, including proxy voting across a wide range of issues. It is a fact that analyzing corporate governance at companies and helping institutional investors decide how to vote at annual meetings has become a big business. The enhancement of shareholders activism and the recognition of corporate governance as a major risk has increased the demand for such services and thrust the leading firms into an influential position.

In this context, there has been a great concern for academics and regulators about the important role acquired by proxy firms and the great power of influence that they may have. For instance, the United States Government Accountability Office<sup>20</sup> (GAO) triggered an investigation motivated on the background for criticism of the expanding activities of proxy firms. Consequently, special attention was paid to the hugest players in the proxy firm arena such as ISS.<sup>21</sup> The GAO issued a report<sup>22</sup> that included an overview of the major proxy advisory firms that may be useful to clarify the standing position of the five largest firms.

<i>Firm</i>	<i>Founded</i>	<i>Estimated number of employees</i>	<i>Estimated number of clients</i>	<i>Estimated clients' equity assets (dollars)</i>
Institutional Shareholder Services (ISS)	1985	630	1,700	25.5 trillion
Marco Consulting Group (MCG)	1988	70	350	85 trillion

has increased, in the opinion of some academics, as a reaction by investors to the massive financial frauds perpetrated by management of public companies.

<sup>20</sup> The U.S. Government Accountability Office (GAO) is an independent, nonpartisan agency that works for Congress. Often called the “congressional watchdog,” GAO investigates how the federal government spends taxpayer dollars. For further information about the office see <http://www.gao.gov>.

<sup>21</sup> ISS (some experts estimate) is the largest proxy adviser, was bought for proximately \$550 million by Risk Metrics Group; seven years before, ISS was sold to other investors for about \$50 million dollars. That implies an exponential growth of the corporation’s value in a relatively short period of time. Risk Metrics had \$303 million of revenues in 2009. Almost half or \$145 million came from the ISS segment. In 2010, the company 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. From, *Proxy Advisors Find Themselves in the Spotlight*, May 17, 2010 by James Hyatt.

<sup>22</sup> Report GAO-07-765 on Proxy Advisory Services.

<i>Firm</i>	<i>Founded</i>	<i>Estimated number of employees</i>	<i>Estimated number of clients</i>	<i>Estimated clients' equity assets (dollars)</i>
Glass Lewis & Company	2003	70	300	15 trillion
Proxy Governance, Inc. (PGI)	2004	31	100	1 trillion
Egan-Jones Proxy Services (Egan-Jones)	2005	Not available	400	Not available

From: GAO report.

It is undisputed that large proxy firms have achieved a strong and influent position. This situation in addition to the lack of a proper regulation regarding the activities developed by proxy advisors have created a scenario which seems not clear at all and which generates criticism among sectors in the corporate network. This scenario has been identified in recent years in the United States and lately in Europe, inviting specialist to analyze this issues and which leads this paper to the next part in the examination.

### III. PROBLEMS ISSUED FROM PROXY VOTING SYSTEM

Before addressing the possible problems issued by proxy advisors, particular attention must be paid to the problems issued from the proxy voting system in general. As it has been mentioned, voting in publicly held corporations is in itself a hard task; it implies for the stockholders to be not just aware, but well informed about the corporate management, the background of proposed decisions and the possible effects over the corporation. If this work seems complex for one shareholder in only one corporation, the complexity grows exponentially in a scenario of multiple investors gathered into one institutional investor, holding shares in hundreds of corporations. Moreover, if the direct voting process entails a degree of complexity, the proxy voting system issues a higher degree of difficulty, requiring more careful and detailed knowledge of governance matters. Proxy voting devices have incurred in conflicts through history; thus, it is for sure that the latter developed devices such as proxy advisory firms may entail their own problems for which the legal framework must be prepared.

Related to voting in general, some shareholders' practices have been object of legal discussion and answered through court decisions. For example, some proxy holders have sought to pay to the share's owners as compensation for being allowed to vote the owner's shares. In general this practice of, vote selling has been considered as violating the law of some of the sister states in the United States. Nevertheless, "more recently, the Delaware courts have shifted from viewing vote-buying as *per se* invalid, to being *voidable*, subject to a test for intrinsic fairness".<sup>23</sup>

The most common dilemma that presents voting devices is that those are used as weapons in proxy fights.<sup>24</sup> In these conflicts the activist shareholders (mostly the dissenting ones) try to persuade other shareholders to use their proxy votes to install new management for specific reasons. Usually, in a proxy fight, directors have a bulk of tools in their favor over those trying to force the corporate change, they hold the strong position and are more freely to act while the shareholders may only pursue actions through shareholders meetings.

On the other hand dissenting shareholders, more often minority shareholders, use proxy devices such as voting trusts or pool of voting shares in order to obtain more weight in shareholders' meetings. Over this ground where the corporate management of publicly held corporations is a field mined with difficulties and possible conflicts between directors and stockholders, the regulation of proxy advisors must be analyzed with precaution, being so the capital interest of this paper.

#### IV. PROBLEMS ISSUED FROM PROXY ADVISORY INDUSTRY

Since the past decade, some academics, shareholders and regulators have started to issue questions regarding the services provided by proxy advisors but also their behavior and performance; questions about the influence they exercise over business and the possible conflict of interests derived from their expanding offer of services. The main concern is that proxy firms must provide truly independent, conflict-free proxy research and vot-

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<sup>23</sup> Cox, James *et al.*, *op. cit.*, p. 332.

<sup>24</sup> A proxy battle occurs when shareholders of a corporation present opposition to the corporate governance, often against directors and management decisions.

ing services; nevertheless, as services provided by proxy advisors have diversified, the concerns have also multiplied.

The services offered by proxy advisors require a high degree of professionalism and responsibility for several reasons. First, it is important for proxy advisors to consider in their research, not only local market rules but also regulations in the international landscape. Second, the recommendations they issue may have a direct impact over the company's value and over the market, reason why their research must be conducted with integrity and accuracy of data including not only primary information such as reports of meetings or meetings notices. Third, the use of proxy advisory firms represents for institutional investors and for shareholders in general, savings of time and effort; nonetheless they must keep in mind that no two investors are exactly alike, and therefore the research conducted for one shareholder may not be suitable for another one in the same situation. Lastly, it is important that proxy firms ensure, expressly, the confidentiality of their clients' voting intention; being engaged not to respond requests to disclose voting intentions, or to resold this kind of data or transmit it otherwise.

At this stage, proxy advisory firms seem to be aware of the possible conflicts that may arise in the scope of their activities, and therefore try to guarantee their clients of the high professionalism in their practices by performing marketing efforts in order to be considered as reliable advisors. Notwithstanding, the scope of services provided by proxy firms has widened to include, for example, governance monitoring to help identifying contentious meetings in the client's portfolio, ensuring that institutional investors would be able to monitor and audit their governance, voting and activism policies. These are some of diverse services provided but the list is not exhaustive and may be as large as the need of institutional investors.

The situation got so complicated that growing concerns made their way to the Congress of the United States. On June 2007, the GAO issued a report in a Congress' request entitled "*Issues Relating to Firms That Advise Institutional Investors on Proxy Voting*". The GAO was demanded to provide a report,<sup>25</sup> among other things, on potential problems that may arise from the services provided by the proxy advisory firms.

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<sup>25</sup> GAO-07-765 Proxy Advisory Services; this document contains a detailed analysis of the actual landscape and the main worries of industry associations and academics.

The GAO report was based on Securities Exchange Commission (SEC) examinations and professional opinions. The Accountability Office found that some potential conflicts may arise, nevertheless recognized that the SEC did not identify any major violations; in this report no recommendations were issued. Different interesting and controversial issues were developed in this report among them, the possible conflicts of interests, the lack of competition and the disproportionate influence advisors have.

The capital concern about proxy advisors is related to their capacity of granting independent and conflict-free voting recommendations to their clients, yet with the expanding of their activities they have turned to give advice also to boards of directors in order to improve their corporate governance. This expansion of their service have left some sensitive subject matters prone to conflict of interest, especially those identified as “Say on Pay” issues which include questions such as the remuneration of executives, salary and bonus of directors, performance pay and pensions among others.<sup>26</sup> It has been identified that nowadays, some proxy advisors provide corporate governance and executive compensation consulting services as well as voting recommendations on proposals at shareholder elections, situation that may create conflicts of interest.

In an ideal scenario the influence of proxy advisors would encourage boards to work on addressing the issues that investors do not like, specially those concerning remuneration of officers, or rather, to improve disclosures to better inform shareholders of their best interests for such remunerations; unfortunately it rarely happens in such a way. It is crucial for shareholders to exercise their right to have the corporation managed honestly and prudently for the benefit and profit of the shareholders, and not in the economic interest of directors:

...(T)he traditional model of directorial accountability to the shareholders depends heavily upon the ability of the shareholders in general to review the performance of the board (notably when the annual report and accounts are presented to them) and to take decisions if they think that performance

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<sup>26</sup> For instance and regarding ISS it was said that; “Because it provides both type of services, ISS could, for example, help a corporate client develop an executive compensation proposal to be submitted for shareholder approval while at the same time making a recommendation to investor clients on how to vote for this proposal”. GAO, report p. 4.

has not been adequate, for example, by removing the existing directors and installing a new board.<sup>27</sup>

Still, the phenomenon of shareholders activism and the power of influence of proxy firms affect directly the corporate governance making board of directors wary about proxy advisors which, in order to assure their management may feel compelled to retain proxy consulting services in order to obtain favorable proxy vote recommendations.

Without any doubt, proxy firms have become a powerful tool when the board and institutional investors contest over matters such as the election of directors. An institutional investor that seeks to elect directors to a company board or to approve a specific resolution, will have to persuade one or more proxy advisors to recommend his proposition over the management; thus, executives have to confront the reality of the power influence in the hands of proxy firms, as an author pointed out “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”.<sup>28</sup> In addition, a second scenario of possible conflict was identified by the Report in the case that officials from a proxy firm own interests over corporations in which the firms are offering vote recommendations, but the greater concern was that policies regarding conflicts of interest are not fully disclosed by proxy firms.

Moreover, the experts working on the Report noted that there might be a problem of competition barriers issued by the actual players. Although new firms have entered into the market the position of the main companies has been regarded by some professional as a barrier to competition. Large proxy firms have confirmed their long-standing position due to the access of great sources of information that allows them to offer accurate research services; which on the contrary, will be difficult for new firms to develop in the beginning.

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<sup>27</sup> Davies, L. Paul, *Gower and Davies’ Principles of Modern Company Law*, Seventh edition, London, Sweet & Maxwell, 2003, p. 327.

<sup>28</sup> *Proxy Advisors Find Themselves in the Spotlight*, May 17, 2010 by James Hyatt <http://business-ethics.com/2010/05/17/243-proxy-advisors-find-themselves-in-the-spotlight/>. It is a fact that other types of corporations are being attracted by the business of proxy advisory, specially for the big profits and fast growth. There is even interest from credit rating agencies such as Standard & Poor’s and Moody’s to enter into the business. When such corporations are appealed by an activity is normally for strong financial reasons.

Concerning measures to promote competition among proxy firms some solutions have been suggested in the framework for other similar entities such as credit rating agencies. Opening the competition among proxy advisors is desirable too, as it could reduce the risk that some firm may exercise undue influence over corporate voting. At this respect, the regulation work seems harder since there are some external barriers such as the high costs for establishing information networks like the ones established by the largest proxy firms. In this context, regulators acknowledge that there would be a hard work to try to set up rules against competition barriers when the clients' preference appoints to strength the position of the largest proxy firms.

In the Report some other issues were mentioned for example, concerning the information gathered by proxy firms. If it is true that it is expensive to initially research companies and come up with voting recommendations, this may incite firms to re-sell that research to as many customers as possible. Information is an important asset in nowadays businesses and selling of such asset may represent important incomes.<sup>29</sup> Deplorably, the GAO report did not depth in such question and offered just a superficial review.

Another problem that has become evident is that some proxy firms offer standard voting policies, which represent a low-cost means by which some institutional investors look to discharge their proxy voting responsibilities. Nonetheless these policies are not exactly in accordance or supported by notions of good governance and are usually applied without taking into account the specific circumstances of the corporations.

Finally, a strong criticism was made against the lack of accountability and oversight enjoyed by proxy advisors under United States and European Union regulations. "Compared to other market participants, proxy advisors appear to operate in a regulatory vacuum".<sup>30</sup> As Fleischer points out, they owe no fiduciary duties to the companies whose policies they seek to influence, and they have no economic interest at stake.

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<sup>29</sup> "Moreover, there have been reports of one particular proxy advisor selling voting information—in the sense that companies are notified of how institutional investors have been instructed to vote in return for payment". Fleischer, Holger, "Proxy Advisors in Europe: Reform Proposals and Regulatory Strategies", *European Company Law*, vol. 9, pp. 12-20, 2012; Max Planck Private Law Research Paper No. 12/4, p. 14.

<sup>30</sup> See for example Matsouros, P., "Is the EU Taking Shareholders Rights Seriously?", *European Company Law*, 7 (2010): 199, 195; from Fleischer, *op. cit.*

Even though GAO found that various potential conflicts might arise at proxy advisors firms it was not identified any violation to regulations by these firms. Nevertheless is to be kept in mind that, as M. Harvey Pitt, former SEC Chairman expressed during the debates: “The potential for conflicts of interest is there... Mercifully we haven’t seen the worst potential realized, but we clearly have to anticipate that where money is involved people sometimes do strange things”. The GAO Report raised awareness of the situation in the United States; nevertheless it does not seem to have triggered any international regulatory measures. Since there is a lack of international regulation it is important to take a look on the national regulations at this stage.

## V. CURRENT REGULATORY MEASURES

Once the possible issues concerning proxy advisors have been pointed-out, it becomes fundamental to analyze the existing legal frame for the activities of proxy firms. It is important to take a look over the existing regulation in order to understand the basis in which proxy advisors are working, which are the limits for such activities and if there are remedies for breach of their duties. In this paper we use the example of the United States and the European Union (with a particular regard to the United Kingdom and France) as hints to acquire an overview on the matter. Generally speaking the American rulings are nowadays the more updated regulation concerning proxy firms, followed by the United Kingdom. In Europe, there are no common dispositions related to proxy advisors and the rulings have a national source. Until recent years, regulators have become aware of such lack of provisions and have reacted at this respect, as we shall see in this development.

### 1. *United States*

At present in the Unites States there is no regulation enacted specifically for the proxy advisory industry; still, there are some applicable regulations to such activities among diverse acts that are useful to establish some directives and that must be taken into account as the may constitute the basis of more developed regulation. For instance, under the Section



14(a) Securities Exchange Act of 1934,<sup>31</sup> the Securities Exchange Commission (SEC) regulates the proxy solicitation process<sup>32</sup> with respect to publicly traded equity securities. This is not a much-extended regulation; however, it constitutes the primary regulation concerning proxy system of voting. The relevance of Section 14(a) is that this is the source of the SEC's regulating power; pursuant this section, the SEC has promulgated a set of Proxy Rules that cover basically proxy solicitation.

As complement of the previous mentioned Act, the SEC regulates the activities of proxy advisors that are registered before the Commission as *investment advisers*, under the Investments Advisers Act of 1940. Nevertheless, not all the major proxy advisors have registered as investment advisers and are not, therefore, subject to this regulation.<sup>33</sup> From this ruling, registered advisers are required to take specific measures in order to protect their clients, including disclosure about potential conflict of interests.<sup>34</sup> According to a US commentator, the fundamental moment for the proxy advisory industry came with the passage of the 2003 Securities and Exchange Commission Rule; "Finally, in 2003, SEC adopted a rule and amendments under the Investment Advisers Act of 1940 that requires registered investment advisers to adopt policies and procedures reasonably designed to ensure that proxies in the best interest of clients".<sup>35</sup>

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<sup>31</sup> Due to the lack of regulation, abuses in proxy soliciting became notorious and widespread encouraging the US Congress to enact in 1934, Section 14(a) of the Securities Exchange Act; notwithstanding, this ruling does not frame private conduct, it has the only effect to authorize the SEC to enact rules that will govern it.

<sup>32</sup> Proxy solicitation has been defined as "the process of systematically contacting shareholders and urging them to execute and return proxy forms that authorize named proxy-holders to cast the shareholder's vote, either in a manner designated in the proxy form of according to the proxy-holder's discretion". Cary *et al.*, *op. cit.*, p. 334.

<sup>33</sup> Some proxy advisors are subject to the US regulation established in the Investment Advisers Act 1940, and its regulatory developments such as the Proxy Voting by Investment Advisers 2003. Nevertheless the only firms subject to these rules are those registered as Investment Advisers before the Securities Exchange Commission, as is the case for ISS. From the major proxy advisory firms only some of them are registered with SEC as investment advisers.

<sup>34</sup> The appointed authority to watch the application of such rules is the Securities Exchange Commission, it is charged to monitor compliance through periodical examinations to registered advisers. In case of violations and depending on their degree, SEC is entrusted to send recommendations or rather set fines if there is some contravention against the law.

<sup>35</sup> GAO report page 7.

Finally, the Dodd-Frank Act<sup>36</sup> enacted in summer of 2010, frame the regulation of proxy advisors but only in processes known as say on pay, mostly in compensation practices in corporations. This regulation was passed looking forward to attack proxy advisors practices when applying one-size-fits all voting policies and requiring them to exercise a deeper analysis of the particular situation at every corporation when issuing recommendations on say-on-pay matters.

## 2. *European Union*

The activities of proxy firms are barely regulated in the United States but not so in Europe with the exception of the United Kingdom that have some provisions regarding proxy votes soliciting. In the United Kingdom, the Companies Act of 2006 regulates matters related to the process of proxy soliciting through sections 324 to 327; nevertheless, such provisions are only related to proxy system of voting and do not establish provisions for advisory industry. The same situation accounts for the existing regulation in France where the Monetary and Financial Code regulates the proxy voting but does not establish specific regulation over proxy advisors.

Taking into account the lack of regulation for the proxy advisory industry some governments in the European Union and the EU it-self have summoned experts and professionals in order to analyze the situation. For the sake of this paper we take support on three different recommendations issued by the French, British and European authorities.

In France, the Financial Markets Authority (AMF)<sup>37</sup> published in 2011, a recommendation over proxy advisors.<sup>38</sup> The AMF manifested favorable to the exercise of voting rights by shareholders at general meetings and reminded that institutional investors are accountable before the stockholders for whose they manage assets, and their practices regarding voting rights must be in the best interest of stockholders. Previously, in 2005, the AMF issued a recommendation<sup>39</sup> stating that the exercise of voting rights

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<sup>36</sup> The Dodd-Frank Wall Street Reform and Consumer Protection Act.

<sup>37</sup> *Autorité des Marchés Financiers*.

<sup>38</sup> *Recommandation AMF.No 2011-06 sur les agences de conseil en vote*.

<sup>39</sup> “Pour l’amélioration de l’exercice des droits de vote des actionnaires en France” – Rapport du groupe de travail de l’AMF de septembre 2005. «L’exercice du droit de vote constitue pour les investisseurs institutionnels une responsabilité de grande importance. Il

by institutional investors must be preceded by an exhaustive analysis and not to apply only without control the opinions issued by proxy shareholders by applying their own judgment while voting resolutions.

The AMF encourage institutional investors to develop their own vote policies; it was clearly stated that, even if institutional investors hire proxy advisors this does not free them from their responsibility before shareholders. At the same, it extends an invitation to issuers in order to keep informed the Board of Directors about communications with proxy advisors about their recommendations. The recommendation was directed to proxy advisory firms, and suggested the elaboration and application of voting policy. It is an open invitation for transparency in the activities of proxy advisors considering this quality as essential. For this reason, the AMF encouraged proxy firms to publish their general policies at their web site and appealed proxy advisors to define and publish at their web site, the appropriate and reasonable measures in order to avoid conflict of interests that may affect the proxy firm, the stockholders or others. The advice urged to prepare a code of ethics and ensure its implementation. The suggestions were made in wide terms; nevertheless, it is to be kept in mind that this recommendation may be the seed of further regulation in France.

In the United Kingdom, the Financial Reporting Council (FRC) released its UK Stewardship Code in July 2010, suggesting a disclosure regime under which institutional investors disclose how they use services provided by proxy advisory firms. This recommendation focuses in institutional investors and question if these are exercising enough diligence and care when it comes to managing relationships with proxy advisors. "With regard to the regulation of proxy advisors themselves, however, the UK Government takes a very cautious stance: Unless there is a clear evidence that a regulatory response is necessary and justifiable in cost-benefit terms, the United Kingdom favors non regulatory measures..."<sup>40</sup>

At the European level the concerning regulator is the European Securities and Markets Authority (ESMA) published a discussion paper<sup>41</sup> in

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doit être précédé d'un examen attentif du sens et de la portée des résolutions proposées permettant de porter sur elles un jugement circonstancié, et ne doit pas en particulier se limiter à appliquer sans contrôle des grilles d'analyse ou des recommandations élaborées par des sociétés de conseil de vote».

<sup>40</sup> Fleischer, *op. cit.*, p. 16.

<sup>41</sup> The discussion paper considered the state and structure of the proxy adviser market in the European Union. It focused in the factors that may influence the accuracy, indepen-

order to analyze the regulation of proxy advisers. In its corporate governance paper issued in April 2011, concerns were expressed about the role of proxy advisers and a fact-finding exercise was then carried out by ESMA. Nevertheless (as the Accountability Office in the United States) the ESMA does not state formal proposals but looks for opinions under four alternatives; (a) taking no action at EU level; (b) encouraging the development of improved investor protection and proxy advising standards; (c) recommending the development of quasi-binding European regulatory instruments or; (d) recommending the introduction of formal legislative measures.

The ESMA published the opinions and feedback to the discussion paper and issued a Final Report on the Proxy Advisory Industry.<sup>42</sup> The result of the analysis was the issuing of a recommendation that reads as follows:

The Report has found that there is no current market failure related to proxy advisors interaction with investors and issuers in the European Union (EU), which would require regulatory intervention. However, ESMA has identified a number of concerns regarding the independence of proxy advisors, and the accuracy and reliability of the advice provided which would benefit from improved clarity and understanding amongst stakeholders... ESMA is recommending that the proxy advising industry should develop an EU Code of Conduct (Code) that focuses on: identifying, disclosing and managing conflicts of interest; and fostering transparency to ensure the accuracy and reliability of the advice.<sup>43</sup>

## VI. CONCLUSION

From the previous analysis, it is possible to say that the role of proxy advisers in corporate voting process involves intricate questions to lawmakers and legal scholars. On the one hand, proxy advisers provide a valuable

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dence and reliability of proxy advice such as the potential for conflicts. This paper, tried to foresee the methodology of proxy advisers and their dialogue with issuers, but also, the degree of transparency on the management of conflicts and voting policies and guidelines.

<sup>42</sup> Available on <http://www.esma.europa.eu/content/Feedback-statement-consultation-regarding-role-proxy-advisory-industry>.

<sup>43</sup> Available on <http://www.esma.europa.eu/news/ESMA-recommends-EU-Code-Conduct-proxy-advisor-industry>.

service to institutional investors and shareholders in general. On the other hand, they have become a powerful industry with a heavy influence on the corporate matters without a proper regulation. In light of these ambivalent findings, there is a patent need for action in order to avoid situations where proxy advisors exercise undue power or act without the due diligence but also in order to avoid conflict of interest.

As we could see authorities from different countries have expressed their concern and opened the debate about the present and the future of proxy advisors. The general conclusion of the experts considered that there are, for the time being, no conduct to punish from the activities and services developed by the major proxy advisors. Nevertheless, as the recent financial crisis and corporate governance scandals have demonstrated, it seems desirable to enhance regulation to a certain point before problems start to show-up specially when such entities participating as auxiliaries in the corporate governance of publicly held corporations might yield a great impact in day-to-day life.

In the present day a direct regulation from governmental agencies seems hardly plausible and it is not clear if future national regulations for proxy advisors will arrive. The reports issued by the competent authorities (market regulators) do not point-out a need for regulation, still there is a dissenting feeling that proxy advisors should be under some kind of control. In this context it seems to be an opportunity for international organizations to deep the analysis and develop a common code of conduct that will help enhance both the practices and the security of the market.

Even though if a few of the largest proxy advisors have started to develop internal codes of conduct voluntarily (with the hope to bring confidence to their clients and respond to the concerns about their practices) we argue instead for the participation of international organizations given the cross-border dimension of proxy advisory services and the fact that there are almost identical problems in many countries, it goes almost without saying that unilateral national action will only be of limited success.

The existing and closest regulation is focused on proxy holders who have been traditionally considered as agents of the shareholder who entrust them. Those holders are regarded by the law as fiduciaries and are subject to the inherent duties in the conception of the agency; notwithstanding, proxy advisors are not, properly said, proxy holders. Certainly the better approach for regulation, since there are no flagrant violations,

is the one by self-regulation as the authorities have expressed in their recommendations. It seems more suitable that to the traditional congressional process. There is an interesting and continued suggestion from some professionals to promote internal codes of ethics among proxy advisors; such codes may be issued internally or may be adopted voluntarily from the proposition of an international organization. There are some existing examples of this type of self-regulation applicable to other analogous entities such as the credit rating agencies.

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