A LONG/SHORT INCENTIVE SCHEME FOR PROXY ADVISORY FIRMS

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Proxy advisory firms such as Institutional Shareholder Services and Glass, Lewis & Co. play an important role in our capital markets. They advise institutional investors how to vote in shareholder meetings and often have a dramatic influence on the outcome. Such immense power, however, has sparked concern and calls for regulation, given that proxy advisors have no skin in the game. In this Article we propose a novel framework for an incentive pay scheme for proxy advisors within the highly important M&A context that would align their incentives properly. In short, instead of their current flat-fee arrangements, part of proxy advisors' fees would be used to create the following incentive framework: if proxy advisors recommend their clients vote "AGAINST" an acquisition, and shareholders accept their recommendation, proxy advisors should be placed in a long position on the stock of the target. Consequently, proxy advisors would gain if share prices eventually pass the acquisition price and lose if they do not. However, if proxy advisors recommend shareholders vote "FOR" an acquisition, and shareholders nevertheless reject the takeover bid and advice, proxy advisors should be placed in a short position on the stock. They would lose if share prices eventually pass the acquisition price and gain if they do not. In this Article we discuss how to implement and promote this proposal.

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I. INTRODUCTION

Proxy advisory firms play a highly influential role in the capital markets all over the world. These firms help institutional investors determine how to vote their clients' shares on thousands of proxy questions companies pose each year.[1] Academic research has found, empirically, that proxy advisors have a strong impact on the voting outcome in many cases.[2] Furthermore, studies of proxy advisors' impact on voting results understates their influence on the market as a whole, given that companies try to meet the proxy advisors' standards and expectations in the first place.[3]

1. *Examining the Market Power and Impact of Proxy Advisory Firms: Hearing Before the Subcomm. on Capital Mkts. and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 113th Cong. 2 (2013), https://www.gpo.gov/fdsys/pkg/CHRG-113hhrg81762/pdf/CHRG-113hhrg81762.pdf [hereinafter *Hearing*] (statement of Hon. Scott Garrett, Chairman, Subomm. on Capital Mkts. and Gov't Sponsored Enters) (introducing the subject of public shareholder proxy advising).

2. *See infra* Subpart II.B.

3. *See* CTR. ON EXEC. COMP., A CALL FOR CHANGE IN THE PROXY ADVISORY INDUSTRY STATUS QUO: THE CASE FOR GREATER ACCOUNTABILITY AND OVERSIGHT

The leading proxy advisory firms—Institutional Shareholder Services ("ISS") and Glass, Lewis & Co. ("Glass Lewis"), which together account for ninety-seven percent of the industry[4]—have been called "de facto corporate governance regulators,"[5] and "de facto arbiters of U.S. corporate governance."[6] Their voting recommendations have been described as "a strong predictor" of voting outcomes[7] and a "milestone" for many crucial deals.[8] The question, "'What will ISS say?' is regularly asked in the board rooms,"[9] and dissidents of management frequently admit that they "couldn't have won without ISS."[10] Recent market and legal developments, such as the Dodd-Frank Wall Street Reform and Consumer Protection ("Dodd-Frank") Act's say-on-pay provisions, have further fortified proxy advisors' potency.[11] Given such immense power, it is no wonder that management teams frequently lobby proxy advisors to endorse their positions. As Chief Justice of the Delaware Supreme Court Leo Strine noted: "[P]owerful CEOs come on bended knee to Rockville, Maryland, where ISS resides, to persuade the managers of ISS of the merits of their views about issues like proposed mergers, executive compensation, and poison pills."[12]

Recognition of the major role played by proxy advisory firms has also sparked much criticism. Critics persistently complain that proxy advisory firms' activities lack transparency, that proxy advisors

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3–4 (2011). *See generally* David F. Larcker et al., *Proxy Advisory Firms and Stock Option Repricing*, 56 J. ACCT. ECON. 149, 150 (2013) (explaining how "boards may respond to [proxy advisors'] influence by making [compensation plan and corporate governance] choices that increase the likelihood of receiving a favorable recommendation from proxy advisors").

4. *See Hearing*, *supra* note 1.

5. Letter from Wachtell, Lipton, Rosen & Katz, to Elizabeth M. Murphy, Sec'y, SEC 6 (Oct. 19, 2010), http://www.sec.gov/comments/s7-14-10/s71410-129.pdf [hereinafter Wachtell Letter].

6. *Hearing*, *supra* note 1, at 7.

7. Transcript of Proxy Advisory Firms Roundtable at 17, SEC (Dec. 5, 2013), https://www.sec.gov/spotlight/proxy-advisory-services/proxy-advisory-services-transcript.txt [hereinafter SEC Roundtable].

8. *See* Jim Greer, *Compaq, HP Merger Deal Lands Critical Support*, HOUS. BUS. J. (Mar. 11, 2002, 12:00 AM) (quoting Michael Capellas), https://www.bizjournals.com/houston/stories/2002/03/11/story4.html ("Today's ISS recommendation to Hewlett-Packard shareholders represents an important milestone in the merger process . . . .").

9. *Hearing*, *supra* note 1, at 16.

10. *See* Shawn Tully, *Taking the Guesswork Out of Proxy Voting*, FORTUNE (Dec. 21, 2006, 10:42 AM) (quoting Alan Miller), http://archive.fortune.com/magazines/fortune/fortune_archive/2006/12/25/8396763/index.htm.

11. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951-14A, 124 Stat. 1376, 1899 (2010) (codified at 15 U.S.C. § 78n-1 (2012)).

12. Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 688 (2005).

operate in oligopolistic markets, that they have a check-the-box mentality, and that they suffer from conflicts of interest.[13] But above all, critics have accused proxy advisors of having no skin in the game.[14]

Despite their great influence over companies' votes and practices, "proxy advisory firms have no economic interest in the companies for which they are giving [their] recommendations."[15] They operate without a horse in the race[16] and, on top of that, do not "owe fiduciary duties to the corporations whose policies they seek to influence."[17] Put differently, proxy advisory firms are not subject to the impact that their advice has—both positive and negative—on public corporations and their shareholders.

While Congress and the Securities and Exchange Commission ("SEC") contemplate legislation and regulation to tackle some of these shortfalls,[18] we offer a different approach—designing a suitable pay-for-performance scheme for proxy advisory firms. In contrast to the current flat fee for advisory services, we offer a novel model which is based on a long/short position on the shares of the company that is the subject of the vote recommendation. This model is suitable for vote recommendations that have a large impact on the welfare of the shareholders of the relevant company. In this Article we concentrate on M&A deals. In many cases, proxy advisors' recommendations can make or break a transaction that has a huge impact on the shareholders on both sides of the transaction.

In designing a pay-for-performance scheme aimed at improving proxy advisors' recommendations in the M&A context, one can take advantage of the market value of the shares of the target. However, this presents a twofold challenge. First, on the target side, when a cash bid is ultimately accepted, the target is delisted, and it is impossible to use the market price of the target's stock in the compensation scheme. Second, the shareholders of the target firm may overrule the proxy advisory firm's recommendations and vote against the advice. In such a case, the compensation scheme should be carefully crafted to reflect the value of the recommendation of the proxy advisor and not the contradicting decision of the clients.

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13. *See infra* Subpart II.C.

14. Asaf Eckstein, *Skin in the Game for Credit Rating Agencies and Proxy Advisors: Reality Meets Theory*, 7 HARV. BUS. L. REV. 221, 224 (2017).

15. *Hearing*, *supra* note 1, at 9 (statement of Timothy J. Bartl, President, Center on Executive Compensation); *see also* Daniel M. Gallagher, *Outsized Power & Influence: The Role of Proxy Advisers* 8 (Washington Legal Found., Working Paper No. 187, 2014), http://www.wlf.org/upload/legalstudies/workingpaper/GallagherWP8-14.pdf (stating that proxy advisory firms owe shareholders no fiduciary duties).

16. Wachtell Letter, *supra* note 5, at 1.

17. Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1765 (2006).

18. *See infra* Part III.

Our proposed model is designed to deal with these two challenges, at least in part. We suggest that in the case of a proxy advisory firm's recommendation to reject a bid, and an ensuing decision by the shareholders (in line with the recommendation) to reject the bid, the advisory compensation shall be crafted to put the proxy advisor in a long position on the target stock. However, if the proxy advisory firm recommends accepting a bid, and the bid is rejected contrary to the proxy advisory firm's recommendation, the advisory compensation shall be crafted to put the proxy advisor in a short position on the target stock. Such a compensation structure provides the proxy advisors with a healthy portion of skin in the game that does not exist under today's framework. Because there is always a chance that the bid will be rejected, or even more frequently, withdrawn, the proposed pay-for-performance scheme means that the proxy advisor must be ready to put its money where its mouth is. This is especially true given the increasing number of failed M&A deals. A recent study identified no less than 3,721 failed bids for public, nonfinancial corporations during the period of 1980 to 2015.[19] In 2016 alone, more than twenty percent of the announced $3.7 trillion global deal volume eventually broke apart.[20] Hence, proxy advisors should always be ready to bear the financial consequences of their recommendations.

To explain how our scheme plays out, consider a bid of $35 per share for a target that is traded at $30 per share. If the proxy advisor recommends rejecting the deal, then it must be prepared to stand behind its recommendation. If the bid is indeed rejected (or withdrawn before the vote), the advisory fee shall be used in part to purchase a forward contract to buy the target shares for $35 each. When the time comes to close the forward agreement (say, in two years), the proxy advisor will gain if the target share price rose beyond the contract price (which is the rejected deal price of $35) and lose if the target share price did not meet the threshold. Note that when the target share price reaches exactly $35 at the relevant time, the fee generated by the proxy advisor equals the fixed fee structure under the current pay system. Like the shareholders, the proxy advisor would neither gain nor lose from the rejection of the bid.

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19. *See* Carolina Salva & Xiqian Zhang, *Do Financial Bidders Bid on Underpriced Targets? Evidence from Failed Bids* 8–9 (Working Paper, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3215749 (discussing data from the Security Data Company Mergers and Acquisitions database).

20. *See* MATTHEW TOOLE, THOMSON REUTERS, DEAL MAKING 2016: SURPRISES LEFT IN STORE 2, 9 (2017), https://financial.thomsonreuters.com/content/dam/openweb/documents/pdf/financial/deal-making-2016.pdf; *see also* DEALOGIC, GLOBAL M&A REVIEW: FULL YEAR 2016, at 4 (2017), https://publishing.dealogic.com/ib/DealogicGlobalMAReviewFullYear2016FINALMEDIA.pdf.

A contrary scenario follows if the proxy advisor recommends accepting the $35 bid. Here, too, the proxy advisor must be prepared to put its money where its mouth is. In case the bid is rejected against the recommendation, the advisory fee shall be used in part to purchase a forward contract to sell the target shares for $35 each. When the time comes to close the forward agreement (say, in two years), the proxy advisor will gain if target share prices are below the contract price (which is the rejected deal price of $35) and lose if the target share prices rose beyond the threshold.

Our model of a long/short compensation scheme improves proxy advisors' incentives and makes their recommendations more credible. This incentive-aligning compensation scheme therefore alleviates concerns recently voiced by Congress, the SEC, practitioners, and the media.[21] In this Article, we explain why our proposal is important and why a similar scheme has not emerged in the market thus far. We will also explain that while we do not recommend making our proposed model mandatory, we believe that the regulator should encourage or at least acknowledge its benefits, which should allow it to flourish. The SEC'S Staff Legal Bulletin No. 20 ("SLB-20"), issued in June 2014, requires investment advisors (i.e., institutional investors) to ascertain that proxy advisory firms have the capacity and competency to adequately analyze proxy issues.[22] SLB-20 ignores, however, the important aspect of advisory fees. We suggest amending SLB-20 to require institutional investors to contemplate whether the proxy advisor's fee arrangement promotes effective performance. Specifically, institutional investors should consider if the advisory fee structure should be sensitive, at least in part, to the proxy advisor's performance.

This Article continues as follows: Part II provides background for our inquiry by describing the evolution of proxy advisory firms and the structure of the proxy advisory industry. Part II then describes the influence of proxy advisors on the votes of institutional investors, as well as the criticism directed toward proxy advisors (in particular the criticism that they have no skin in the game). Part III delineates the existing legislative and regulatory setup that governs proxy advisors' operations as well as the proposed legislation aimed at improving the procedures that proxy advisors use in formulating voting recommendations. We show how these existing and proposed legal safeguards have limited power in enhancing the quality of proxy advisors' work. As such, this Part lays the groundwork for the incentive-based model for proxy advisory firms, which we expand upon in Part IV. Following the introduction of our proposal, we consider certain questions and objections that are raised by our

21. *See infra* Subpart II.C.

22. SEC Staff Legal Bulletin No. 20 (June 30, 2014), https://www.sec.gov/interps/legal/cfslb20.htm.

incentive-based model. Part V briefly concludes the discussion and sheds light on some hidden benefits of our proposal.

II. BACKGROUND

A. *The Evolution of the Proxy Advisory Industry*

Proxy advisory firms provide institutional investors with research and recommendations regarding how to vote on various matters as shareholders in public corporations. ISS, which controls approximately sixty-one percent of the market and is seen as the leader of the proxy advisory industry,[23] was founded in 1985.[24] The proxy industry is exceptionally concentrated. ISS was a monopoly for almost twenty years until its main competitor, Glass Lewis, was established in 2003.[25] Today, Glass Lewis has a market share of approximately thirty-six percent.[26] The other much smaller firms that operate within the advisory industry include: Egan-Jones Proxy Services ("Egan-Jones"), operating since 2002; Marco Consulting Group, operating since 1988; and ProxyVote Plus, formed in 2002.[27]

While the business models of proxy advisory firms may vary from firm to firm, it is important to note that ISS provides both proxy voting recommendations to institutional investors and consulting services to corporations seeking assistance with improving their corporate governance ratings or with crafting proposals to be presented to shareholders.[28] To avoid potential conflicts of interest, other proxy advisors do not offer corporate governance advice to public companies and instead sell their advisory services exclusively to institutional investors.[29]

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23. Tamara C. Belinfanti, *The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control*, 14 STAN. J.L. BUS. & FIN. 384, 397 (2009).

24. *Id.*

25. *Id.* at 396, 429.

26. *Id.* at 395.

27. U.S. GOV'T ACCOUNTABILITY OFF., GAO-17-47, CORPORATE SHAREHOLDER MEETINGS: PROXY ADVISORY FIRMS' ROLE IN VOTING AND CORPORATE GOVERNANCE PRACTICES 6–8 (2016), https://www.gao.gov/assets/690/681050.pdf [hereinafter GAO 2016]. There are also several European firms that offer international research. *Id.* at 6 n.10. Another proxy advisory firm, Proxy Governance, Inc., was acquired in 2011 by Ernst & Young. *E&Y Acquires Proxy Governance Assets*, INT'L ACCT. BULL. (May 26, 2011), http://www.internationalaccountingbulletin.com/news/ey-acquires-proxy-governance-assets.

28. Belinfanti, *supra* note 23, at 399.

29. *See Hearing*, *supra* note 1, at 403 (statement of Katherine H. Rabin, CEO, Glass Lewis) (stating that Glass Lewis does not provide consulting services); *see also* Belinfanti, *supra* note 23, at 397 (explaining that such potential conflict exists only for ISS, because the other proxy advisors do not provide consulting services).

A few major factors have fueled the evolution of the proxy advisory industry. First, the growth in the importance of the proxy advisory industry closely follows the immense growth of institutional investors over the past few decades.[30] Institutional investors—proxy advisors' clients— now account for around 70% of share ownership in the largest U.S corporations.[31] Moreover, "[t]he largest twenty-five institutions hold more than 30% of all U.S. corporate shares, and the largest ten managers manage[] 23.4% of all assets."[32] Second, during the last two decades, corporate law and regulation have significantly expanded the types of issues now subject to shareholder votes.[33] Accordingly, institutional investors are being called upon much more frequently to cast their votes. This load has created a strong relationship between institutional investors and proxy advisory firms.[34] To illustrate, every year BlackRock, one of the largest institutional investors and money managers, "vote[s] globally at more than 15,000 shareholder meetings, on over 130,000 proposals."[35]

Third, regulatory initiatives that have reinforced institutional investors' fiduciary duty to vote their proxies in the best interest of their clients have enhanced proxy advisors' power. A 1988 Department of Labor opinion letter regarding pension funds[36] and a

30. Asaf Eckstein, *Great Expectations: The Peril of an Expectations Gap in Proxy Advisory Firm Regulation*, 40 DEL. J. CORP. L. 77, 89–90 (2015).

31. *Id.* at 90; Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987, 995–98 (2010) (discussing the rise in power of institutional investors and its consequences).

32. Zohar Goshen & Sharon Hannes, *The Death of Corporate Law* 38 (European Corp. Governance Inst., Working Paper No. 402, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3171023.

33. Eckstein, *supra* note 30, at 90.

34. *Id.* at 90–91.

35. *Investment Stewardship*, BLACKROCK, https://www.blackrock.com/corporate/en-gb/about-us/investment-stewardship (last visited Dec. 7, 2018). Similarly, Vanguard, another major money manager, voted at 12,785 meetings in the 2015 proxy season, 16,740 meetings in the 2016 proxy season, and 18,905 in the 2017 proxy season. VANGUARD, INVESTMENT STEWARDSHIP 2017 ANNUAL REPORT 6 (2017), https://about.vanguard.com/investment-stewardship/annual-report.pdf. Proxy season begins on July 1st and ends on June 30th the next year. *Id.* Finally, State Street Global Advisors, a third major money manager, voted at 15,471 meetings in the 2015 proxy season and at 17,337 meetings in the 2016 proxy season. STATE ST. GLOB. ADVISORS, 2016 YEAR END ANNUAL STEWARDSHIP REPORT 4 (2017), https://www.ssga.com/investment-topics/environmental-social-governance/2017/2016-Annual-Stewardship-Report-Year-End.pdf.

36. U.S. Dep't of Labor, Wage & Hour Div., Opinion Letter (Feb. 23, 1988). This letter is commonly known as the "Avon Letter." Eckstein, *supra* note 30, at 91. This letter explains that "shareholder voting rights are considered valuable pension plan assets under the Employee Retirement Income Security Act (ERISA), and therefore the fiduciary duties of loyalty and prudence applied to proxy voting." *Id.* This requires "pension plan fiduciaries . . . [to] vote the plan's shares on the basis of active analysis, regardless of whether or not the fiduciary was certain that expending time and effort to analyze how to vote would create value for a fund." *Id.*

2003 SEC rulemaking regarding mutual funds and investment advisors—requiring institutional investors to disclose how they voted on proxy proposals presented at shareholder meetings[37]—are two major regulatory initiatives that have done this.[38] Relatedly, two SEC interpretations, issued in 2003 and 2004, clearly indicate that investment advisors can discharge their duty to vote their proxies (and demonstrate that their vote was not a product of a conflict of interest) if they vote in accordance with a predetermined policy and based on the recommendations of an independent third party—a proxy advisory firm.[39]

The key takeaway is that the growth of institutional investors, the increase in the volume of proxy votes, the regulatory mandates regarding the duty to vote, and the clearance from conflicts of interest to institutional investors who use proxy advisory services have all dramatically increased the importance of proxy advisory firms.

B. Proxy Advisors' Impact

As explained above, proxy advisory firms play a crucial role in the proxy voting system. As such, it should come as no surprise that their influence on shareholder voting is significant. Scholars have recently provided empirical support for proxy advisors' power. For example, a 2009 study found that in director elections ISS is able to sway a significant fraction of the shareholder votes.[40] An earlier study found that "ISS recommendations unfavorable to management were associated with 13.6% to 20.6% fewer votes cast in favor of management, depending on proposal type."[41] In the context of executive compensation, a 2013 study found that say-on-pay proposals with a positive ISS recommendation received on average

37. 17 C.F.R. § 275.206(4)-6(b) (2003).

38. Eckstein, *supra* note 30, at 91–92. *See generally* K.J. Martijn Cremers & Roberta Romano, *Institutional Investors and Proxy Voting on Compensation Plans: The Impact of the 2003 Mutual Fund Voting Disclosure Rule*, 13 AM. L. & ECON. REV. 220 (2011) (discussing the 2003 SEC rule).

39. 17 C.F.R. § 275.204-2(b)(5)–(c)(2)(iii) (2011); Eckstein, *supra* note 30, at 92–93 (discussing the SEC's 2004 Egan-Jones Proxy Services no-action letter). Quite recently, the SEC withdrew its Egan-Jones Proxy Services no-action letter for reconsideration. *Statement Regarding Staff Proxy Advisory Letters*, SEC (Sept. 13, 2018), https://www.sec.gov/news/public-statement/statement-regarding-staff-proxy-advisory-letters.

40. *See* Jie Cai et al., *Electing Directors*, 64 J. FIN. 2389, 2391 (2009) (finding that directors receiving a negative recommendation from ISS receive nineteen percent fewer votes). *But cf.* Stephen Choi et al., *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. 869, 869 (2010) (analyzing the significance of voting recommendations issued by proxy advisors in connection with uncontested director elections, estimating that an ISS recommendation shifts six-to-ten percent of shareholder votes, and concluding that the influence of ISS is overstated).

41. Jennifer E. Bethel & Stuart L. Gillan, *The Impact of the Institutional and Regulatory Environment on Shareholder Voting*, 31 FIN. MGMT. 29, 30 (2002).

28.2% more shareholder support than say-on-pay proposals with a negative ISS recommendation.[42] Similarly, another 2013 study found that negative ISS and Glass Lewis recommendations are associated with 24.7% and 12.9% more votes against executive compensation plans, respectively.[43] Finally, a 2015 study also found that "negative ISS recommendations reduce the percentage of votes in favor of say-on-pay proposals by about 25 percentage points."[44]

Furthermore, the evidence of direct influence described above hardly tells the whole story. These studies understate proxy advisors' influence on the market as a whole, given that companies try to meet proxy advisors' standards and expectations in the first place, thereby avoiding the need for a vote.[45] Bear in mind that in many cases, a public company's voting block held by ISS clients has much more influence on the voting results than the largest shareholder of the company.[46]

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42. James F. Cotter, Alan R. Palmiter & Randall S. Thomas, *The First Year of Say-on-Pay Under Dodd-Frank: An Empirical Analysis and Look Forward*, 81 GEO. WASH. L. REV. 967, 982 (2013).

43. Yonca Ertimur et al., *Shareholder Votes and Proxy Advisors: Evidence from Say on Pay*, 51 J. ACCT. RES. 951, 953 (2013); *see also* Yonca Ertimur et al., *Shareholder Activism and CEO Pay*, 24 REV. FIN. STUD. 535, 565 n.23 (2011) (finding that proxy advisors influence around twenty-five percent of the votes concerning compensation-related shareholder proposals).

44. Nadya Malenko & Yao Shen, *The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design*, 29 REV. FIN. STUD. 3394, 3424 (2016).

45. *See Hearing*, *supra* note 1, at 42 (written statement of Timothy J. Bartl, President, Center on Executive Compensation) (noting, for example, that in a 2010 survey conducted by the Center on Executive Compensation and the HR Policy Association, fifty-four percent of respondents said they had changed or adopted a compensation plan or practice in the past three years primarily to meet the standard of a proxy advisory firm); *see also* SEC Roundtable, *supra* note 7, at 41–42 (statement of Michael Ryan, Vice President, Business Roundtable) (discussing influence of proxy advisory firms on voting outcomes); *id.* at 138 (statement of Hoil Kim, Vice President, Chief Administrative Officer and General Counsel, GT Advanced Technologies, Inc.); David F. Larcker et al., *Outsourcing Shareholder Voting to Proxy Advisory Firms*, 58 J.L. & ECON. 173, 203 (2015) (finding that a substantial number of firms change their compensation programs in the time period before the formal shareholder vote in a manner consistent with the features known to be favored by proxy advisory firms in an effort to avoid a negative voting recommendation).

46. *See, e.g.*, Int'l Bus. Machines Corp., Comment Letter on Concept Release on the U.S. Proxy System 3 (Oct. 15, 2010), https://www.sec.gov/comments/s7-14-10/s71410-84.pdf (noting the effect of ISS's recommendation on IBM's 2009 and 2010 board elections); 3M Company, Comment Letter on Proposed Rule on Security Holder Director Nominations (Dec. 5, 2003), https://www.sec.gov/rules/proposed/s71903/3m120503.htm (noting that ISS effectively controlled the vote of fifty percent of 3M's total shares outstanding); William Holstein, *Is ISS Too Powerful? And Whose Interests Does It Serve?*, CBS NEWS: MONEYWATCH, (Feb. 7, 2008, 11:03 AM), https://www.cbsnews.com/news/is-iss-too-powerful-and-whose-interests-does-it-serve/ ("ISS may control 30 percent of the vote in any proxy battle.").

In many cases, therefore, proxy advisors' recommendations can make or break a transaction. For example, in 2001, "when Hewlett-Packard's then-CEO Carly Fiorina [famously] announced that the technology giant proposed to merge with Compaq Computer Corp., she set off a firestorm of controversy."[47] ISS eventually issued an opinion backing the deal that turned out to be "crucial" as ISS clients controlled "about 23 percent of HP's outstanding shares."[48] The merger was completed.[49] According to one Merrill Lynch (now part of Bank of America) analyst that covered the deal, "If [ISS] had gone the other way, the deal would have been dead."[50] Similarly, ISS's recommendation to approve Royal Dutch Shell PLC's takeover of BG Group PLC—valued at about fifty-one billion dollars—was "considered influential as more than half of Shell's top 50 shareholders subscribe to the adviser's services."[51]

Finally, as recently demonstrated, the views of proxy advisors are taken into account by courts judging directors' decisions. In *In re Zale Corp. Stockholders Litigation*,[52] the Delaware Court of Chancery rejected the claim that the Zale board acted in bad faith by agreeing to an unreasonable merger price, noting that ISS supported the transaction.[53]

C. *Criticism and Calls for Intervention*

The dramatic increase in proxy advisors' power has been followed by extensive criticism regarding many aspects of the advisory market and proxy advisors' operations. This Subpart briefly outlines the major criticisms. First, critics point to the extreme lack of competition in the proxy advisory industry. As explained before, ISS and Glass Lewis currently enjoy a duopoly on providing proxy advisory

47. Alice LaPlante, *Compaq and HP: Ultimately, the Urge to Merge Was Right*, STAN. GRADUATE SCH. BUS.: INSIGHTS (June 1, 2007), https://www.gsb.stanford.edu/insights/compaq-hp-ultimately-urge-merge-was-right.

48. *See* Luisa Beltran, *ISS Backs HP-Compaq Merger*, CNNMONEY (Mar. 5, 2002, 4:36 PM), http://money.cnn.com/2002/03/05/deals/iss_hp/index.htm.

49. *See* LaPlante, *supra* note 47.

50. *See* Peter Burrows & Andrew Park, *Compaq and HP: What's an Investor to Do?*, BUSINESSWEEK, Mar. 18, 2002, at 62; *see also* Luisa Beltran, *ISS Could Kill HP-Compaq*, CNNMONEY (Mar. 4, 2002, 4:02 PM), http://money.cnn.com/2002/03/04/deals/iss_hp/index.htm (quoting several analysts who believed that ISS's recommendation would significantly influence the outcome).

51. Selina Williams, *Shell's BG Group Takeover Backed by Shareholder Adviser*, WALL ST. J. (Jan. 8, 2016, 9:04 PM), https://www.wsj.com/articles/shells-bg-group-takeover-backed-by-shareholder-adviser-1452256823.

52. Consolidated C.A. No. 9388–VCP, 2015 WL 5853693 (Del. Ch. Oct. 1, 2015), *amended on reargument by* 2015 WL 6551418 (Del. Ch. Oct. 29, 2015), *aff'd sub nom.* Singh v. Attenborough, 137 A.3d 151 (Del. 2016).

53. *Id.* at *16 ("ISS's support for the Merger [is] evidence of the Merger's fairness."). Interestingly, Glass Lewis recommended voting against the merger in this case. *See id.*

services;[54] no other firm has a significant enough market share to be considered a serious competitor.[55] A recent empirical study suggests that competition is highly important in improving the quality of proxy advisory services.[56]

Scarce competition and market concentration stems in part from the fact that the proxy advisory market builds significantly on reputation, which creates mighty entry barriers. Institutional investors are likely to prefer the services of an experienced and well-known proxy advisor like ISS and Glass Lewis rather than the services offered by a new player.[57] Economies of scale serve as another significant barrier.[58] Because there are significant fixed costs for the proxy advisory operation, it is much easier to bear these costs when the proxy advisory firm has a large client base. Newcomers to the industry do not have this advantage. Hence, it is unlikely that ISS and Glass Lewis will be subject to fierce competition any time soon.

Another major criticism points to the lack of transparency concerning the way proxy advisors formulate their recommendations, which gives companies "no real opportunity to review, or even understand, the rationale for their recommendations or how various factors are weighed, if at all."[59] In hindsight, proxy advisors

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54. *See supra* Subpart II.A.

55. *See* JAMES K. GLASSMAN & J. W. VERRET, HOW TO FIX OUR BROKEN PROXY ADVISORY SYSTEM 8 (2013), https://www.mercatus.org/system/files/Glassman_ProxyAdvisorySystem_041520 13.pdf; *see also* CTR. ON EXEC. COMP., *supra* note 3, at 15 (discussing the background to centralization of the proxy advisory market).

56. Tao Li, *Outsourcing Corporate Governance: Conflicts of Interest Within the Proxy Advisory Industry*, 64 MGMT. SCI. 2951, 2952 (2018) (demonstrating that "increased competition brought by Glass Lewis's entry into the proxy advisory market has reduced ISS's favoritism to corporate managers").

57. *See, e.g.*, *Hearing*, *supra* note 1, at 31 (statement of Lynn Turner, Managing Director, LitiNomics) ("Having started Glass Lewis, I would totally agree with that. . . . [W]e had to be able to cover 5,000 or 10,000 companies right out of the gate, so you have to have the ability to raise some money, to ramp the scale, put in the technologies, and then get institutional investors to be willing to sign on. *And they are reluctant to sign on to someone who has never done it before*, so—and it is not a big marketplace.") (emphasis added). Turner was formerly a regulator at the SEC and a senior executive and head of research at Glass Lewis from 2003 to 2007. *See id.* at 17.

58. *See, e.g.*, *id.* at 30 (statement of Niels Holch, Executive Director, Shareholder Communications Coalition) ("I think one of the problems is for institutional investors *you need to have a certain amount of scale to function in this market.* You have to cover 13,000 annual meetings. The proxy statements, as Darla Stuckey said earlier, average 100 pages. *You need to be of a certain size to really service the marketplace.*") (emphasis added).

59. *See* NASDAQ OMX, Petition Related to Proxy Advisory Firms 5 (Oct. 8, 2013), https://www.sec.gov/rules/petitions/2013/petn4-666.pdf; *see also Hearing*, *supra* note 1, at 159–60 (statement of Niels Holch, Executive Director, Shareholder Communications Coalition) (indicating that ISS provides draft

sometimes base their recommendations on inaccurate information.[60] Another criticism argues that proxy advisory firms have a check-the-box mentality, although a more thoughtful, case-by-case analysis is needed in the industry. According to this criticism, proxy advisors simply do not have the resources to tailor arrangements to the particular features of different companies.[61]

Additionally, the leading proxy advisory firm, ISS, is criticized for inherent conflicts of interest derived from the fact that it provides proxy voting recommendations to institutional investors, on the one hand, and consulting services to corporations seeking assistance with proposals to be presented to shareholders, on the other hand.[62] Finally, and most relevant to this Article, a major criticism points to proxy advisors' lack of skin in the game; despite their increasing power and influence on shareholders' voting decisions and market practices, proxy advisors have no stake in the corporations that are affected by their actions.[63] Proxy advisors do not benefit or suffer based on the outcomes of the votes they advise. This leads to decreased incentives to provide quality advice.

In the absence of a direct financial award or penalty, there is a fear that proxy advisors would not invest enough in the accuracy of their recommendations.[64] Moreover, there is no force to counter mild biases that arise and generally push proxy advisors to recommend that shareholders vote for a proposed merger. Thus, proxy advisors may be inclined to recommend a certain transaction to evade confrontation with management. Recommending in favor of a merger has another benefit from the point of view of proxy advisors. Once a merger succeeds (and a favorable recommendation makes it more likely to succeed), it is extremely hard to figure out whether the recommendation of the proxy advisor was well advised. Following the merger, the shares of the target vanish, making it is impossible to compare the deal price with the market price of the target shares in the long run. The opposite is true in the case of a rejected bid. If proxy advisors had skin in the game, they would have a good reason to overcome these biases.

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copies of their reports only to S&P 500 companies, while Glass Lewis does not provide reports to any public companies except those that pay for a subscription).

60. Eckstein, *supra* note 30, at 114–15.

61. *Id.* at 80 n.13.

62. Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42982, 43011–12 (July 22, 2010) (to be codified at 17 C.F.R. pts. 240, 270, 274, et al.), http://perma.cc/5VL3-RS6J [hereinafter SEC Concept Release]; *see also* Belinfanti, *supra* note 23, at 397 n.71 (explaining the second potential conflict exists only for ISS, because the other proxy advisors do not provide consulting services); Sagiv Edelman, *Proxy Advisory Firms: A Guide for Regulatory Reform*, 62 EMORY L.J. 1369, 1383–84 (2013) (expressing concern that the integrity of voting recommendations issued by the proxy advisory firm could be tainted by business considerations).

63. Eckstein, *supra* note 14, at 231–33.

64. *Id.* at 223–24.

This vocal criticism led the SEC to issue SLB-20, an interpretative, nonbinding release regarding proxy voting systems,[65] as well as proposed legislation that mainly aims to increase the level of transparency in proxy advisors' operations.[66] As we explain in Part III, although existing and proposed legislation and regulation have the potential to make some progress in improving proxy advisors' operations, they have limited power and are not able to guarantee the effectiveness of proxy advisors' work.

III. THE LIMITED POWER OF THE EXISTING AND PROPOSED LEGAL AND REGULATORY FRAMEWORKS

Traditionally, proxy advisors have been subject to relatively lax legal and regulatory discipline. This Part outlines the legal and regulatory framework relevant to proxy advisors' operations. It explains how proxy advisors may be subject to the federal securities laws in two respects: first, they may be subject to the SEC proxy rules; second, they may meet the definition of an "investment adviser" under the Investment Advisers Act of 1940 ("Advisers Act") and thus be subject to corresponding regulation under this law. This Part also contemplates SLB-20 as well as currently proposed legislation. As demonstrated below, there are good reasons to suspect that the legal and regulatory setup—both current and proposed—hardly guarantees effective proxy advisory operations.

A. The Securities Exchange Act of 1934

Under the SEC rules, when soliciting proxies, certain information must be disclosed in writing to shareholders in a "proxy statement."[67] These disclosure requirements are quite burdensome and require fairly extensive disclosures.[68] The definition of solicitation is broad.[69] According to the SEC's view, because proxy advisors "provide recommendations that are reasonably calculated to result in the procurement, withholding, or revocation of a proxy," then "[a]s a general matter, the furnishing of proxy voting advice

65. *See infra* Subpart III.C.

66. *See infra* Subpart III.D.

67. *See generally* EY, 2018 PROXY STATEMENTS: AN OVERVIEW OF THE REQUIREMENTS AND OBSERVATIONS ABOUT CURRENT PRACTICE (2018), https://www.ey.com/publication/vwluassetsdld/2018proxystatements_06548-171us_30november2017/$file/2018proxystatements_06548-171us_30november2017.pdf (providing an overview of the information required in the proxy statement).

68. *See generally id.*

69. *See* 17 C.F.R. § 240.14a-1(l) (2018). A "solicitation" is defined under Exchange Act Rule 14a-1(l)(iii) to include "[t]he furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy." *Id.*

constitutes a 'solicitation,'" and hence is subject to the information disclosure requirements of the proxy rules.[70]

The SEC view stated above has been widely debated. Whether or not proxy advisory firms indeed "solicit" proxy votes, as such term is defined in the proxy rules, remains unclear and debate over this issue shows no signs of waning.[71]

Moreover, Rule 14a-2(b)(3) of the Securities Exchange Act of 1934 exempts from the informational and filing requirements of the federal proxy rules proxy voting advice by any advisor to any other person with whom the advisor has a business relationship.[72] For such an exemption to hold, four conditions must be met:

> (i) The advisor renders financial advice in the ordinary course of his business;
>
> (ii) The advisor discloses to the recipient of the advice any significant relationship with the registrant or any of its affiliates, or a security holder proponent of the matter on which advice is given, as well as any material interests of the advisor in such matter;
>
> (iii) The advisor receives no special commission or remuneration for furnishing the proxy voting advice from any person other than a recipient of the advice and other persons who receive similar advice under this subsection; and
>
> (iv) The proxy voting advice is not furnished on behalf of any person soliciting proxies or on behalf of a participant in an election subject to the provisions of § 240.14a-12(c) . . . .[73]

The exemption offered by Rule 14a-2(b)(3) seems quite fit to cover the operations of the proxy advisory industry. In practice, the SEC gives a high degree of deference to those that apply the exemption.[74]

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70. SEC Concept Release, *supra* note 62, at 43,009; *see also* Edelman, *supra* note 62, at 1377–78 (explaining the implications of the broad definition of "solicitation").

71. *See, e.g.*, ISS, STATEMENT OF GARY RETELNY, PRESIDENT AND CEO INSTITUTIONAL SHAREHOLDER SERVICES INC. TO THE SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES COMMITTEE ON FINANCIAL SERVICES, at A-3–A-4 (2016), https://www.issgovernance.com/file/duediligence/iss-statement-hfsc-17-may-2016.pdf (explaining why proxy advisors do not "solicit" proxy votes).

72. 17 C.F.R. § 240.14a-2(b)(3) (2018).

73. *Id.* This includes "[s]olicitations by any person or group of persons for the purpose of opposing a solicitation subject to this regulation by any other person or group of persons with respect to the election or removal of directors at any annual or special meeting of security holders." *Id.* § 240.14a-12(c).

74. SEC Staff Legal Bulletin No. 20 (June 30, 2014), https://www.sec.gov/interps/legal/cfslb20.htm; *see* GLASS LEWIS, STATEMENT OF KATHERINE H. RABIN, CHIEF EXECUTIVE OFFICER, GLASS, LEWIS & CO., SUBMITTED TO THE U.S. HOUSE OF REPRESENTATIVES COMMITTEE ON FINANCIAL SERVICES 3, 7

And it seems that proxy advisors feel protected under the exemption. As Katherine H. Rabin, CEO of Glass Lewis, recently said, "Commercial proxy voting advisors operating today, including Glass Lewis, are generally deemed by the SEC as qualifying for the exemptions based on . . . 14a-2(b)(3)."[75] The bottom line is that the proxy rules hardly influence the operations of proxy advisors. The main impact is achieved by the fact that proxy advisory firms make sure they meet the requirements of the exemption discussed above.

B. The Investment Advisers Act of 1940

Under the Advisers Act, a person is an "investment adviser" if the person engages, for compensation, in the business of advising others as to the value of securities or certain other matters concerning securities.[76] In turn, the SEC's view is that proxy advisory firms meet this definition of investment adviser.[77] According to § 206 of the Advisers Act, investment advisers owe a fiduciary duty to their advisory clients.[78] Section 206 also contains antifraud provisions that apply to any person who meets the definition of investment adviser and as such may apply to proxy advisors.[79]

Although proxy advisors are subject to certain duties under the Advisers Act, proxy advisors are not typically required to register with the SEC under the Advisers Act.[80] Proxy advisors may, however, register voluntarily, and if they choose to register, they would become "subject to a number of additional regulatory requirements."[81] Specifically, they would be required to do the following: disclose arrangements that may lead to conflicts of interest with their

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(2016), http://www.glasslewis.com/wp-content/uploads/2016/09/2016_0912_Glass-Lewis-Statement-re-H.R.-5983_final.pdf (explaining how the SEC defers the exemption).

75. *Id.*

76. Investment Advisers Act of 1940, 15 U.S.C. § 80b-2(a)(11) (2012).

77. SEC Concept Release, *supra* note 62, at 43010 ("[A]dvisory firms provide analyses of shareholder proposals, director candidacies or corporate actions and provide advice concerning particular votes in a manner that is intended to assist their institutional clients in achieving their investment goals with respect to the voting securities they hold. In that way, proxy advisory firms meet the definition of investment adviser because they, for compensation, engage in the business of issuing reports or analyses concerning securities and providing advice to others as to the value of securities.").

78. *Id.* ("The Supreme Court has construed Section 206 of the Advisers Act as establishing a federal fiduciary standard governing the conduct of investment advisers.").

79. *Id.*

80. *Id.* (stating that there are some circumstances when proxy advisors may be required to register).

81. *Id.* at 43,010–11. Such voluntary registration may serve as a bonding mechanism and therefore enhance reputation.

clients;[82] adopt, implement, and annually review an internal compliance program designed to prevent the adviser (or its employees) from violating the Advisers Act;[83] and designate a chief compliance officer to oversee the compliance program.[84]

In practice, ISS, Marco Consulting, and ProxyVote Plus are registered as investment advisers, while Egan-Jones and the second largest proxy advisor—Glass Lewis—are not.[85] Such a situation, in which only part of the proxy advisory industry is registered, has attracted heavy criticism from those calling to develop a uniform legal or regulatory framework that requires proxy advisors to register as investment advisers.[86] However, registration with the SEC by itself is not a panacea, since the SEC's enforcement against proxy advisors under the Advisers Act tends to be sporadic.[87]

C. *Calls for Reform and SLB-20*

Given the lax legal and regulatory regime described above as well as the rapid growth in the importance of proxy advisors over the past several years, public companies have urged policymakers to take a stronger position on the proxy advisory industry.[88] In response, policymakers have started to seek solutions that would help to ease public companies' concerns.

In 2010, the SEC issued a Concept Release that focused on the U.S. proxy system in general and on proxy advisors in particular.[89] The House of Representatives held a hearing on the matter in June 2013,[90] and the SEC followed this hearing with a roundtable discussion in December 2013.[91] No rulemaking initiatives resulted from these discussions until June 30, 2014, when the Investment Management and Corporate Finance divisions of the SEC issued

82. Investment Advisers Act of 1940, 17 C.F.R. § 275.204-3(a), (f) (2018); SEC, INSTRUCTIONS FOR FORM ADV PART 2, https://www.sec.gov/about/forms/formadv-part2.pdf.

83. 17 C.F.R. § 275.206(4)-7(a)–(b).

84. *Id.* § 275.206(4)-7(c).

85. GAO 2016, *supra* note 27, at 10; Belinfanti, *supra* note 23, at 384–85, 395–96.

86. *See, e.g.*, Niels Holch, *Time to Rein in Proxy Advisory Firms*, SHAREHOLDER COMM. COALITION, (June 23, 2015), http://shareholdercoalition.com/content/time-rein-proxy-advisory-firms-june-23-2015.

87. *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFF., GAO-07-765, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING 4 (2007), http://www.gao.gov/new.items/d07765.pdf ("To date, SEC has not identified any major violations and has not initiated any enforcement action against proxy advisory firms.").

88. SEC Concept Release, *supra* note 62, at 42982–83.

89. *Id.*

90. *Hearing*, *supra* note 1, at 1.

91. SEC Roundtable, *supra* note 7, at 1.

SLB-20, outlining the responsibilities of proxy advisors and institutional investors when casting proxy votes.[92]

SLB-20 is a nonbinding release regarding proxy voting systems and the responsibilities of investment advisers.[93] SLB-20 prompts investment advisers to take an active role on behalf of their clients, particularly in evaluating and overseeing any proxy advisory firm they may engage to assist in fulfilling their voting responsibilities.[94] In brief, SLB-20 states that "[w]hen considering whether to retain or continue retaining any particular proxy advisory firm to provide proxy voting recommendations," an investment adviser should ensure that "the proxy advisory firm has the capacity and competency to adequately analyze proxy issues."[95]

In addition to verifying the quality of the proxy advisory firm's personnel, institutional investors are urged to consider the "robustness" of the proxy advisory firm's policies and procedures.[96] Specifically SLB-20 advises investors (1) to "ensure that its proxy voting recommendations are based on current and accurate information" and (2) to "identify and address any conflicts of interest and any other considerations" affecting "the nature and quality" of the advice and services provided.[97]

Moreover, SLB-20 advises institutional investors to oversee the proxy advisory firm on an ongoing basis to ensure that the proxy advisor continues to guide proxy voting in the best interests of the investment adviser's clients.[98] If the institutional investor determines that the proxy advisory firm's recommendations were based on inaccurate information, the institutional investor must investigate the error and determine whether the proxy advisory firm addressed such errors.[99] Finally, according to SLB-20, public corporations who are the subject of proxy advisor recommendations should be granted a proactive role in reviewing the information in proxy voting reports and submitting any necessary corrections.[100] Remarkably, and most relevant to this Article, SLB-20 completely ignores the important matter of advisory fees. The idea that fee structures may have an important impact on proxy advisor performance, for better or for worse, has not surfaced. This void is

92. SEC Staff Legal Bulletin No. 20 (June 30, 2014), https://www.sec.gov/interps/legal/cfslb20.htm (consisting of a set of questions and answers summarizing investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms, as well as the availability and requirements of two exemptions to the federal proxy rules that are often relied upon by proxy advisory firms).

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.*

97. *Id.*

98. *Id.*

99. *Id.*

100. *Id.*

illustrative of the entrenched nature of the current flat-fee arrangements.

The key takeaway from SLB-20 is that institutional investors now have to monitor the proxy advisory firms that they employ. However, it is doubtful institutional investors are willing to play a much more active role in supervising proxy advisors. Proxy advisors provide institutional investors with research on matters put forth for a vote.[101] They take a great burden off the shoulders of institutional investors and prevent duplicative research on the same matter. In a sense, subjecting proxy advisors to tight supervision of institutional investors would take away part of the benefits of relying on proxy advisors in the first place.

It therefore comes as no surprise that institutional investors strongly oppose new legislation and regulation for proxy advisors.[102] In sum, Daniel M. Gallagher, former commissioner of the SEC, made the following statement regarding SLB-20: "I had hoped that Staff Legal Bulletin No. 20, which was issued a year ago, would have been the catalyst for improvement. But so far it appears like many market participants have taken a 'business as usual' approach."[103]

D. The Financial CHOICE Act of 2017

On June 8, 2017, the House of Representatives passed H.R. 10, the Financial CHOICE Act of 2017 ("CHOICE Act"), a Republican proposal that would significantly amend the postcrisis financial

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101. *Hearing*, *supra* note 1, at 12 (statement of Michael P. McCauley, Senior Officer, Investment Programs and Governance, Florida State Board of Administration). Proxy advisors gather useful information and assist with providing analysis of the issues in question. *See id.* at 17 (statement of Lynn E. Turner, Managing Director, LitiNomics). Proxy advisors "take and distill the information down," and "standardize the ability to read" that material. *See* SEC Roundtable, *supra* note 7, at 150 (statement of Michael Ryan, Vice President, Business Roundtable).

102. On April 24, 2017, the Council of Institutional Investors ("CII") delivered a letter to House Financial Services Committee Chairman Jeb Hensarling and Ranking Member Maxine Waters, opposing the new legal scheme included in the Financial CHOICE Act discussed in Subpart II.D. Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors, to Hon. Jeb Hensarling and Hon. Maxine Waters, U.S. House of Rep., (April 24, 2017) (on file with author). In particular, the CII opposes congressional interference with proxy advisors operation. *See id.*

103. Daniel M. Gallagher, SEC Comm'r, *Activism, Short-Termism, and the SEC: Remarks at the 21st Annual Stanford Directors' College*, (June 23, 2015), https://www.sec.gov/news/speech/activism-short-termism-and-the-sec.html/. This statement was made following Gallagher's expression of disappointment that "[u]nfortunately . . . too many institutional investors uncritically vote the proxy advisory firm recommendations. And proxy advisory firms in turn seem to have done little to address the factors that have given rise to poor research, erroneous recommendations, and conflicted advice." *Id.*

regulatory framework implemented under the Dodd-Frank Act.[104] The proposed CHOICE Act incorporates several bills that have already passed the Committee on Financial Services of the House of Representatives, including the Corporate Governance Reform and Transparency Act of 2016, H.R. 5311, which defines proxy advisory firms for purposes of federal securities laws and requires such firms to register with the SEC.[105]

As part of this registration process, proxy advisory firms would have to provide information regarding their procedures and methodologies, their organizational structure, and whether they have a code of ethics.[106] Importantly, proxy advisory firms would also have to certify that they have "adequate financial and managerial resources to consistently provide proxy advice based on accurate information."[107] In addition, addressing a widespread concern, proxy advisory firms would have to disclose any potential or actual conflicts of interest created by their ownership structure and the services they provide to clients.[108] Specifically, proxy advisor firms would have to disclose whether they engage in consulting services for public companies, file a report disclosing their largest clients (which can be disclosed confidentially to the SEC), as well as disclose the policies and procedures they have in place to manage conflicts that may arise in this context.[109]

Under the proposed legislation, registered proxy advisory firms would have to file an annual report with the SEC.[110] The filing would contain information on the number of shareholder proposals reviewed in the past year, the number of recommendations that were made, how many employees reviewed the proposals, and how many of the proposals were sponsored by clients of the proxy advisory firm.[111] Proxy advisory firms would also be required to file and make publicly available their policies regarding the formulation of their proxy voting policies and voting recommendations.[112] The bill further gives public corporations the right to review and comment on a proposed

104. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010); Financial CHOICE Act of 2017, H.R. 10, 115th Cong. (2017), https://www.gpo.gov/fdsys/pkg/BILLS-115hr10rfs/pdf/BILLS-115hr10rfs.pdf.

105. Corporate Governance Reform and Transparency Act of 2016, H.R. 5311, 114th Cong. (2016). The purpose of this Act is "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." *Id.*

106. H.R. 10 § 482. If the firm does not have a code of ethics, it must explain why it has chosen not to do so. *Id.*

107. *Id.*

108. *Id.*

109. *See id.*

110. *Id.*

111. *Id.*

112. *Id.*

recommendation by a proxy advisory firm "in a reasonable time" before the recommendation is presented to investors.[113] Finally, registered proxy advisory firms would be required to appoint an internal compliance officer responsible for administering the policies and procedures that are required pursuant to the CHOICE Act and other relevant laws and regulations.[114]

For now, the chance of the CHOICE Act garnering the necessary support in the Senate is unclear.[115] Consequently, on October 11, 2017, H.R. 4015—which is mostly a resubmission of last year's H.R. 5311—was introduced.[116]

E. The Limited Power of Legislation and Regulation

So far, this Article has outlined the legislative and regulatory approaches aimed at enhancing proxy advisors' operations. However, the legislative and regulatory measures currently proposed in the proxy advisory context are incapable of significantly affecting the way that proxy advisory firms process information and provide recommendations.[117] As explained above, the proposals focus mainly on improving transparency, requiring disclosure of proxy advisors' conflicts of interest, providing public companies with draft reports prior to submitting their reports to institutional investors, and permitting these companies to review drafts and suggest corrections—before a final report is issued.[118] Altogether, these requirements have limited power.

While it is true that increased transparency and oversight can somewhat enhance the procedural fairness of advisors' decision-making, it is an illusion to believe that these protective measures vest the SEC or anyone else with real control over proxy advisors' operations. Simply put, mere transparency requirements leave much discretion in the hands of proxy advisors to decide how much transparency to give. This stems from the fact that the very nature of the service that proxy advisors provide is far from a technical one. Advisors can also evade the need to revise their reports by simply insisting on their factual assumptions and adhering to their

113. *Id.*

114. *Id.*

115. *See, e.g.*, Dimitri Zagoroff, *House Bill 4015 and the Proposed Regulation of Proxy Advisors*, HARV. LAW SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Nov. 1, 2017), https://corpgov.law.harvard.edu/2017/11/01/house-bill-4015-and-the-proposed-regulation-of-proxy-advisors/.

116. Corporate Governance Reform and Transparency Act of 2017, H.R. 4015, 115th Cong. (2017); *see* Zagoroff, *supra* note 115 (arguing that although it has some differences, H.R. 4015 is mostly the same as H.R. 5311 and that the compliance scheme of H.R. 4015 is the same as that of H.R. 5311).

117. This point has been widely discussed in Eckstein, *supra* note 30, and is briefly explained in this Part of this Article.

118. *See supra* Subpart III.D.

conclusions.[119] Even when the reports contain sheer factual errors, proxy advisors may still assert that the recommendations contained within the reports have not been compromised by the errors. For example, a survey conducted by the Society of Corporate Secretaries and Governance Professionals in 2010 indicated that: "[I]n 44% of the instances where issuers found mistakes the proxy advisory firm reviewed its recommendations but was unwilling to change the recommendation or factual assertion. In another 22% of the instances where issuers found mistakes, the proxy advisory firm was unwilling to reconsider the recommendation at all."[120]

Similar results were obtained by a survey conducted in 2010 by the Human Resource Policy Association, which showed that "[o]f the firms that indicated the use of such an inappropriate peer group [by proxy advisory firm], 96 percent indicated that the peer group was not adjusted in the final version of the report."[121] ISS and Glass Lewis insist that they hardly make mistakes. During a 2013 congressional hearing on the matter, Katherine H. Rabin, CEO of Glass Lewis, explained that: "[O]ften what a corporation indicates is an error is ultimately a difference in interpretation or opinion regarding a certain issue, and therefore requires no correction."[122] She added the following:

> As of May 31, 2013, material errors in Glass Lewis' research (brought to our attention by the company, its advisors or through subsequent disclosure) that resulted in a change to the Glass Lewis recommendation represented one-tenth of 1% of the items up for vote at US companies analyzed by Glass Lewis.[123]

It is doubtful, however, if proxy advisors can be so accurate in their analyses.

Similarly, a 2016 GAO report best illustrates the limited power of law and regulation. As the report demonstrates, even after the extensive discussions regarding the role of proxy advisors held by

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119. Eckstein, *supra* note 30, at 114.

120. *Hearing*, *supra* note 1, at 234 (statement of Darla C. Stuckey, Senior Vice President of Policy & Advocacy, Society of Corporate Secretaries and Governance Professionals).

121. *Id.* at 113 (written statement of Center on Executive Compensation). A "peer group" is a group of firms that the proxy advisor compares to the company raising a matter for a vote. *Peer Groups*, CTR. ON EXEC. COMP., http://www.execcomp.org/Issues/Issue/executive-compensation-plan-design/peer-groups (last visited Dec. 7, 2018). The peer group should have similar relevant characteristics to the company in question. MERIDIAN COMP. PARTNERS, DEVELOPING EFFECTIVE PEER GROUPS 2–3 (2015), http://www.meridiancp.com/wp-content/uploads/Developing-Effective-Peer-Groups.pdf.

122. *Hearing*, *supra* note 1, at 416 (statement of Katherine H. Rabin, CEO, Glass Lewis).

123. *Id.*

Congress and the SEC between 2010 and 2013,[124] the release of SLB-20 in 2014,[125] and threats of stricter legal and regulatory intervention, proxy advisory firms have not allowed companies an open door for reviewing their work. Despite some recent improvements, the large proxy advisors are still only mildly responsive to feedback. For example, "Glass Lewis developed a new process in 2015 by which companies can receive a draft data-only version of a report for review before the firm completes its analysis."[126] ISS has also improved its openness, offering reports "contain[ing] ISS's analyses and vote recommendations."[127] Both ISS and Glass Lewis have made it clear, however, that they only allow companies the opportunity to check data for factual errors. They do not allow "a mechanism for conveying disagreement with [their] methodologies or analyses."[128]

Regarding conflicts of interest, it is unlikely that the SEC will adopt an approach that prohibits ISS from providing services to both institutional investors and public corporations at the same time. Procedures that are designed to prevent an exchange of information between the corporate side and the investors side (so-called Chinese walls) cannot function as a hermetic seal to prevent two-way communication between the groups.[129]

To summarize, even the procedural mechanisms designed to improve proxy advisory firms' operations—mainly by proposed legislation that has been up in the air now for almost two years—may still allow those firms a large amount of discretion regarding how they will comply with these new procedures.[130] Therefore, these mechanisms cannot guarantee real improvement of proxy advisory firms' quality of services.

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124. For records of such discussions, see generally SEC Concept Release, *supra* note 62; *Hearing*, *supra* note 1; SEC Roundtable, *supra* note 7.

125. SEC Staff Legal Bulletin No. 20 (June 30, 2014), https://www.sec.gov/interps/legal/cfslb20.htm.

126. GAO 2016, *supra* note 27, at 28.

127. *Id.* at 29. These reports are offered to Standard and Poor's 500 companies and some large international companies. *Id.* The companies have the opportunity to review the reports and provide feedback within 1–2 business days. *Id.*

128. *Id.* at 28–29.

129. *See* SEC Roundtable, *supra* note 7, at 123–24 (statement of Michael Ryan, Vice President, Business Roundtable) (noting that Chinese firewalls designed within ISS did not prevent communication between the corporate side and the institutional side).

130. Eckstein, *supra* note 30, at 116.

IV. THE PROPOSED INCENTIVE PAY SCHEME FOR PROXY ADVISORY FIRMS

A. A Proposed Model

In this Subpart, we will propose an incentive pay structure that we believe will properly regulate proxy advisory firms. We illustrate the structure and importance of our proposal with a real-life, recent example. On September 28, 2015, The Williams Companies, Inc. ("Williams"), a publicly traded energy infrastructure corporation, entered into a merger agreement with Energy Transfer Equity ("Energy Transfer").[131]

According to the merger agreement, at the effective time, each issued and outstanding share of Williams common stock would be cancelled and converted into the right to receive the consideration of the merger.[132] Such consideration would be, at the election of each Williams stockholder, either $43.50 in cash, stock, or mixed consideration in Energy Transfer.[133] The deal was valued at about thirty-eight billion dollars, and would have created one of the world's largest energy infrastructure companies, alongside competitors Kinder Morgan Inc. and Enterprise Products Partners L.P.[134] Williams' share price just prior to announcing the deal on September 25, 2015, was $41.60.[135] This was the deal that Williams shareholders were asked to approve, and that proxy advisory firms had to advise.

Importantly for our purposes, three out of the four proxy advisory firms that covered the vote—ISS, Egan-Jones, and Pensions & Investment Research Consultants Limited ("PIRC")[136]—

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131. The Williams Companies, Inc., Current Report (Form 8-K) (Sept. 28, 2015), https://www.sec.gov/Archives/edgar/data/107263/000119312515329829/d20025d8k.htm. Energy Transfer included Energy Transfer Equity, L.P., Energy Transfer Corp LP, Energy Transfer Corp GP, LLC, LE GP, LLC, and Energy Transfer Equity GP, LLC. *Id.*

132. *Id.*

133. The Williams Companies, Inc., Proxy Statement (Schedule 14A) (Sept. 28, 2015), https://www.sec.gov/Archives/edgar/data/107263/000119312515330719/d31611ddefa14a.htm.

134. *Energy Transfer Equity to Combine With Williams*, THE WILLIAMS COMPANIES, INC. (Sept. 28, 2015, 7:00 AM), http://jnvestor.williams.com/press-release/williams/energy-transfer-equity-combine-williams.

135. *The Williams Companies, Inc. (WMB)*, YAHOO FIN., https://finance.yahoo.com/quote/WMB/history?period1=1443214800&period2=1443214800&interval=1d&filter=history&frequency=1d (last visited Dec. 7, 2018) (documenting the closing share price on September 25, 2015).

136. PIRC "is Europe's largest independent corporate governance and shareholder advisory consultancy" and it was founded in 1986. *See About Us*, PIRC, http://pirc.co.uk/about-us-1 (last visited Dec. 7, 2018); *see also* EUROPEAN SEC. & MKTS. AUTH., AN OVERVIEW OF THE PROXY ADVISORY INDUSTRY. CONSIDERATIONS ON POSSIBLE POLICY OPTIONS 10 (Mar. 22, 2012), https://www.esma.europa.eu/sites/default/files/library/2015/11/2012-212.pdf.

recommended that Williams stockholders vote "FOR" the proposed transaction with Energy Transfer.[137] Only Glass Lewis recommended that Williams shareholders vote "AGAINST" the proposed transaction.[138]

Ultimately, the shareholders never had a chance to vote on the deal. The buyer, Energy Transfer, withdrew from the deal.[139] Williams' share price on the closing day of June 24, 2016, the day the deal broke apart, was $21.31.[140] Williams' share price half a year later, on December 23, 2016, was $31.56,[141] and one year later, on June 23, 2017, it was $28.75.[142]

In hindsight, Williams shareholders lost a lot of money because of the termination of the deal. However, Glass Lewis, who was against the deal, and had the bid not been withdrawn might have caused its clients to vote against it, did not bear any direct cost.[143] In contrast, ISS, Egan-Jones, and PIRC, who were all in favor of the

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137. *Three Out of Four Leading Proxy Advisory Firms – ISS, Egan-Jones and Pensions & Investment Research Consultants – Recommend Williams Stockholders Vote "FOR" the Merger Agreement With ETE*, WILLIAMS COMPANIES, INC. (June 20, 2016, 9:04 AM), https://investor.williams.com/press-release/williams/three-out-four-leading-proxy-advisory-firms-%E2%80%93-iss-egan-jones-and-pensions-inv.

138. *Id.*

139. The deal was in doubt for months, with Williams accusing Energy Transfer of actively trying to break the deal. Williams Companies, Inc. v. Energy Transfer Equity, L.P., C.A. No. 12168-VCG, 2016 WL 3576682, at *1 (Del. Ch. June 24, 2016), *aff'd*, 159 A.3d 264 (Del. 2017). The two companies sued each other. Finally, on June 24, 2016, Vice Chancellor Glasscock of the Delaware Court of Chancery ruled that Energy Transfer was entitled to terminate its merger with Williams, culminating one of the most contentious cases of buyer's remorse in recent memory. *See id.* at *2.

140. *The Williams Companies, Inc. (WMB)*, YAHOO FIN., https://finance.yahoo.com/quote/WMB/history?period1=1466802000&period2=1466802000&interval=1d&filter=history&frequency=1d (last visited Dec. 7, 2018) (documenting the closing share price on June 24, 2016).

141. *The Williams Companies, Inc. (WMB)*, YAHOO FIN., https://finance.yahoo.com/quote/WMB/history?period1=1482530400&period2=1482530400&interval=1d&filter=history&frequency=1d (last visited Dec. 7, 2018) (documenting the closing share price on Dec. 23, 2016).

142. *The Williams Companies, Inc. (WMB)*, YAHOO FIN., https://finance.yahoo.com/quote/WMB/history?period1=1498251600&period2=1498251600&interval=1d&filter=history&frequency=1d (last visited Dec. 7, 2018) (documenting the closing share price on June 23, 2017).

143. Because Energy Transfer backed out of the deal and not Williams, we do not argue that Glass Lewis' stance against the deal had anything to do with the breakdown of the proposed merger. However, the demise of the proposed merger provides an opportunity to evaluate the quality of Glass Lewis' advice against the deal, and therefore the application of our fee structure is pertinent. In other cases, were shareholders to reject the deal *because* of the advice of the proxy advisor, it seems even more suitable that the proxy advisor share the fate of the shareholders who rejected the deal, but this is not a necessary condition for our proposed fee structure. *We seek no causal link between the advice of the proxy advisor and the fate of the deal.*

deal, did not receive any reward for their recommendation, even though at least in hindsight it seems they provided valuable advice.

Our proposed pay scheme aims to correct both related shortfalls, and thus improve proxy advisors' incentives to provide thoughtful advice. Figure 1 below delineates the basic concept we propose.[144] The current flat-fee structure should be replaced, at least in part, with incentive pay.[145] Specifically, proxy advisors should be placed in a long position on the stock of the target in case the bid is rejected (or withdrawn) in line with an "AGAINST" recommendation of a proxy advisor.[146] This is because a proxy advisor that is against the bid should manifest its belief in the long-term, stand-alone value of the target.[147] A long position is such a bet on the long-term value of the shares.

However, if the bid is rejected (or withdrawn) in contradiction to a "FOR" recommendation of a proxy advisor, a proxy advisor should be placed in a short position on the stock of the target.[148] This is because a proxy advisor that is for the merger should manifest its belief that the long-term, stand-alone value of the target would not meet the merger price.[149] A short position is such a bet against the long-term value of the shares. Finally, if the bid is accepted, the target stock would no longer trade on the stock exchange. Hence, in such a case, and whether or not a proxy advisor was for or against the deal, a flat-fee pay scheme would be used.[150] Figure 1 reflects the key elements of our proposed fee structure.

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144. *See infra* Figure 1.

145. *Id.*

146. *Id.*

147. In a similar vein Professor Lucian Bebchuk once suggested that corporate managers who advocate the rejection of a hostile takeover should buy their company's stock. *See* Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973, 1002 (2002) ("[M]anagers that view the target's independent value as significantly higher than the bid price might elect to take steps that would credibly signal that their recommendation is indeed based on their genuine estimate of the target's value. For example, managers could so signal by committing themselves, in the event that the bid fails, to spend some of their own funds to purchase from the company at the bid price some specified number of shares and hold them for a specified period of time.") (emphasis omitted).

148. *See infra* Figure 1. Note that as long as the proxy advisor maintains this short position it has a contrarian interest to the shareholders of the target. This probably means that during this period the proxy advisor should be barred from providing voting recommendations, at least on significant matters that involve discretion. Given that this proxy advisor made a recommendation to sell the company (which shareholders rejected), such cooling off period may be advisable even in the absence of our fee scheme. Whether or not the proxy advisor is in a short position, it may have an interest to show that the forsaken acquisition, against its advice, was a wrong decision by the shareholders.

149. *See id.*

150. *See id.*

FIGURE 1

	Proxy Advisor Recommends to Vote "FOR"	**Proxy Advisor Recommends to Vote "AGAINST"**
Shareholders Accept the Recommendation	Fixed Fee	Long
Shareholders Reject the Recommendation	Short	Fixed Fee

The conceptual idea manifested in Figure 1 is achievable if we use part (or all) of the advisory fee to buy suitable forward agreements on the stock of the target.[151] We shall illustrate how this plays out in the Williams example. Imagine that a certain part of the advisor's currently fixed fee (say, $100,000) was used to purchase forward agreements on Williams stock. Let us turn first to Glass Lewis, which recommended rejecting the bid. In such a case Glass Lewis would receive a forward agreement to buy Williams stock for $43.50, which is the price of the deal. In contrast, ISS (or Egan-Jones or PIRC), which recommended accepting the bid, would receive a forward agreement to sell the Williams stock for $43.50. Figure 2 below illustrates the payoff structure that Glass Lewis would face when holding such a forward agreement to buy Williams stock.

151. To administer our proposed fee arrangement, the proxy advisor and its clients would require the assistance of a trustee, as is customary in employee equity-based compensation plans, which have some resemblance to our case. *See, e.g.*, *How an Employee Stock Ownership Plan (ESOP) Works*, NAT'L CTR. FOR EMP. OWNERSHIP, https://www.nceo.org/articles/esop-employee-stock-ownership-plan (last visited Dec. 7, 2018). The main task of the trustee would be to buy the requisite forward agreements on the market and hold them for the proxy advisory firm to prevent resale of the forward agreements. In a similar vein, the proxy advisor must commit not to hedge against the forward agreements in any manner. If the trustee cannot buy the forward agreement on the market it will have to find a third party that would be the opposite side of the transaction. The administration of this scheme would certainly involve costs, but given the benefits for the proposal, we believe the costs would be far from prohibitive.

FIGURE 2

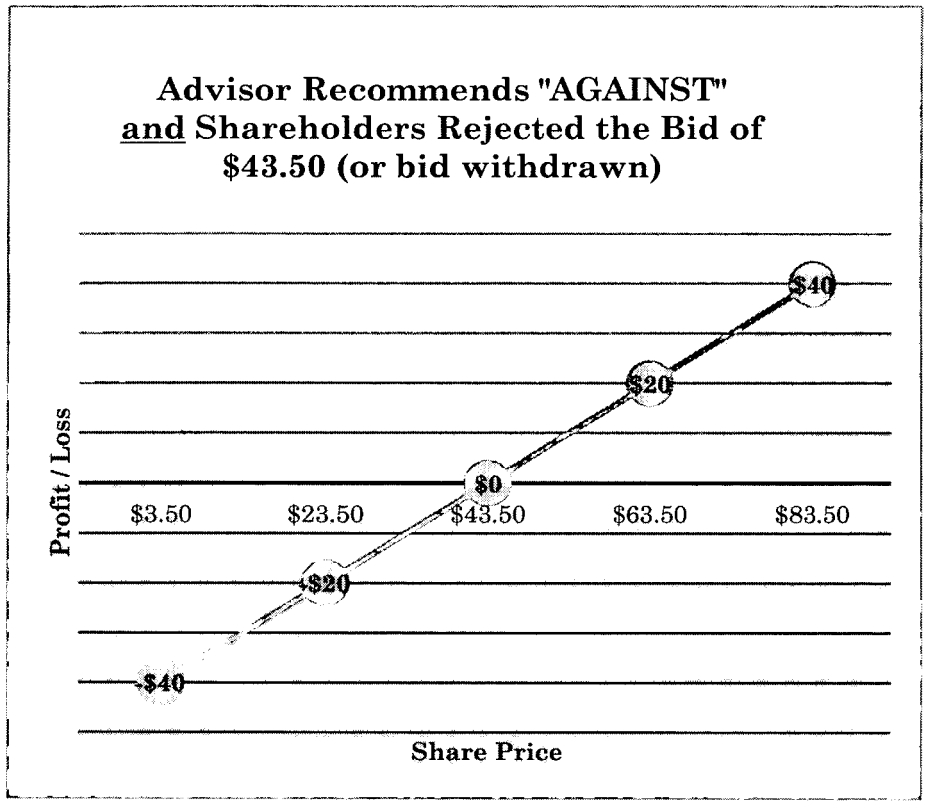

Figure 2 shows that a forward agreement (to buy the shares of Williams for the strike price of $43.50) yields a profit of one dollar for any dollar that Williams' share price tops the deal price upon the closure of the agreement.[152] When Williams' share price passes the deal price, the forward agreement promises its holder to buy Williams shares below their market price.[153] Alternatively, if Williams' share price upon termination of the forward agreement falls short of $43.50, Glass Lewis would bear a loss.[154] The reason for the loss is that the forward agreement would compel Glass Lewis in such a case to buy Williams shares above their market price.

This fee structure, therefore, would put Glass Lewis in the same boat as the Williams shareholders, at least in part. The length of the forward agreement should be a reasonable period of time in which the benefits of rejecting the deal (as Glass Lewis advised) should materialize. Perhaps a one-year time frame is too short for such

152. *See supra* Figure 2.
153. *See id.*
154. *See id.*

purpose, but if this were the period used, then the results would be quite grim for Glass Lewis. Recall that the share price of Williams a year after the deal broke apart ($28.75) is significantly below the deal price ($43.50).

How much exactly would Glass Lewis lose? Assume, for the sake of simplicity, that Glass Lewis received a forward agreement for 2500 shares (the exact number being $100,000 divided by the price of the future agreement to buy shares for $43.50 per share).[155] Let us also assume, for the sake of this example, that the forward agreement is designed to terminate one year after the termination of the deal. Based on the June 23, 2017 share price, this means that Glass Lewis would bear a loss of approximately $37,000 (the result of $14.75 multiplied by 2500) out of its $100,000 advisory fees for the transaction. As we shall see, Glass Lewis' loss is the mirror image of the gain that ISS (and the other proxy advisors that were for the deal) would make under our proposed fee structure.[156] And, no less important than its direct financial impact, this novel compensation scheme would allow both clients and proxy advisors, as well as the market, to quantify the quality of the advice.[157]

Let us turn to the fee structure of proxy advisors that recommend voting "FOR" the merger. Figure 3 below illustrates the payoff to the proxy advisors (ISS, Egan-Jones, and PIRC) that were in favor of the deal in the Williams case.

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155. The actual price of a forward agreement should equal the current price of the stock on the market together with interest (at the risk-free rate) for the period until the expiration of the agreement, subject to adjustments for dividends. To see why, assume that the holder of the forward agreement also buys a share of the company by borrowing money for this purpose. When the forward agreement expires, the holder also sells her share. This means she has no exposure but for paying interest of the loan. Recall, however, that our proxy advisor is prohibited from hedging her forward position and therefore cannot buy shares of the company.

156. For example, in its 2013 annual report, ISS, then-owner of MSCI Inc. ("MSCI"), reported: "revenues related to our ISS Corporate Services products and services represented 29.2% of our Governance business total revenues." MSCI Inc., Annual Report 2013 (Form 10-K) 10 (Feb. 28, 2014). As reflected in the annual report: "Revenues related to [MSCI] governance products decreased 0.7% to $122.3 million for the year ended December 31, 2013." *Id.* at 67. This means that ISS revenue for 2013 was $35.7 million and, based on MSCI's net income/revenue ratio, we estimate ISS's annual profit was about $7 million. Hence, in order to achieve a substantial impact on the profits of the proxy advisor, one may need to increase the use of incentive fees beyond the figures in the text above (by multiplying the amount of shares subject to the forward agreement).

157. The regulator may wish to take advantage of this quantification and require public disclosure. In a similar manner, Nationally Recognized Statistical Rating Organizations are required today to disclose extensive information about their performance. Eckstein, *supra* note 14, at 257.

FIGURE 3

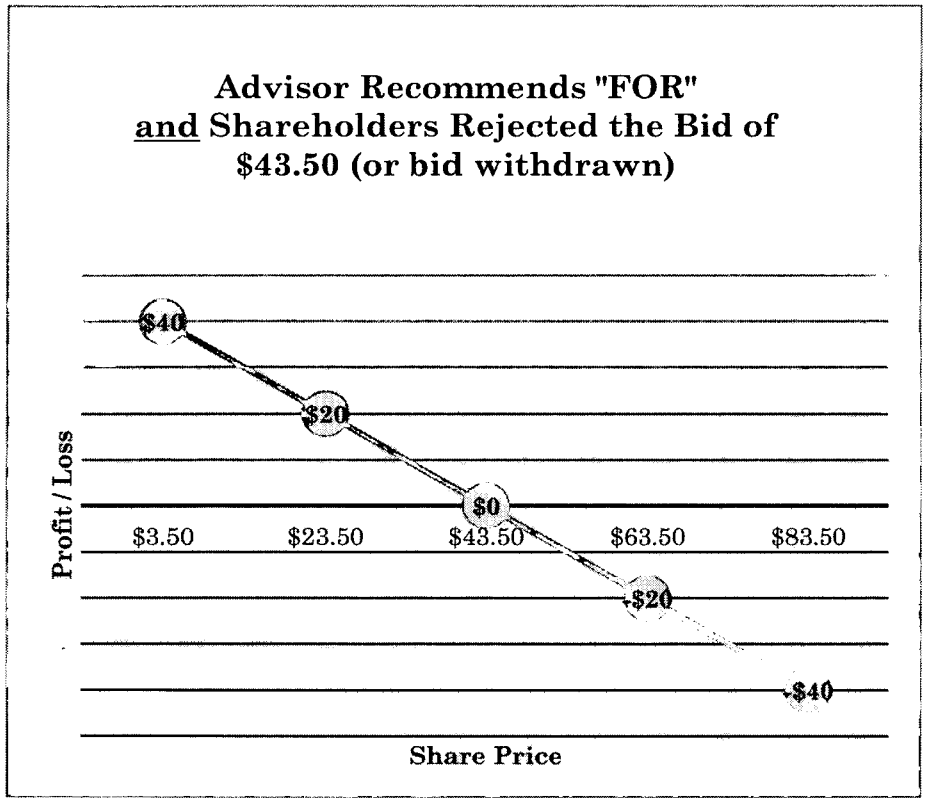

Figure 3 shows that a forward agreement (to sell the shares of Williams for a strike price of $43.50) yields a profit of one dollar for any dollar that Williams' share price *falls short* of the deal price upon the closure of the agreement.[158] When Williams' share price passes the deal price, however, the forward agreement requires its holder to sell Williams shares below their market price.[159] For instance, if Williams' share price reached $50 when the forward agreement terminates, then the proxy advisor would have to purchase Williams shares in the market for $50 and sell it in accordance with the forward agreement for $43.50 (in reality the agreement settles on the difference—$6.50—without execution of the buy-and-sell transactions).

The opposite is true if Williams' share price upon termination of the forward agreement falls short of $43.50, yielding a profit for ISS. In such a case, the forward agreement requires ISS to sell Williams shares above their market price. Recall that ISS was for the deal. Its

158. *See supra* Figure 3.
159. *See id.*

advice to the shareholders was to get rid of their shares for $43.50. If this turns out to be good advice, given that Williams shares fall short of this price after the deal breaks down, ISS would gain from it. In the contrary scenario—ISS would lose.

The benefits of our proposed fee structure are quite straightforward. Our model of a long/short compensation scheme improves proxy advisors' incentives, which in turn makes their recommendations more credible. This incentive-aligning compensation scheme therefore alleviates concerns that were recently voiced by Congress, the SEC, practitioners, and the media.[160] Unlike the current flat-fee structure, under our proposed fee structure the proxy advisor may suffer a direct financial loss from what turns out to be a bad recommendation. Similarly, the proxy advisor can now profit from a good recommendation. In other words, the proxy advisor now has substantial skin in the game. Indeed, our incentive fee scheme kicks in only when the deal breaks apart. However, the incentives are generated ex ante, when the proxy advisor provides its recommendation before the fate of the bid is clear. Given that the annual volume of rejected or withdrawn bids is enormous,[161] proxy advisors should always be ready to bear the financial consequences of their recommendations. We now move on to a discussion of possible objections to our proposed fee structure and additional questions raised by our model.

B. The Need for an Incentive-Based Fee Structure—Further Analysis

1. The Insufficiency of Reputational Mechanisms

Flat-fee structures, by themselves, provide little incentive, if any, for proxy advisors to invest necessary efforts and produce optimal recommendations. However, one might argue that reputational forces may overcome this weakness. After all, proxy advisors have sophisticated clients, institutional investors, that may discontinue the proxy advisor's services if it does not provide good advice. Put differently, why do we not believe in proxy advisors' reputational concerns and related market mechanisms?

We are hardly the first to identify the weakness in the existing forces that motivate proxy advisors to operate well. The vocal criticism against proxy advisory firms and the calls for stricter legislation and regulation implies much disbelief in these forces.[162] There are a few good reasons to doubt the ability of reputational concerns and other market mechanisms to perfect proxy advisors' incentives. First, it is often hard for outside observers to judge the

160. *See* Eckstein, *supra* note 14, at 230–33.
161. *See* TOOLE, *supra* note 20, at 9.
162. *See supra* Subpart II.C.

quality of the proxy advisor's advice. Even if the result of the advice is bad, it is hard to pass judgment on its ex ante quality because no one expects a proxy advisor to perfectly predict future developments.

Recall that proxy advisors insist on not disclosing the methodologies used to arrive at their voting recommendations.[163] Proposed legislation aims to improve transparency, but as discussed earlier, we doubt that it will have a meaningful impact. With such a nontransparent decision-making process, it is quite hard to pinpoint weaknesses in the analysis conducted by the proxy advisor. Moreover, most voting recommendations involve complex facts and many uncertainties. Hence, it is difficult to conclude that certain advice was indeed faulty. Therefore, poor advice may not translate into an acute reputational penalty.

Second, given that the industry is governed by a de facto duopoly (ISS and Glass Lewis dominate approximately ninety-seven percent of the advisory market),[164] and given the nontrivial entry barriers to the industry,[165] competitive pressures to perform well are compromised. As noted by then-acting SEC Commissioner Michael Piwowar, "[There] appears to be a stable duopoly preserved by near-impenetrable barriers for new entrants."[166]

Third, in addition to business needs, regulation promotes institutional investors' use of proxy advisory services. When clients subscribe to a certain service out of their free will, their revealed preference testifies to the benefits of the service for them. However, when services are required or promoted by the regulator, there is less reason to believe in the quality of those services. This problem, termed the problem of "regulatory licenses," is well known in the market for rating agencies,[167] but it also exists to some degree in the market for proxy advice. In 2004, the SEC indicated that reliance on proxy advisory firms may remove the votes of institutional investors from any suspicion of conflict of interest.[168] This position, which gave

163. *See* GAO 2016, *supra* note 27, at 28–30.

164. GLASSMAN & VERRET, *supra* note 55.

165. *See Hearing*, *supra* note 1, at 30–31 (statements of Niels Holch, Executive Director, Shareholder Communications Coalition, and Lynn E. Turner, Managing Director, LitiNomics); *see also supra* notes 57–58 and accompanying text.

166. SEC Roundtable, *supra* note 7, at 18 (statement of Michael S. Piwowar, Comm'r, SEC).

167. *See* Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 682–86 (1999) ("Absent regulation incorporating ratings, . . . rating agencies sell information and survive based on their ability to accumulate and retain reputational capital. However, . . . [with the regulation of credit ratings since the 1970s,] rating agencies begin to sell not only information but also the valuable property rights associated with compliance with that regulation.").

168. Eckstein, *supra* note 30, at 93 (explaining how no-action letters issued by the SEC in May and September 2004 interpreted SEC rules in a manner that

a significant boost to the proxy advisory industry,[169] also compromises, to some extent, the market powers that should guarantee smooth performance of the proxy advisors. The regulator's promotion of those services may be a good enough reason to use them, even if proxy advisors do not perform optimally.

2. The Persistence of the Current Fixed Fee Structure

Given the suboptimal nature of the current flat-fee structure, one may wonder why an incentive fee structure has not emerged in the proxy advisory industry previously. One answer is that some of the aforementioned forces that prevent market mechanisms and reputational concerns from working well also impede the creation of a proper incentive structure. To start with, as explained above, if institutional investors use the services of proxy advisors not only for their skills but also because the regulator pushes them do to so, the quality of the advice becomes less important.[170] In such a setting, it is no wonder that incentive pay schemes do not evolve.

Second, given the market concentration in the proxy advisory industry, the two major proxy advisory firms (ISS and Glass Lewis) have little reason to change their pay practices. They have little incentive to rock the boat and compete with one another on any front, including (or especially) in relation to their fees.

Moreover, the current flat-fee arrangement is particularly comfortable for the existing larger players in the industry because it deters the entry of other firms. Currently, with a flat-fee structure, there is no way to signal quality with the fee structure of proxy advisory services, and therefore reputation is the main avenue of quality assurance. A newcomer to the industry or a small competitor may find it very hard to signal its quality.[171] In sharp contrast to the current scheme, an incentive pay scheme may promote entry to the industry by allowing a high-quality player to put its money where its mouth is and establish its reputation based on high-quality recommendations and advice. From the point of view of the incumbent large players, this is a frightening possibility, and they have good reason to preserve the status quo.

Finally, another good explanation for the nonexistence of incentive fees in the proxy advisory industry lies in the fact that proxy advisors' clients—institutional investors—are themselves under regulation that restricts their ability to receive incentive fees.

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allows institutional investors to overcome conflicts of interest by relying on proxy advisory firms).

169. *Id.* at 147.

170. *Id.* at 93.

171. *See generally* George A. Akerlof, *The Market for "Lemons": Qualitative Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970) (explaining, in a seminal paper, how quality uncertainty may reduce incentives for sellers of high-quality goods to enter the market).

Institutional investors are financial intermediaries that invest on behalf of the pubic. To prevent excessive risk-taking (in the selection of investments) the relevant regulators of the different institutional investors act against unrestricted incentive fee structures.[172] The results are, for instance, that "97% of all funds, accounting for 92% of all mutual fund assets, charge fees based on a flat percentage of the fund's assets under management."[173]

The abovementioned regulation against unrestricted incentive fee structures of institutional investors translates into an environment that does not promote such fee structures for their own service providers—proxy advisory firms. The logic behind the restrictions on certain incentive fee structures for institutional investors does not apply, however, to incentive fees for proxy advisors. Such fee structures may improve proxy advisors' voting recommendations without leading to excessively risky investments. But perhaps it is too much to expect institutional investors, barred from charging success fees from their clients, to require such a fee structure from their proxy advisors.

3. Voluntary Versus Mandatory Arrangements

The current flat-fee structure is a sticky arrangement, in the sense that it will be hard to change it even if it is suboptimal, as we suspect it to be. The existing players in the industry—large proxy advisors and their clients—are unlikely to change it for the reasons we delineated above.[174] Despite the inefficiency of the flat-fee structure, we do not suggest making the incentive fee structure proposed in this Article mandatory. Our proposal is likely to be optimal and useful under certain conditions but not under others. When and precisely how to use our proposed fee structure is hardly possible for the regulator to decide optimally, and it is preferable to leave the design of the exact arrangement to the market players.

Moreover, a one-size-fits-all solution might not fit. Our fee structure is perhaps suitable only for certain M&A transactions.[175]

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172. For example, § 205(a)(1) of the Investment Advisers Act of 1940, prevents investment advisers from taking unwarranted risks by ordering that their "[p]erformance fees must be symmetrical, such that if fees are higher than normal after a good year, they must also be lower than normal after a bad year." *See* Investment Advisers Act of 1940, 15 U.S.C. § 80b-5(a)(1) (2012); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1050 (2007); *see also* Edwin J. Elton et al., *Incentive Fees and Mutual Funds*, 58 J. FIN. 779, 780 (2003); Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225, 275–77, 312 (2007); Linlin Ma et al., *Portfolio Manager Compensation in the U.S. Mutual Fund Industry*, J. FIN. 6–7 (forthcoming), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2024027.

173. Kahan & Rock, *supra* note 172, at 1051.

174. *See supra* Subpart IV.B.2.

175. Recall that our model is designed to apply to cases where a bid is rejected, either in line with an "AGAINST" recommendation of the proxy advisor or in

The size of the information gap between the proxy advisor and its clients in a given case, the strength of the opinion of the proxy advisor about the particular transaction, and the extent of the dispersion of ownership in the target company[176] are but a few examples of the relevant factors that could make our proposal more desirable.

As we discuss below, we believe that a considerable nudge from the regulator is required in order to implement our proposal. Nevertheless, our proposed arrangement should not be mandated but rather structured as an option for the proxy advisor to use whenever it wants to fortify its recommendation and signal its quality and conviction.[177] The arrangement would work best if the market players crafted the scheme themselves and used it in the right circumstances.

Moreover, as mentioned above, there are major features of the arrangement that should be tailored by the market and not by the regulator. One such feature is the length of the forward-agreement period under our proposed arrangement.[178] For instance, if the proxy advisory firm advocates against a deal because the full stand-alone value of the target should materialize in two years, then the proxy advisor's long position under our plan should close at the end of such period. Another issue the parties may wish to consider is whether the proxy advisor should keep the option to ask for a release from the incentive scheme at the time the proxy advisor provides its recommendation. This would allow the proxy advisor to signal that it has no strong view about the benefits of the proposed merger when asking for the release, and would fortify its position regarding the bid when the proxy advisor does not ask for such release.[179]

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contradiction to a "FOR" recommendation of the proxy advisor. *See supra* Figure 1.

176. When ownership is more dispersed, the opinion of the proxy advisor is more important because there is less incentive for each shareholder to make in depth inquiries into the desirability for the proposed M&A transaction. Hence, the incentives of the proxy advisor are more important in such setting. *See supra* Subpart III.E.

177. Leaving the door open for the proxy advisor not to use the incentive fee structure when it does not have a strong opinion may prevent a perverse incentive. Because the incentive fee structure becomes operative only when the shareholders reject the deal, a proxy advisor that has a *mild* negative opinion about the deal may nevertheless encourage the shareholders to approve the deal. Such an affirmative vote would prevent any exposure from a wrong bet against the deal. Therefore, when the proxy advisor can forgo the incentive scheme and reveal its mild recommendation against the deal, all parties benefit. Eckstein, *supra* note 14, at 245–46.

178. *See supra* Subpart IV.A.

179. Carrying this logic even further, the parties may wish the proxy advisor to multiply its "bet" on the bid based on its belief about the quality of the bid - either for or against the bid. For example, a multiple of two means that the proxy advisor would lose or gain two dollars instead of one dollar in our original framework.

For all of these reasons, we do not believe in a mandated fee arrangement. The inefficiencies of the flat-fee structure should be tackled in other ways. One simple and hopefully effective way would be for the relevant regulators to encourage use of the incentive fee structure. Recall that SLB-20 requires institutional investors that retain proxy advisory firms to undertake due diligence to ensure that such firms have the capacity and competency to adequately analyze proxy issues.[180]

In this regard, SLB-20 suggests that institutional investors consider whether proxy advisory firms have proper resources and robust policies and procedures.[181] SLB-20's silence regarding advisory fees is puzzling and needs to be corrected. We suggest amending SLB-20 to require institutional investors to contemplate whether the advisory fee arrangement promotes effective performance. Specifically, the regulator should require institutional investors to consider if the advisory fee structure should be sensitive, at least in part, to proxy advisors' performances. Given the significant influence of the SEC on the industry, such a regulatory push, even in the form of the SEC's interpretive guidance, may be sufficient to tilt the industry towards more efficient fee structures.[182]

4. Risk-Aversion Costs

One type of cost that our proposed fee structure entails is the risk-taking cost that the current flat-fee structure evades. Even good advice may bring about a bad result, and bad advice may bring about a good result. For our proposal to work, there only needs to be a high correlation between the quality of the advice and the outcome, but we acknowledge the existence of random results. Therefore, unlike the current flat-fee arrangement, our proposed incentive fee scheme exposes proxy advisors to risk. The proposed arrangement therefore entails a real cost—a risk-aversion cost. Accordingly, proxy advisors should react to this newly imposed cost and try to compensate for it

180. SEC Staff Legal Bulletin No. 20 (June 30, 2014), https://www.sec.gov/interps/legal/cfslb20.htm.

181. *Id.*

182. In that respect, it should be noted that although in theory the SEC's interpretive releases do not have a legally binding effect on the regulated entities, they are highly effective in practice. *See* Donna M. Nagy, *Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework*, 83 CORNELL L. REV. 921, 966–67 (1998) (showing how courts tend to defer to the SEC's regulatory interpretations in no-action letters); *see also* Robert A. Anthony, *Three Settings in Which Nonlegislative Rules Should Not Bind*, 53 ADMIN. L. REV. 1313, 1314 (2001) ("[T]he practical binding effect of an interpretive guidance is a function of the likelihood that it will be challenged in court, and then of the likelihood that the court will uphold the guidance."); Richard J. Pierce, Jr., *Seven Ways to Deossify Agency Rulemaking*, 47 ADMIN. L. REV. 59, 84–85 (1995) (explaining how interpretative rules and policy statements influence courts).

by increasing their fees.[183] Put differently, proxy advisory services will be more expensive under the new proposal. The benefits of our proposed plan—improved incentives and better advice—should outweigh these costs.

A short comparison to the common use of share-based compensation for executives and employees in public corporations[184] reveals that risk-bearing costs are unlikely to be prohibitive. Share-based (or equity-based) compensation, such as restricted stock and stock options, brings about huge risk-bearing costs to executives.[185] This means that stock-based remuneration is more expensive to corporations than payment of regular salaries, and total compensation indeed skyrocketed because of the generous use of these mechanisms.[186] Notwithstanding these tremendous costs, however, public corporations insist that around forty percent of total pay is granted to senior managers in the form of stock-based compensation.[187]

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183. *See generally* Canice Prendergast, *The Tenuous Trade-off Between Risk and Incentives*, 110 J. POL. ECON. 1071 (2002) (showing that when firms choose performance pay, they trade the benefits of greater effort for higher wage costs that are intended to offset the risk on advisor compensation).

184. *See, e.g.*, *Employee Stock Options Fact Sheet*, NAT'L CTR. FOR EMP. OWNERSHIP, https://www.nceo.org/articles/employee-stock-options-factsheet (last visited Dec. 7, 2018) ("Broad-based options remain the norm in high-technology companies and have become more widely used in other industries as well. Larger, publicly traded companies such as Starbucks, Southwest Airlines, and Cisco now give stock options to most or all of their employees. Many non-high tech, closely held companies are joining the ranks as well.").

185. "Employees are typically risk-averse. The value of stock-based compensation . . . is highly contingent on risk factors and uncertainties that are far beyond the control of the recipient employees." Sharon Hannes, *Reverse Monitoring: On the Hidden Role of Employee Stock-Based Compensation*, 105 MICH. L. REV. 1421, 1437 (2007). "Risk-averse employees therefore discount the value of stock-based compensation." *Id.* Firms could substitute this type of compensation with a much lower payment in cash that does not entail uncertainty. The difference between the two alternatives is the cost, or the waste, involved in stock-based compensation. Under reasonable assumptions about risk aversion and diversification, it is estimated that employees value options at "only about half of their cost to the firm." Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSP. 49, 56 (2003); *see also* Brian J. Hall & Kevin J. Murphy, *Optimal Exercise Prices for Executive Stock Options*, 90 AM. ECON. REV. 209, 211 (2000); Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, 33 J. ACCT. & ECON. 3, 12–13 (2002); Hannes, *supra* at 1437–38.

186. Kevin J. Murphy, *Executive Compensation: Where We Are, and How We Got There*, *in* HANDBOOK OF THE ECONOMICS OF FINANCE 211, 274–75 (George M. Constantinides et al. eds., 2013) ("As shown in Figure 17 (and Figures 3 and 4), the median pay for CEOs in S&P 500 firms more than tripled between 1992 and 2001, driven by an explosion in the use of stock options.").

187. *Pay for Performance Becomes More Dominant in CEO Comp Plans*, EQUILAR (Sept. 20, 2017), http://www.equilar.com/press-releases/84-pay-for-performance-equity-trends-report.html ("In fiscal year 2016 alone, the percentage of Equilar 500* companies that provided at least half of CEO equity

The frequent use of stock-based incentive compensation for corporate executives is encouraging for our case as well. Our proposed fee scheme is also a stock-based compensation structure that we believe can improve valuable advice. Risk-bearing costs for proxy advisory firms seem to be modest in comparison to those born by corporate executives. Corporate executives are generally more vulnerable to this particular risk than proxy advisory firms for at least two reasons. First, the executive is an individual whereas the proxy advisory firm is a deep-pocketed entity, making it much less risk averse.[188] Second, unlike the executive, the proxy advisory firm can better diversify its portfolio by accepting this type of compensation from a few clients at the same time.[189] Finally, part of the risk-bearing costs that stem from movements in stock prices unrelated to the recommendation of the proxy advisor could be eliminated by neutralizing general stock market trends from the fee scheme.[190] Such improvement comes, however, at the cost of making the fee structure more complicated.

5. Increased Liability as an Alternative Solution

Liability and incentive compensation may sometimes serve as substitute solutions. Although these two methods are quite different, they can achieve similar results.[191] In the case of proxy advisory

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compensation based on performance awards increased from 52.5% to 60.8%."); *see also* Nuno Fernandes et al., *Are U.S. CEOs Paid More? New International Evidence*, 26 REV. FIN. STUD. 323, 328, 330 (2013) (showing that "equity-based pay (consisting of restricted stock, stock options, and performance shares) accounts, on average, for 39% of total pay for U.S. CEOs").

188. *See, e.g.*, Avraham D. Tabbach, *Criminal Behavior, Sanctions, and Income Taxation: An Economic Analysis*, 32 J. LEG. STUD. 383, 392 (2003) ("Under the standard assumption of decreasing absolute risk aversion (DARA), that is, the assumption that individuals become more risk averse as they become poorer . . . .").

189. Eckstein, *supra* note 14, at 260 (explaining that risk involved in proxy advisors' work "relative to a single public firm is well-diversified because many institutional investors hire proxy advisory firms to provide analysis and voting recommendations regarding thousands of public firms," and therefore risk-aversion consideration is less relevant to them). Diversification cannot, of course, alleviate the risk of the entire market fluctuations (so called "systematic risk"). For a discussion on market ("systematic") risk and diversification, see RICHARD A. BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE 154–72 (8th ed. 2006).

190. The strike price of the forward agreement could be adjusted to cancel out price movements of the market portfolio or a movement of the share price of a similar corporation. For example, if the rejected deal price was $43.50 and the entire market fell by 10% prior to the termination of the forward agreement, the strike price would be adjusted to $39.15 (90% of $43.50). This would mean that the proxy advisor that recommended against the deal would not lose if the share price of the target did not reach $43.50 (but reaches at least $39.15) at the end of the period because of market movements that are unrelated to the target company.

191. Sharon Hannes, *Compensating for Executive Compensation: The Case for Gatekeeper Incentive Pay*, 98 CAL. L. REV. 385, 433 (2010).

firms, liability is almost unheard of.[192] One might therefore suggest that instead of proposing an incentive-based fee structure, the proper reform should simply aim to increase potential liability of proxy advisory firms. This would, so the argument goes, bring about improved incentives to perform well without any need to replace the existing fee schemes.

However, any successful legal liability regime fundamentally relies on the plaintiff's ability to detect and verify wrongdoing (i.e., to prove it in court).[193] Where an agent's work is difficult to observe and verify, legal intervention is likely to be less useful as well as too costly.[194] As mentioned above, this is exactly the challenge posed by proxy advisory services.[195] Intensified liability is therefore not a promising solution for reform.

A good analogy for our proposal is once again the omnibus use of equity-based compensation for corporate managers. Similar reasoning applies to equity-based compensation for corporate executives and performance fee structures (of the type suggested in this Article) for proxy advisors.[196] Both arrangements generate performance incentives without the need to take anyone to court.[197]

Finally, beyond the obvious disadvantages that stem from the difficulty of observing and verifying the quality of proxy advisors' work, a legal liability regime inflicts sticks without offering carrots. It is one-dimensional in the sense that it imposes sanctions for

192. *See* George W. Dent, Jr., *A Defense of Proxy Advisors*, 2014 MICH. ST. L. REV. 1287, 1307 (2014). Courts understand this challenge, and this is perhaps why "no institutional investor has ever been held liable for failing to vote proxies or voting them 'incorrectly.'" *See id.*

193. *See, e.g.*, ROBERT D. COOTER & ARIEL PORAT, GETTING INCENTIVES RIGHT: IMPROVING TORTS, CONTRACTS, AND RESTITUTION 74 (2014) (explaining how "[t]raditional approaches to liability do not work when individual behavior is unverifiable, because officials cannot prove how much harm any injurer caused"); *see also* Lewis A. Kornhauser, *Constrained Optimization: Corporate Law and the Maximization of Social Welfare*, *in* THE JURISPRUDENTIAL FOUNDATIONS OF CORPORATE AND COMMERCIAL LAW 87, 97 (Jody S. Kraus & Steven D. Walt eds., 2000) (explaining how "[d]eterminations of liability and assessments of damages must depend only on verifiable actions or factors").

194. Hannes, *supra* note 191, at 390 ("More generally, since accounting and auditing standards involve many uncertainties and a fair amount of unpublicized information, the quality of much of the auditor's work is often unverifiable, unobservable, and, consequently, protected from legal penalty and even reputation backfire.").

195. *See supra* Subpart IV.B.1. In a similar vein, the risk of judicial errors constitutes a major justification for the Business Judgment Rule to shield executive decisions from judicial intervention. *See, e.g.*, Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 114–15 (2004); E. Norman Veasey & Christine T. Di Guglielmo, *What Happened In Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1422–24 (2005).

196. *See supra* Subpart IV.B.4; *see also* Hannes, *supra* note 191.

197. Hannes, *supra* note 191.

misconduct, but it does not provide rewards for success.[198] Our proposed performance fee structure is symmetrical and therefore offers both rewards and penalties. Moreover, the size of the sticks and the carrots can be easily calibrated by determining the fraction of the fees that will be subject to our proposal.[199]

V. SHORT SUMMARY AND FINAL NOTES

Our model of a long/short compensation scheme improves proxy advisors' incentives, which in turn makes their recommendations more credible. This incentive-aligning compensation scheme may therefore alleviate concerns that were recently voiced by Congress, the SEC, practitioners, and the media. Unlike the current flat-fee structure, under our proposed fee structure the proxy advisor may suffer a direct financial loss from its bad recommendation. Similarly, the proxy advisor can now profit from its good recommendation. Put differently, the proxy advisor now has substantial skin in the game.

The concentrated nature of the proxy advisory industry, the difficulty of observing the quality of given advice, and the regulatory push to use proxy advisory services, all compromise the ability of market forces to create proper incentives for proxy advisors. The combination of these factors makes our incentive-based fee structure a proper response in lieu of the current flat-fee structure.

In this Article, we illustrate our proposal in the context of M&A recommendations. Our framework, however, can be adapted to fit any vote that has significant potential impact on the value of a corporation. One good example could be contested elections for boards of directors. The same concept of long/short incentive scheme could be applied in this context. The proxy advisor should hold a long position on the stock of the corporation if shareholders accept the proxy advisor's recommendation for the slate of directors and should be placed in a short position if shareholders reject its recommendations. Instead of the deal price, the strike price of the forward contracts in this case could be the value of the shares of the corporation on the eve of the proxy advisor's recommendation.[200]

Ironically, proxy advisors would be wise to support our proposed incentive fee structure even if they actually perform flawlessly under the current flat-fee structure (an argument that we find hard to believe). As mentioned above, proxy advisory firms are subject to loud criticism for failing to operate efficiently and for holding immense

198. *See* Gerrit De Geest & Giuseppe Dari-Mattiacci, *The Rise of Carrots and the Decline of Sticks*, 80 U. CHI. L. REV. 341, 361 (2013) (explaining how carrots incentivize by effectively rewarding while sticks incentivize only by threatening).

199. Lawrence A. Cunningham, *Beyond Liability: Rewarding Effective Gatekeepers*, 92 MINN. L. REV. 323, 357, 361 (2007).

200. Unlike the M&A context, which requires rejection (or withdrawal) of the bid for our incentive fee scheme to apply, in the context of contested elections for the board the inventive pay scheme works every time the vote takes place.

power without having any responsibility.[201] The adoption of an incentive-based fee structure of the type advocated by this Article may therefore serve them right from a political economy point of view. A proxy advisor with such a fee structure manifests that its incentives are aligned with those of the shareholders of the corporation in question, and that it assumes responsibility for its advice. This is a perfect answer for critics.

Finally, proxy advisors argue that having no skin in the game is a virtue and not a sin. They argue that they wish to maintain their disinterested status, which in turn prevents biased advice.[202] We do not believe, however, that being disinterested is a panacea. We prefer that proxy advisors have a stake in their advice, as long as the incentives created by such a stake are calibrated correctly. We believe our model of a long/short compensation scheme adheres to this principle and improves the current suboptimal flat-fee structure. We therefore urge regulators to consider advocating for its adoption. Well-crafted incentives may do much better than the pending legislative initiatives.

201. *See supra* Subpart II.C.

202. *See* ISS, *supra* note 71, at A-12, A-12 n.16 (stating that "[b]ecause advisers are paid to render disinterested advice, fiduciary concerns arise when an adviser or its employees have a personal stake in the subject of their advice," adding that "[t]his fiduciary concern is the exact *opposite* of proxy adviser critics' suggestion that proxy advisers should have 'skin in the game'" and explaining that "[i]n fiduciary parlance, 'skin in the game' means 'conflict of interest'"); *see also* Letter from Gary Retelny, President, ISS, to Elizabeth M. Murphy, Sec'y, Sec. and Exch. Comm'n 14–15 (March 5, 2014), https://www.sec.gov/comments/4-670/4670-13.pdf (emphasizing that to have skin in the game is to have a conflict of interest).

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