



Report to the Chairman, Subcommittee  
on Economic Policy, Committee on  
Banking, Housing, and Urban Affairs,  
U.S. Senate

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November 2016

# CORPORATE SHAREHOLDER MEETINGS

## Proxy Advisory Firms' Role in Voting and Corporate Governance Practices

# GAO Highlights

Highlights of [GAO-17-47](#), a report to the Chairman, Subcommittee on Economic Policy, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

## Why GAO Did This Study

As institutional investment has grown over the last 30 years, institutional investors increasingly have relied on proxy advisory firms. The proxy advisory industry in the United States consists of five firms—two of which are the largest and most dominant proxy advisory firms. Some members of Congress, industry associations, and academics have raised issues about proxy advisory firms' influence on voting and corporate governance, the level of transparency in their methods, and the level of regulatory oversight.

GAO was asked to review the current state of the proxy advisory industry. This report discusses (1) the influence proxy advisory firms may have on voting and corporate governance, (2) how firms develop and apply policies to make vote recommendations, and (3) SEC's oversight activities. GAO reviewed literature; analyzed the proxy advisory firms' policies and SEC policies and examinations; and interviewed the 5 proxy advisory firms, 13 institutional investors, 11 corporate issuers, SEC officials, and industry stakeholders. GAO randomly selected corporate issuers from Standard and Poor's indexes and judgmentally selected institutional investors (based on size and type of investor) from industry associations' information.

GAO makes no recommendations in this report. GAO provided a draft to SEC for its review and received technical comments, which were incorporated as appropriate.

View [GAO-17-47](#). For more information, contact Michael Clements at (202) 512-8678 or [clementsm@gao.gov](mailto:clementsm@gao.gov).

November 2016

## CORPORATE SHAREHOLDER MEETINGS

### Proxy Advisory Firms' Role in Voting and Corporate Governance Practices

## What GAO Found

Institutional investors, such as pension plans and mutual funds, hire proxy advisory firms to obtain research and vote recommendations on issues, such as executive compensation and proposed mergers that are addressed at shareholder meetings of public corporations (corporate issuers). Market participants and other stakeholders with whom GAO spoke agreed that with the increased demand for their services, proxy advisory firms' influence on shareholder voting and corporate governance practices has increased. But recent studies, market participants, and stakeholders had mixed views about the extent of the influence. For example, some said influence can vary based on institutional investor size (there is less influence on large institutional investors that often perform research in-house and have their own voting policies).

Proxy advisory firms, specifically Institutional Shareholder Services and Glass Lewis & Company—the two largest firms—develop and update their general voting policies through an iterative process, involving analysis of regulatory requirements, industry practices, and discussions with market participants. Corporate issuers and institutional investors told GAO that unlike in the past, the firms have made more of an effort to engage market participants in the development and updating of voting policies, such as criteria for assessing the independence of board directors and executive compensation packages. According to the firms, they apply these general voting policies to publicly available company information to develop vote recommendations, which also are based on institutional investor voting instructions and criteria that firm analysts determine are applicable to the issue being voted on. Firms have taken steps to communicate with corporate issuers and allow review of data used to make vote recommendations before they are finalized. However, some corporate issuers told GAO that firms continue to apply policies in a one-size-fits-all manner, which can lead to recommendations not in the best interest of shareholders. Corporate issuers also stated that they often do not understand the rationale for some vote recommendations and would like to discuss them before they are finalized. Proxy advisory firms told GAO that to maintain objectivity and satisfy research reporting timelines for clients, they limit the breadth of such discussions.

Securities and Exchange Commission (SEC) oversight of proxy advisory firms and the services they provide has included gathering information, issuing guidance, and examining proxy advisory firms and use of the firms by investment companies, such as mutual funds. In 2010, SEC summarized concerns that market participants raised about conflicts of interest, accuracy, and transparency of proxy advisory firms and requested comments on potential regulatory solutions. In December 2013, SEC held a roundtable to discuss issues facing the proxy advisory industry, and issued guidance in June 2014 on disclosure of conflicts of interest, among other things. According to SEC, it also has continued to address concerns surrounding proxy advisory firms through its examinations of investment advisers and investment proxy companies that retain their services. SEC made these examinations a priority in 2015 and an area of focus in its ongoing initiative for registered investment companies that had not been examined by SEC.

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## Abbreviations

Advisers Act	Investment Advisers Act of 1940
AUM	assets under management
CEO	chief executive officer
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
Egan-Jones	Egan-Jones Proxy Services
Exchange Act	Securities Exchange Act of 1934
Glass Lewis	Glass Lewis & Co.
ISS	Institutional Shareholder Services
Marco Consulting	Marco Consulting Group
NASDAQ	NASDAQ Stock Market
NYSE	New York Stock Exchange
SEC	Securities and Exchange Commission

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November 15, 2016

The Honorable Dean Heller  
Chairman  
Subcommittee on Economic Policy  
Committee on Banking, Housing, and Urban Affairs  
United States Senate

Dear Mr. Chairman:

Each year at tens of thousands of meetings, shareholders of publicly traded companies (corporate issuers) vote on issues that could affect the companies' value, such as the election of directors, executive compensation packages, and proposed mergers and acquisitions. The shareholders receive advance notice of the votes through a written proxy statement—information about the issues subject to vote—and may vote in person or choose a third party (proxy) to cast their vote.<sup>1</sup> Most proxy votes are cast by or on behalf of institutional investors, such as mutual funds and pension funds, because of the level of stocks they manage relative to other types of investors. Institutional investors frequently hire proxy advisory firms to provide research on the issues being voted on and also make recommendations on whether to vote for or against these issues.

As demand for the services of proxy advisory firms has grown, concerns about the industry in the United States also have increased. For example, some former Securities and Exchange Commission (SEC) commissioners, industry associations, and academics have raised concerns about the firms and their influence on shareholder votes and corporate governance, and whether increased oversight and transparency was needed. More recently, some members of Congress expressed similar concerns and introduced legislation aimed at improving

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<sup>1</sup>A proxy statement contains information the Securities and Exchange Commission (SEC) requires companies to provide to shareholders so shareholders can make informed decisions about matters that will be voted on at an annual or special shareholder meeting. Proxy statements, which must be filed by a publicly traded company before a shareholder meeting, are filed with SEC on Schedule 14A.

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the accountability and transparency of proxy advisory firms.<sup>2</sup> Critics contend the firms have a disproportionate influence on shareholder votes and have no obligation to make voting recommendations in the best interests of shareholders, and the proxy advisory industry suffers from conflicts of interest and a lack of competition. Others counter that proxy advisory firms provide a valuable service for institutional investors, including identifying and aggregating information, and note that institutional investors are sophisticated market participants that are free to choose whether and how to employ proxy advisory firms. Moreover, they note that without the services of a proxy advisory firm, institutional investors would need significant resources to adequately manage a complex and variable set of voting decisions on myriad corporate issues. In June 2007, we reported on issues related to the proxy advisory firm industry, including how potential conflicts of interest could affect proxy advisory firms' recommendations, a lack of competition within the industry, and the extent to which institutional investors rely on advisory firms.<sup>3</sup> For example, we found larger institutional investors were less likely to rely on proxy advisory firms because they could research voting issues in-house, in contrast to smaller institutional investors that did not have such research capabilities.

You asked us to review several additional aspects of the proxy advisory firms industry. This report discusses (1) the demand for proxy advisory services and the extent to which firms may influence proxy voting and corporate governance practices, (2) how proxy advisory firms develop and apply voting policies to make vote recommendations and efforts to increase transparency, and (3) SEC's oversight since 2007 related to proxy advisory firms and the services they provide.<sup>4</sup>

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<sup>2</sup>See, e.g., Corporate Governance Reform and Transparency Act of 2016, H.R. 5311, 114th Cong. (2016). Among other things, the bill would require all proxy advisory firms to register with SEC, disclose potential conflicts of interest, and make publicly available their methodologies for formulating proxy recommendations and analyses.

<sup>3</sup>See GAO, *Corporate Shareholder Meetings: Issues Relating to Firms That Advise Institutional Investors on Proxy Voting*, [GAO-07-765](#) (Washington, D.C.: June 29, 2007).

<sup>4</sup>In this report, we focus on SEC oversight related to requirements under the federal securities laws. We do not examine the extent to which proxy advisory firms may or may not, in some cases, be subject to additional requirements applicable to those who provide investment advice or recommendations for a fee or other compensation with respect to assets of a pension plan. 29 C.F.R. § 2510.3-21.

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To address these objectives, we conducted a literature review and examined studies, reports, congressional testimony, documentation from SEC, which regulates the proxy solicitation process for publicly traded equity securities, and documentation from proxy advisory firms. We also identified and conducted interviews with officials and representatives with knowledge of the industry (SEC, 5 proxy advisory firms, 13 institutional investors, 11 corporate issuers, 4 proxy solicitors, 2 international regulatory organizations, and 8 industry and advocacy groups).<sup>5</sup> We conducted the interviews to obtain an understanding of issues affecting the proxy advisory industry and a variety of perspectives, as well as to corroborate the information obtained in our literature review. Additionally, for the first objective, we reviewed and summarized literature, and analyzed available information on users of proxy advisory firms and the demand for proxy advisory services, factors that may have contributed to demand, and the possible influence of firms on proxy voting and corporate governance practices.

For the second objective, we compared proxy advisory firms' policies and procedures for selected voting issues with corporate governance standards developed by other entities, such as stock exchanges that have corporate governance requirements that corporate issuers must meet to be listed on the exchange and one large institutional investor that has developed its own voting policies on corporate governance issues. We analyzed criteria and tools proxy advisory firms use in developing vote recommendations, and identified several examples of different proxy voting issues to illustrate the process.<sup>6</sup> We also reviewed proxy advisory firms' policies and views on the transparency of their processes, including methodologies used to develop vote recommendations.

For the third objective, we reviewed and summarized SEC oversight activities since our 2007 report, including SEC's efforts to solicit

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<sup>5</sup>In selecting corporate issuers (public companies that develop, register, and sell securities to the investing public to finance their operations), we used information from the Standard and Poor's Smallcap 600, Midcap 400, and Large 500 indexes to randomly select a mix of small, midsize, and large corporate issuers. We obtained information from industry associations to judgmentally select a mix of investors by asset size and type (such as mutual fund companies and pension funds). For this report, we define "large" as \$600 billion or more in assets under management (total market value of all financial assets managed on behalf of the institution or its clients) and "small" as \$200 billion or less in assets under management.

<sup>6</sup>Our selection of entities and voting issues was based on our literature review and interviews with market participants and other stakeholders.

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comments about proxy advisory services and updated guidance and examination procedures. We also reviewed several examinations that covered issues related to proxy advisory services. Throughout this report, we use certain qualifiers when describing responses from interview participants, such as “few,” “some,” and “most.” We define few as a small number such as two or three; some as at least four or more but less than most; and most as at least seven or more relative to the total number possible. See appendix I for more information on our scope and methodology.

We conducted this performance audit from August 2015 to November 2016 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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## Background

Publicly traded companies are generally required by state law to hold annual meetings to conduct business that requires shareholder approval. U.S. public companies hold their annual meetings to consider key management and shareholder proposals that may have an effect on a company’s operations and value, such as executive compensation and director elections, or other more routine issues that may not affect value, such as changing a corporate name or approving an auditor. They also occasionally hold special meetings during the year to consider key issues such as proposed mergers and acquisitions.

Shareholders are provided advance notice of annual and special shareholder meetings through a written proxy statement, which typically includes a proxy ballot (also called a proxy card) that allows shareholders to appoint a proxy to vote on the shareholder’s behalf if the shareholder decides not to attend the meeting. Proxy voting can be conducted online, by mail, or by telephone.<sup>7</sup> Shareholders may instruct the proxy how to vote the shares or grant the proxy discretion to make the voting decision. Because of their large stockholdings, institutional investors (such as

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<sup>7</sup>In 2007, SEC amended the proxy rules to allow companies to provide proxy materials to shareholders through the Internet. This model of proxy materials is often referred to as “Notice and Access.” 72 Fed. Reg. 42,222 (Aug. 1, 2007) (codified as amended in scattered sections of 17 C.F.R. Part 240).

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investment advisers, insurance companies, mutual funds, and pension plans) cast the majority of proxy votes.

In general, proxy voting in shareholder meetings involves several key participants such as shareholders (including institutional investors), corporate issuers, proxy agents, and proxy advisory firms (see table 1).<sup>8</sup> Institutional investors frequently hire proxy advisory firms to provide analysis and proxy voting recommendations and facilitate voting, record keeping, reporting, and disclosure requirements. For instance, the mechanics of tracking proxy cut-off times, managing and analyzing proxy materials, and casting votes can require significant resources. Many institutional investors use a proxy advisory firm to help perform some or all of these services. While proxy advisory firms perform services year-round, most of the services center on the proxy season.<sup>9</sup> Some publicly-traded companies also may use a proxy solicitor to identify, locate, and communicate with shareholders to secure votes on certain issues.

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**Table 1: Key Participants in Proxy Voting for Shareholder Meetings**

<b>Name</b>	<b>Description</b>	<b>Role</b>
<b>Shareholder</b>	Owner of one or more shares of stock in a company, also commonly called a stockholder	Vote on issues that come up at shareholder meetings that could affect a company's value
<b>Corporate issuer</b>	Public company subject to reporting requirements under the Securities Exchange Act of 1934	Distribute proxy materials to shareholders; may put forth proposals on certain corporate matters

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<sup>8</sup>Generally speaking, proxy agents are third-party service providers that provide proxy distribution, voting services, and other responsibilities in connection with the proxy voting system. Broadridge Financial Solutions, the proxy agent used by most corporate issuers in the United States and globally, delivers proxy materials for approximately 13,000 shareholder meetings annually, and, in fiscal year 2015, processed more than 2 billion investor communications through paper or electronic channels.

<sup>9</sup>The proxy season generally is from mid-March to early June, when most of the largest publicly traded companies in the United States hold annual meetings to vote on company business, including resolutions introduced by shareholders.

Name	Description	Role
<b>Institutional investor</b>	Entities (such as mutual funds, corporate pension funds, government pension funds, union pension funds, and investment management companies) that hold shares in a large number of public companies; investment advisers to these entities generally are registered with the Securities and Exchange Commission and have fiduciary duties under the Investment Advisers Act of 1940	Carry out fiduciary duty of voting proxy in best interest of the institutional investor's beneficial owners
<b>Proxy advisory firm</b>	Third-party that provides services to institutional investors that include research and vote recommendations on proposals	Provide research and analysis, vote recommendations, and in some cases, cast proxy vote for institutional investors
<b>Proxy solicitor</b>	Specialist (firm) hired to gather proxy votes	Help public companies identify, locate, and communicate with shareholders to secure votes
<b>Proxy agent</b>	Third-party that provides proxy distribution and voting services for corporate issuers.	Provide mailing, execution, and tabulation of proxy votes, (including meeting notifications, tracking, reconciliation, and reporting and record keeping)

Source: Securities and Exchange Commission (SEC). | GAO-17-47

## Proxy Advisory Firms

Currently, the proxy advisory industry in the United States consists of five firms: Institutional Shareholder Services (ISS), Glass Lewis & Co. (Glass Lewis), Egan-Jones Proxy Services (Egan-Jones), Marco Consulting Group (Marco Consulting), and ProxyVote Plus.<sup>10</sup>

- ISS, founded in 1985, provides research and analysis of proxy issues, custom policy implementation, vote recommendations, vote execution, governance data, and related products and services. ISS also provides advisory/consulting services, analytical tools, and other products and services to corporate issuers through ISS Corporate Solutions, Inc. (a wholly owned subsidiary). ISS is owned by Vestar Capital Partners, a private equity firm, and company management. As of September 2016, ISS had more than 900 employees in 18 offices in 12 countries, and covered approximately 39,000 meetings in 115 countries. ISS had about 1,600 institutional investor clients and

<sup>10</sup>There are also several European firms—for example, Manifest, Pensions and Investment Research Consultants, Hermes Equity Ownership Services, and BMO Asset Management—that offer international research, including research reports on U.S. companies, or provide vote management and engagement services to institutional clients that invest globally. We did not include these firms in our review.

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executed more than 8.5 million ballots annually on behalf of those clients.

- Glass Lewis, established in 2003, provides proxy research and analysis, custom policy implementation, vote recommendation, vote execution, and reporting and regulatory disclosure services to institutional investors. Glass Lewis is an independent portfolio company of the Ontario Teachers' Pension Plan Board and Alberta Investment Management Corporation. As of September 2016, Glass Lewis had more than 350 employees and offices in San Francisco, New York, Ireland, Australia, and Germany that provide services to more than 1,200 institutional investors that collectively manage more than \$20 trillion.
- Egan-Jones Proxy Services was established in 2002 as a division of Egan-Jones Ratings Company. Egan-Jones provides proxy services, such as notification of meetings, research and recommendations on selected voting issues, voting guidelines, execution of votes, and vote disclosure. As of September 2016, Egan-Jones Ratings Company had approximately 450 clients of all types firm-wide including funds, institutions, corporate issuers, and public entities. Of these, Egan-Jones' proxy research or voting clients mostly consisted of mid- to large-sized mutual funds. Egan-Jones covers approximately 40,000 companies. Many of its largest institutional clients use Egan-Jones research to augment their own research. Egan-Jones is based in Haverford, Pennsylvania.
- Marco Consulting Group, an Illinois-based firm, was established in 1988 to provide investment analysis and advice, and proxy voting services to a large number of Taft-Hartley and public benefit plans.<sup>11</sup> As of September 2016, Marco Consulting served 300 clients with assets of \$145 billion. Marco Consulting uses ISS as the provider for its proxy voting platform and reporting. Marco Consulting also subscribes to research services from ISS. It has offices in Chicago, Boston, and Denver.
- ProxyVote Plus, also based in Illinois, is an employee-owned firm established in 2002 to provide proxy voting services to Taft-Hartley fund clients. ProxyVote Plus conducts internal research and analysis

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<sup>11</sup>Taft-Hartley refers to funds placed in trust and administered jointly by employers and unions for the exclusive purpose of funding multiemployer employee pension and welfare plans. Taft-Hartley Act refers to the Labor Management Relations Act, 1947, which includes provisions facilitating the establishment of such plans. § 302(c), ch. 120, 61 Stat. 136, 157-58 (1947) (codified at 29 U.S.C. § 186(c)(5)).

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of voting issues and executes votes based on its guidelines. ProxyVote Plus reviews and analyzes proxy statements and other corporate filings, and reports annually to its clients on proxy votes cast on their behalf. As of September 2016, ProxyVote Plus had more than 200 clients throughout the United States and Canada.

Of the five firms, ISS and Glass Lewis are the largest and most often used by institutional investors. To compete, proxy advisory firms must offer comprehensive coverage of corporate proxies and use sophisticated systems to provide research and proxy vote execution services. As we reported in 2007, ISS's long-standing history—since 1985—of working with institutional investors, as well as its reputation for providing comprehensive proxy voting research and recommendations, makes it the most dominant proxy advisory firm.<sup>12</sup> We found that ISS's dominance makes it difficult for competitors to attract clients and compete in the market. We also reported that institutional investors may be reluctant to subscribe to a potentially inexperienced or less-established proxy advisory firm that may not provide thorough coverage of all of their institutional holdings. According to market participants and other stakeholders with whom we spoke, these conditions continue to exist, and, among other things, the initial investment required to develop and implement the necessary technology is a significant expense for firms.

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## U.S. Regulatory Framework

Under the Securities Exchange Act of 1934 (Exchange Act), SEC regulates the proxy solicitation process for publicly traded equity securities.<sup>13</sup> SEC also regulates the activities of proxy advisory firms that are registered with SEC as investment advisers under the Investment Advisers Act of 1940 (Advisers Act).<sup>14</sup> Under SEC rules, when soliciting proxies, certain information must be disclosed in writing to shareholders in a document referred to as a proxy statement. These proxy statements must include important facts about the issues on which shareholders are

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<sup>12</sup>See [GAO-07-765](#).

<sup>13</sup>Section 14 of the Securities Exchange Act of 1934, as amended, established the federal regulation of the proxy voting process. 15 U.S.C. § 78n.

<sup>14</sup>Investment Advisers Act of 1940, 54 Stat. 847 (1940) (codified as amended at 15 U.S.C. § 80b-1 to 80b-21). The Advisers Act defines an investment adviser as any person or firm that, for compensation, is engaged in the business of providing advice to others or issuing reports or analyses on securities, subject to exception. 15 U.S.C. § 80b-2(a)(11). Those meeting the definition of an investment adviser are generally required to register with SEC unless they are subject to an exemption from the definition of investment adviser or are prohibited from registering under the statute. 15 U.S.C. §§ 80b-3, 80b-3a.

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asked to vote. A party soliciting proxies must file such proxy statement with SEC unless it is exempt under the proxy rules.<sup>15</sup> Under the Advisers Act and related SEC rules, registered investment advisers are subject to a number of regulatory requirements that provide important protections to the firm's clients. For example, an investment adviser must disclose information about its business practices and potential conflicts of interest to clients and prospective clients.<sup>16</sup> Additionally, registered investment advisers are required to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act.<sup>17</sup> Finally, regardless of whether a proxy advisory firm is registered as an investment adviser, all firms that meet the statutory definition of investment adviser, and are unable to rely on an exclusion from the definition, are subject to the antifraud provisions of the Advisers Act. This act prohibits investment advisers from engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative.<sup>18</sup>

Table 2 describes whether and how proxy advisory firms are registered with SEC. ISS, Marco Consulting, and ProxyVote Plus are registered as investment advisers and, according to their SEC registration filings, identified their work as pension consultants as the basis for registering as advisers.<sup>19</sup> Egan-Jones Ratings Company (Egan-Jones's parent company) is registered as a Nationally Recognized Statistical Rating Organization and must meet certain regulatory requirements related to its credit ratings activity, but these requirements do not apply to its proxy advisory services. Glass Lewis is not registered with SEC.

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<sup>15</sup>See 17 C.F.R. §§ 240.14a-2, 240.14a-3.

<sup>16</sup>Registered investment advisers are required to disclose certain information, through Part 2 of Form ADV or a brochure containing the same information, to advisory clients or prospective clients. 17 C.F.R. § 275.204-3. The information required to be disclosed includes certain conflicts of interest as well as information on the adviser's fee schedule and business background of management and key advisory personnel.

<sup>17</sup>17 C.F.R. § 275.206(4)-7.

<sup>18</sup>15 U.S.C. § 80b-6.

<sup>19</sup>The Advisers Act prohibits any state-regulated investment adviser who has less than \$100 million in assets under management from registering with SEC, unless the adviser is an investment adviser to a registered investment company, like a mutual fund. 15 U.S.C. § 80b-3a(a)(1). SEC Rule 203A-2(a) exempts certain pension consultants from this general prohibition and requires them to register with SEC if the pension consultants provide investment advice to employee benefit plans, governmental plans, or church plans having an aggregate value of at least \$200 million in assets. 17 C.F.R. § 275.203A-2(a).

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**Table 2: Registration Status of Proxy Advisory Firms, as of June 2016**

<b>Firm</b>	<b>Registered with Securities and Exchange Commission</b>	<b>Registration type</b>
<b>Institutional Shareholder Services</b>	Yes	Investment adviser
<b>Glass Lewis</b>	No	Not applicable
<b>Egan-Jones</b>	Yes	Nationally recognized statistical rating organization
<b>Marco Consulting</b>	Yes	Investment adviser
<b>ProxyVote Plus</b>	Yes	Investment adviser

Source: Securities and Exchange Commission. | GAO-17-47

SEC also has issued several rules and policy documents that provide guidance on proxy voting by investment advisers and investment companies. For example, SEC issued a final rule in February 2003 that addresses an investment adviser's fiduciary responsibilities to clients when the adviser has the authority to vote their proxies, including adopting policies and procedures to ensure proxies are voted in the best interest of clients.<sup>20</sup> The rule also requires that an adviser must (i) disclose to clients how they can obtain information from the adviser on how their securities were voted and (ii) describe the adviser's proxy voting policies and procedures to clients, and upon request, provide clients with a copy of those policies and procedures. SEC issued another final rule in February 2003 that requires investment companies such as mutual funds to disclose how they vote proxies relating to portfolio securities they hold, and file with SEC and make available to shareholders information about specific proxy votes cast.<sup>21</sup> In May 2004 and September 2004, SEC staff issued guidance that, among other things, clarified how an investment adviser could resolve conflicts of interest in voting clients' proxies and ensure that proxy advisory firms could adequately analyze proxy issues

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<sup>20</sup>Proxy Voting by Investment Advisers, 68 Fed. Reg. 6585 (Feb. 7, 2003) (codified as amended at 17 C.F.R. §§ 275.204-2, 275.206(4)-6)).

<sup>21</sup>Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6564 (Feb. 7, 2003) (codified as amended at 17 C.F.R. Parts 239, 249, 270, and 274).

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and make recommendations in the best interests of the adviser's clients.<sup>22</sup> We focus on SEC oversight since 2007 later in this report.

SEC monitors compliance with the federal securities laws and regulations through risk-based examinations of registered investment advisers. Based on examination findings, SEC may send letters to investment advisers, including proxy advisory firms registered as investment advisers, requesting that they correct identified deficiencies. SEC may take enforcement actions for more serious violations. Proxy voting issues and proxy advisory firms may not be examined on a regularly scheduled basis because SEC uses a risk-based approach to identify examination priorities each year. Among other things, SEC may consider the risk of an entity based on prior examination findings; significant changes in a registrant's business activities or disclosures regarding regulatory or other action brought against them; and tips, complaints, or other referrals.<sup>23</sup> SEC uses this approach to help allocate its limited resources to focus on those registrants that examination staff believe place the investing public or market integrity most at risk.

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## International Regulatory Actions Related to Proxy Advisory Firms

International regulatory organizations, including the European Securities and Markets Authority and Canadian Securities Administrators, have taken actions to promote increased engagement among market participants and transparency into proxy advisory firms' processes. In recent years, these organizations conducted reviews of the proxy advisory firm industry and concluded that regulatory intervention was not needed. Specifically, the European Securities and Markets Authority concluded that regulation was not justified because there was no evidence of a market failure in relation to how proxy advisory firms interact with institutional investors and corporate issuers. However, both entities proposed guidance and recommendations for the firms to enhance transparency, among other issues.

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<sup>22</sup>Securities and Exchange Commission, SEC Staff Letter to Kent S. Hughes, Egan-Jones Proxy Services (Washington, D.C.: May 27, 2004); and SEC Staff Letter to Mari Anne Pisarri, on behalf of Institutional Shareholder Services (Washington, D.C.: Sept. 15, 2004).

<sup>23</sup>SEC has a "Tips, Complaints and Referrals" website for members of the public to provide information to SEC regarding possible violations of federal securities laws. Accessed on September 6, 2016, <https://denebleo.sec.gov/TCRExternal/index.xhtml>.

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In a 2013 report, European Securities and Markets Authority officials recommended the creation of an industry code of conduct. Subsequently, a group of proxy advisory firms, including ISS and Glass Lewis, published a set of best practice principles that included disclosing their (1) research methodology and, if applicable, general voting policies; and (2) policies for communication with corporate issuers, shareholder proponents, other stakeholders, media, and the public.<sup>24</sup> In December 2015, European Securities and Markets Authority released a follow-up to its 2013 report responding to the establishment of best practice principles.<sup>25</sup> This report concluded that the best practice principles had a positive impact on the market, mainly in terms of enhanced clarity for different stakeholders on how proxy advisory firms operate. The report also stated that while the majority of the industry is signatory to the principles, including ISS and Glass Lewis, broader sign-up to the principles would contribute to establishing the principles as the prevailing standard in the industry. ISS and Glass Lewis have posted statements of compliance on their websites that describe how they apply the principles in their work.

In April 2015, the Canadian Securities Administrators adopted the National Policy 25-201 Guidance for Proxy Advisory Firms.<sup>26</sup> The policy is intended to promote transparency in the process leading to vote recommendations and the development of proxy voting guidelines, and foster understanding among market participants about the activities of proxy advisory firms. The guidance is not intended to be prescriptive but rather encourage proxy advisory firms to consider the guidance in developing and implementing practices that are tailored to their structure and activities.

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<sup>24</sup>Best Practice Principles for Shareholder Voting Research, Accessed on October 7, 2016. <https://bppgrp.info/>.

<sup>25</sup>European Securities and Markets Authority, *Follow-up on the Development of the Best Practice Principles for Providers of Shareholder Voting Research and Analysis* (Paris, France: December 2015).

<sup>26</sup>Canadian Securities Administrators, *Guidance for Proxy Advisory Firms*, National Policy 25-201 (Montreal, Canada: Apr. 30, 2015).

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## Several Factors Have Led to Increased Demand for and Influence of Proxy Advisory Firms, but Mixed Views Exist on the Extent of Influence

The market for proxy advisory firms has grown, with higher demand stemming from factors including the rise of institutional investing and the effect of some new policies and requirements. Recent studies and the market participants and other stakeholders with whom we spoke agreed that proxy advisory firms influenced shareholder voting and corporate governance practices. But market participants and stakeholders had mixed views about the extent of this influence and some said that influence can vary based on the size of the institutional investor or the voting policies used. Studies we reviewed also did not agree on the extent of the influence or whether it was helpful or harmful.

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## Increased Demand for Proxy Advisory Firms' Services Stems from Rise of Institutional Investing and Requirements for Shareholder Voting

The market for proxy advisory firms has grown over the last 30 years as institutional investors have relied more on firms to provide research, analysis, and vote recommendations. According to academic and industry studies, the increased demand for proxy advisory services stems from several factors, including the growth in the proportion of shares owned by institutional investors, the number and complexity of voting issues, and shareholder activism and the effect of some new policies and requirements. Some of these issues are consistent with themes we identified in 2007.

**Institutional Ownership.** The increased ownership share that institutional investors hold and the high volume of proxy votes they are responsible for casting has increased demand for proxy advisory firms. According to a recent Broadridge and PwC report, in 2016 institutional investors owned 70 percent of shares outstanding in U.S. public companies compared with retail investors (or individual investors) who owned 30 percent of shares outstanding.<sup>27</sup> Institutional investors also have voted at much higher rates; for example, as of June 2016, 91 percent of institutional investors voted their shares compared with 28 percent of retail investors. Because many institutional investors use the services of proxy advisory firms, increased institutional ownership has resulted in a greater demand for these firms.

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<sup>27</sup> Broadridge Financial Solutions and PwC's Governance Insights Center, "2016 Proxy Season Wrap-up," *ProxyPulse*, third ed. (2016). Accessed on September 28, 2016, <http://media.broadridge.com/documents/Broadridge-ProxyPulse-3rd-Edition-2016.pdf>. As mentioned earlier, Broadridge Financial Solutions is the proxy agent used by most corporate issuers in the U.S. and globally.

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**Number and Complexity of Voting Issues.** Some institutional investors may lack the resources to consider the many complex proxy issues that come before them for a vote and instead may opt to use the services of a proxy advisory firm, which adds to the demand for the firms. For example, the Dodd-Frank Wall Street Reform and Consumer Protection Act requires a shareholder advisory vote on executive compensation (“say-on-pay”).<sup>28</sup> The act allows shareholders to vote their opinion on executive compensation plans every 1–3 years, thereby increasing the volume of shareholder votes on this issue. Institutional investors also have become more involved in a range of corporate governance and other issues such as board composition and diversity, executive severance agreements (including “golden parachutes”), strategy and growth, and sustainability and climate change that can require extensive analysis.<sup>29</sup> Thus, the growing number and complexity of proxy voting issues has also contributed to the increased demand for proxy advisory firms.

**Shareholder Activism and Regulation.** Proxy advisory firms also have become more prominent because of continued shareholder activism and the impacts of some regulations. For example, many institutional investors seek the services of proxy advisory firms to assist in their assessments of corporate governance practices and carry out the mechanics of proxy voting. As discussed earlier, in 2003, SEC adopted a final rule that required registered investment advisers, among other things, to adopt policies and procedures reasonably designed to ensure that they vote proxies in the best interests of clients.<sup>30</sup> According to some industry stakeholders, based on certain interpretations of the rule and subsequent SEC staff guidance, some investment advisers determined that they could discharge their duty to vote their proxies and demonstrate that their vote was not a product of a conflict of interest if they voted

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<sup>28</sup>Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899 (2010) (codified as amended at 15 U.S.C. § 78n-1). Section 951 of the act requires public companies subject to the proxy rules to provide their shareholders with an advisory vote on the compensation of certain executives, as well as an advisory vote on the desired frequency of say-on-pay votes (every 1, 2, or 3 years). Frequency votes must be held at least every 6 years.

<sup>29</sup>“Golden parachute” generally refers to compensation arrangements with executive officers concerning any type of compensation (whether present, deferred, or contingent) that are based on or relate to an acquisition, merger, or similar transaction.

<sup>30</sup>68 Fed. Reg. 6585 (Feb. 7, 2003) (codified as amended at 17 C.F.R. §§ 275.204-2, 275.206(4)-6)).

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based on the recommendations of a proxy advisory firm.<sup>31</sup> As a result, institutional investors tended to outsource their research and voting decisions, which helped to increase the demand for proxy advisory services. However, in 2014, SEC staff issued a Staff Legal Bulletin that, among other things, included guidance on investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms, including notice that investment advisers are not required to vote every proxy, depending on the proxy voting arrangements between advisers and their clients.<sup>32</sup> We discuss other aspects of this guidance later in the report.

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### Studies and Market Participants Agreed That Proxy Advisory Firms Influence Voting and Corporate Governance, but Had Mixed Views about Extent of Influence

Recent studies, market participants, and other stakeholders agree that proxy advisory firms have influence on shareholder voting and corporate governance practices, but had mixed views about the extent of their influence. Our review of four recent studies that analyzed the extent to which proxy advisory firms' recommendations influenced voting decisions and shifted some fraction of the votes shows that proxy advisory firms have influence on shareholder voting. For instance, using a sample of director elections, a 2009 study found that ISS recommendations have an impact on shareholder votes, and directors receiving a negative ISS recommendation receive 19 percent fewer votes.<sup>33</sup> However, a 2010 study concluded that while both ISS and Glass Lewis appear to have a meaningful impact on shareholder voting, media reports often overstate the extent of ISS's influence on voting.<sup>34</sup> The study found that the impact of an ISS recommendation is reduced once director- and company-specific factors that are important to investors—failure to attend board meetings, financial performance, corporate misconduct, and a lack of responsiveness to shareholders—are taken into consideration. Unlike higher estimates, the analysis showed that an ISS recommendation shifted 6–10 percent of shareholder votes.

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<sup>31</sup> See, e.g., Daniel M. Gallagher, "Outsized Power and Influence: The Role of Proxy Advisers," Washington Legal Foundation, Critical Legal Issues Working Paper Series 187 (Washington, D.C.: August 2014).

<sup>32</sup> Securities and Exchange Commission, Division of Corporate Finance, Division of Investment Management, Staff Legal Bulletin No. 20 (June 30, 2014).

<sup>33</sup> Jie Cai, Jacqueline L. Garner, and Ralph A. Walking, "Electing Directors," *The Journal of Finance*, vol. 64, no. 5 (October 2009).

<sup>34</sup> Stephen J. Choi, Jill E. Fisch & Marcel Kahan, "The Power of Proxy Advisors: Myth or Reality?" 59 EMORY L.J. 869, 906 (2010).

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Additionally, a 2013 study concluded that proxy advisory firm recommendations are the key determinant of voting outcomes in the context of mandatory “say-on-pay” votes.<sup>35</sup> The study found that negative ISS and Glass Lewis recommendations are associated with 25 percent and 13 percent more votes against the compensation plan, respectively. The study also found that the relationship between proxy advisory firm recommendations and shareholder votes varies based on the rationale behind the recommendation and the institutional investor’s ownership structure. For example, the relationship between negative recommendations and shareholder votes is weaker for shareholders with larger holdings and, thus, presumably greater incentives to perform their own internal research. The study concluded that this suggests that at least some shareholders are not directly influenced by the recommendations and take into account the underlying basis for the recommendation and other relevant factors. A 2015 study also found that proxy advisory firms have an effect on voting outcomes related to say-on-pay proposals. Specifically, the study concluded that negative ISS recommendations reduce the percentage of votes in favor of say-on-pay proposals by about 25 percentage points.<sup>36</sup>

Similarly, our interviews with market participants and other stakeholders showed mixed views on the extent of influence proxy advisory firms have on voting. Most of the 13 institutional investors, 11 corporate issuers, 4 proxy solicitors, and 8 industry association representatives with whom we spoke stated that proxy advisory firms (more specifically, ISS and Glass Lewis—the two firms with the largest number of institutional investor clients) have influence on shareholder voting. However, some investors, solicitors, and investor association representatives said that proxy advisory firms had little influence and that such influence varied based on the size of the institutional investor or whether the institutional investor uses its own or the proxy advisory firm’s research and voting policies. Specifically, they told us that the level of influence that ISS and Glass Lewis have on voting and corporate governance is minimal because large institutional investors cast the majority of proxy votes and do not exclusively rely on the research and vote recommendations offered by proxy advisory firms to help decide how to vote proxies.

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<sup>35</sup>Yonca Ertimur, Fabrizio Ferri, and David Oesch. “Shareholder Votes and Proxy Advisors: Evidence from Say on Pay,” *Journal of Accounting Research*, vol. 51, no. 5 (December 2013).

<sup>36</sup>Nadya Malenko and Yao Shen, “The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design,” (2015).

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We previously found in 2007 that large institutional investors, which cast the great majority of proxy votes made by all institutional investors, placed less emphasis on proxy advisory firms' research and recommendations than smaller institutional investors, and tended to have their own in-house research staffs to conduct research that drove their proxy voting decisions.<sup>37</sup> Some institutional investors and investor association representatives with whom we spoke also said that the firms' influence has significantly declined in recent years, as some institutional investors—in particular, asset managers (such as investment advisers to mutual funds) and pension funds—have taken a greater interest in proxy voting and developed in-house expertise to address proxy vote-related issues.

The institutional investors and investor association representatives also pointed to the growing trend among institutional investors of using their own voting policies as a basis for voting decisions instead of relying on the proxy advisory firms' policies and vote recommendations. For example, officials from the four large institutional investors told us that they conduct their own research and analyses to make voting decisions and use the research of proxy advisory firms only to supplement their internal research and analyses. Officials from one proxy advisory firm also told us that while firms provide vote recommendations, it is the institutional investor that makes the actual vote decision, which is most often based on the institutional investor's own voting policies. Moreover, they noted that as clients of the proxy advisory firm, institutional investors always retain the ability to change the vote that the proxy advisory firm casts on their behalf.

According to large institutional investors and a few investor association representatives that we spoke to, some smaller institutional investors who do not have their own in-house research staffs to analyze the many proxy voting issues and companies in their portfolio will obtain such services from proxy advisory firms and rely more on the research and recommendations proposed by the firms. In these cases, the resulting vote recommendation could have more of an influence on the voting, because some of these smaller institutional investors have a tendency to adopt the firms' recommendations and vote accordingly. One small institutional investor told us that it relies on the research and the vote

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<sup>37</sup>See [GAO-07-765](#).

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recommendations of ISS and will consider the firm's recommendations on certain actions before making voting decisions.

Other studies that we reviewed showed that proxy advisory firms also have an influence on corporate governance practices. For example, a 2015 study found that to avoid a negative vote recommendation, companies changed their compensation programs before the formal shareholder vote in a manner consistent with the features known to be favored by proxy advisory firms.<sup>38</sup> A 2013 study also found that more than half of companies involved in the study responded to a shareholder vote triggered by a negative recommendation from the proxy advisory firms by making changes to their compensation plan.<sup>39</sup> In addition, a 2012 study found that more than two-thirds of U.S. companies say their executive compensation program is influenced by the policies and voting recommendations of the two largest proxy advisory firms—ISS and Glass Lewis. In particular, a majority of companies say they are likely to make changes to their compensation program to gain a favorable “say-on-pay” recommendation from these firms.<sup>40</sup> Two corporate issuers also told us that proxy advisory firms have some influence on the development of their governance practices and they would generally accept the firms’ advice on corporate governance requirements.

Officials from one proxy advisory firm with whom we spoke stated that they agree that proxy advisory firms have influence on corporate governance practices. The proxy advisory firm further indicated that its policy frameworks reflect its institutional investor clients’ preferences for better disclosure, strong shareholders’ rights, and adoption of best practices governance standards. They noted that such influence is good and ultimately they want to have a positive influence on their clients because they view that as part of their responsibility—to promote good governance. Similar to the views expressed by the officials of the proxy advisory firm, investor association representatives also suggested that consideration be given to the context in which influence is often viewed.

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<sup>38</sup>David F. Larcker, Allan L. McCall & Gaizka Ormazabal, “Outsourcing Shareholder Voting to Proxy Advisory Firms,” 58 J.L. & ECON. 173, 173 (2015).

<sup>39</sup>Yonca Ertimur, Fabrizio Ferri, and David Oesch, “Shareholder Votes and Proxy Advisors: Evidence from Say on Pay,” *Journal of Accounting Research*, vol. 51, no. 5 (December 2013).

<sup>40</sup>David F. Larcker, Allan L. McCall, and Brian Tayan, “The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions,” *The Conference Board: Director Notes* (March 2012).

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They noted that most often, influence is viewed negatively. However, the representatives said that proxy advisory firms' influence can be positive. That is, if the recommendations proxy advisory firms make help to promote good governance, then the firms' influence on voting is beneficial to shareholders. Additionally, a 2009 study found that proxy advisory firm recommendations—at least for uncontested director elections—appeared to be based on factors that should matter to institutional investors, such as good governance, director attention, and performance.<sup>41</sup>

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## Proxy Advisory Firms Have Increased Engagement with Market Participants and Stakeholders in the Vote Recommendation Process

Proxy advisory firms develop their general voting policies and update them through an iterative process involving analysis of institutional investor and corporate issuer input, industry practices, and discussions with other stakeholders. These policies are similar to or in some cases stricter than other standards such as those from the New York Stock Exchange (NYSE) and the NASDAQ Stock Market (NASDAQ). Proxy advisory firms have taken steps to communicate with corporate issuers when developing voting recommendations and have allowed some to review proxy reports for accuracy before they are final. While some corporate issuers said they still do not understand the bases for some vote recommendations and would like to have a dialogue about the proxy reports, proxy advisory firms said that to maintain objectivity and satisfy research reporting timelines for clients they have to limit the breadth of such discussions.

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## Proxy Advisory Firms Have Increased Engagement with Stakeholders in Development of Their Voting Policies to Address Concerns

Proxy advisory firms' voting policies outline their approaches for evaluating positions on, and rationales for, recommendations on corporate governance issues. For example, ISS and Glass Lewis officials said they develop three types of policies: general, specialized, and client-customized.

- General policies reflect the firm's own positions and rationales on various corporate governance issues and are generally used in developing their vote recommendations. The policies may take into account national and international corporate governance codes and practices, as well as the views of institutional investors, corporate issuers, and other stakeholders.

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<sup>41</sup>Stephen J. Choi, Jill E. Fisch & Marcel Kahan, "Director Elections and the Role of Proxy Advisors," 82 S. CAL. L. REV. 649, 696 (2009).

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- Specialized policies reflect the institutional investor clients' perspective on specific governance issues such as sustainability, socially responsible investing, public funds, labor unions, or mission and faith-based investing. Since these policies reflect specific institutional investor perspectives or needs of different institutional investors, voting recommendations developed under these policies may in some cases differ from recommendations formed under general policies.
  - Client customized policies are based on institutional investor clients' unique corporate governance guidelines, and reflect each investor's specific philosophies and approaches. For these clients, the proxy advisory firm prepares voting recommendations based on these policies. As a result, the vote recommendations issued under these policies may differ from those issued under general policies.

Since specialized and client customized policies reflect different perspectives of different institutional investors, voting recommendations developed under these policies in some cases may differ from recommendations formed under general policies. The following discussion focuses on general policies, which represent the general guidelines the firms use for their analyses in developing vote recommendations.

According to the two largest proxy advisory firms—ISS and Glass Lewis—they develop their general voting policies and update them through an iterative process, which recently has included increased engagement with institutional investors, corporate issuers, and other stakeholders.<sup>42</sup> ISS and Glass Lewis have taken steps to obtain input from and communicate with market participants about voting policies. Some corporate issuers we interviewed said that both ISS and Glass Lewis recently have made more of an effort to engage market participants in the general policy development process unlike in the past when their outreach was less frequent or formal.<sup>43</sup> When we spoke to both proxy advisory firms, they also said that they made their processes more transparent than they were in the past. For example, they have begun to

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<sup>42</sup>We focused most of our discussion on ISS and Glass Lewis, the two firms that have the largest number of clients in the proxy advisory firm market in the United States. Market participants we interviewed also mostly spoke of ISS and Glass Lewis.

<sup>43</sup>As previously noted, we interviewed various officials and representatives with knowledge of the industry, including SEC officials, 5 proxy advisory firms, 13 institutional investors, 11 corporate issuers, 4 proxy solicitors, 2 international regulatory organizations, and 8 industry and advocacy groups.

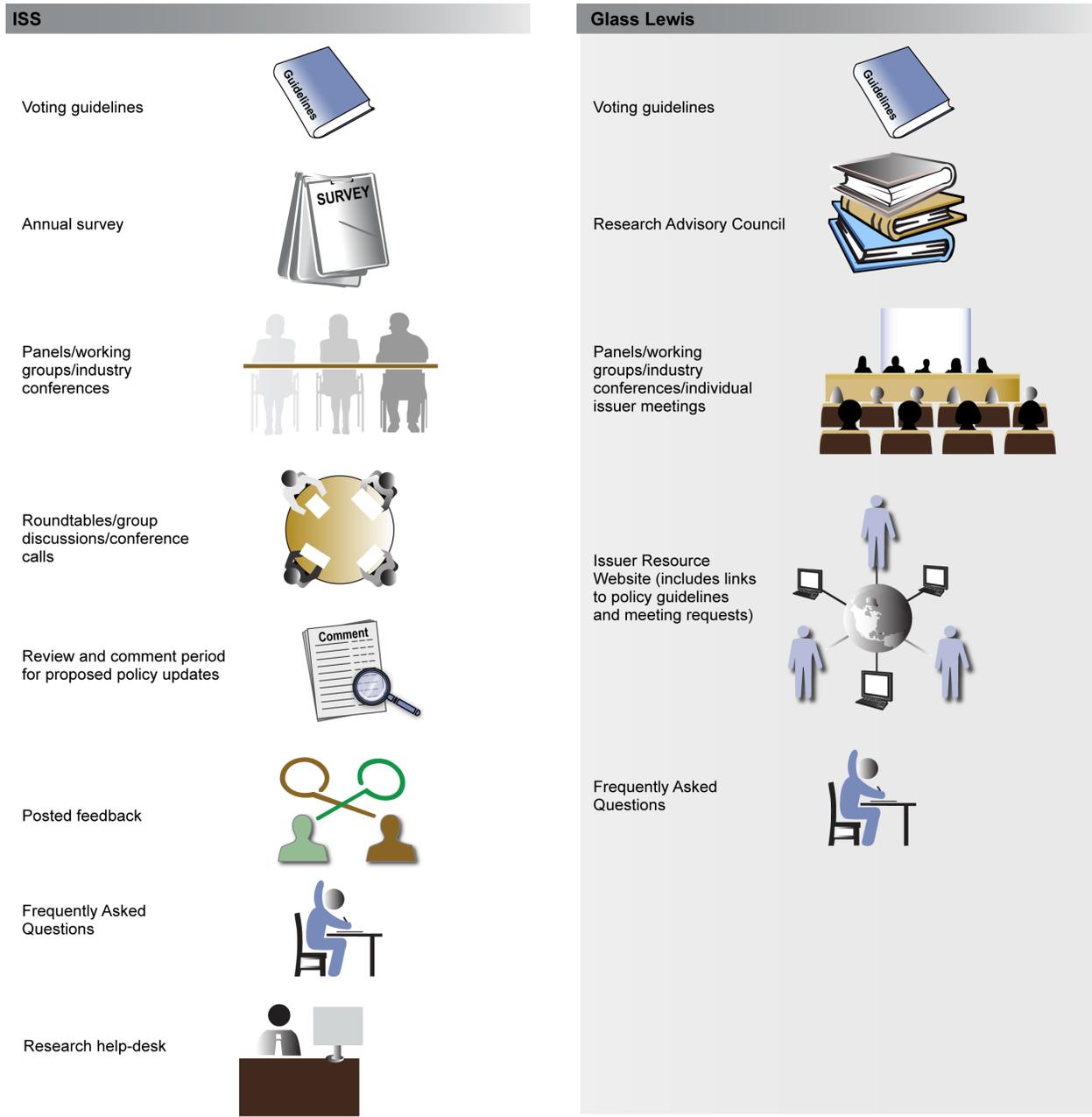
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conduct engagement meetings, hold roundtables, and post guidelines to their websites. Specifically, Glass Lewis officials said they have created a corporate issuer resource website that offers links to its guidance documents, forms to request engagement meetings, and responses to frequently asked questions. ISS officials said they invite institutional investors, corporate issuers' management and board directors, and other industry stakeholders to participate in its annual proxy voting policy survey.<sup>44</sup> According to ISS, the survey is designed to provide input on key issues that are factored into the development of ISS's general policy guidelines, including proposed policy updates as well as new policies. See figure 3 for examples of the types of communication mechanisms used.

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<sup>44</sup>ISS publicly announces the opening of the annual survey through methods such as press releases and social media.

**Figure 1: Examples of Communication Mechanisms Institutional Shareholder Services (ISS) and Glass Lewis Used for Proxy Voting Policy Development, as of September 2016**



Source: GAO representation of proxy firm information. | GAO-17-47

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A few corporate issuers told us that although input is obtained from both corporate issuers and institutional investors, it does not necessarily make its way into the final general policy guidelines. One corporate issuer we interviewed said there has been a noticeable increase in outreach (a lack of outreach was evident in the past). But the corporate issuer also said there is a difference between proxy advisory firms soliciting input and using input to modify policies. Another corporate issuer, who said it was not solicited for feedback, said it seemed like policies were sometimes developed in a vacuum. However, Glass Lewis officials said that they have responded to issuer feedback, for example, Glass Lewis changed its approach for selecting issuer peer groups used in its pay for performance analysis. Also, Glass Lewis officials said that they work with an independent advisory council that provides guidance in the development and updating of its voting policies.<sup>45</sup>

Further, some have raised concerns about ISS's policy survey and published results. For example, one market participant we interviewed said that a relatively small number of institutional investors drive ISS's policy formation process in part because a small number of ISS investor clients participated in the survey. In a February 2013 working paper, the authors also noted that ISS's policy survey relied on a small number of participants and provided little detail about the composition of the respondent pool.<sup>46</sup> ISS officials said there has been consistency in the relative mix of institutional investors and corporate issuers responding to the survey, with more corporate issuers than institutional investors answering the survey questions.

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<sup>45</sup>According to Glass Lewis, the Research Advisory Council consists of individuals from the fields of corporate governance, finance, law, management, and accounting. The council meets annually, but is available year round for questions related to policy development.

<sup>46</sup>David F. Larcker, Allen L. McCall, and Brian Tayan, *And Then a Miracle Happens! How Do Proxy Advisory Firms Develop Their Voting Recommendations?* Stanford University Closer Look Series (Feb. 25, 2013).

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## Proxy Advisory Firms' Voting Policies for Selected Governance Issues Generally Were Similar to or Stricter Than Those of Other Selected Market Participants

### Selected Corporate Governance Issues

**Board independence:** A board of directors comprises members whose position on the board does not pose a potential conflict of interest to the company they oversee.

**Overboarding:** The number of public company boards for which a director can serve before being considered overextended.

**Independent chairman/chief executive officer (CEO):** The separation of the roles of board chairman and CEO creates the ability to, for example, monitor and advise the CEO.

**Proxy access:** The ability of shareholders to nominate board directors and require companies to provide information about, and the ability to vote for, those shareholder nominees in the companies' proxy materials.

Source: GAO. | GAO-17-47

Based on our review of selected general voting policies of proxy advisory firms and other market standards on corporate governance, the firms' policies were similar to or in some cases stricter than the other standards and covered a broader range of issues. We reviewed selected policies from the five proxy advisory firms, NYSE, NASDAQ, and a large institutional investor, and looked specifically at the issues of director independence, overboarding (number of public company boards for which a director can serve before being considered overextended), independent chairman/chief executive officer (CEO), and proxy access,<sup>47</sup> as illustrated in the following examples:

- **Board independence.** Proxy advisory firms and the exchanges (NYSE and NASDAQ) require some level of independence on corporate boards. Specifically, both exchange listing requirements and firm voting policies call for a majority of independent board directors on corporate boards.<sup>48</sup> However, these bodies vary on the "look-back" period required for directors to be deemed independent from the company. The five proxy advisory firms and one institutional investor policy that we reviewed require a 5-year look back, while the exchanges require 3 years. One proxy advisory firm's rationale for this difference was that 5 years allows enough time for management and board members to settle any conflicts of interest. This firm also notes that it does not automatically apply the 5-year threshold and will consider the type of relationship the nominee has with the company.
- **Overboarding.** Proxy advisory firms and some institutional investors have policies on overboarding, but the exchanges do not. In 2016, both ISS and Glass Lewis updated their director overboarding policies to reflect concerns about directors overcommitting themselves. Specifically, a few institutional investors expressed the position that if directors served on too many boards, they would not have sufficient time to focus on the issues related to any one company. The institutional investor policy we reviewed—which had a lower threshold

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<sup>47</sup>We selected NYSE and NASDAQ because they have corporate governance requirements that corporate issuers must meet to be listed on the exchanges and some of these requirements cover the same issues in the voting policies proxy advisory firms use to make vote recommendations. We selected one large institutional investor that has developed its own voting policies on corporate governance issues because several institutional investors develop their own voting policies rather than rely on proxy advisory firms. Although some of the proxy advisory firms have voting policies for different countries, we focused on the proxy voting policies for the United States.

<sup>48</sup>Market participants define independent directors as having no current familial or financial relationships with the company on whose board they serve.

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than that of the proxy advisory firms—explained that generally it is unlikely that a director will be able to commit sufficient focus to a particular company when a director commits himself or herself to a large number of boards. Both ISS and Glass Lewis’s policies outline a phased transition to a lower board membership threshold for directors. ISS policy states, for example, that it will recommend that shareholders vote against directors who sit on more than six boards, but beginning in 2017, ISS policy states that it plans to make negative recommendations for directors sitting on more than five. Glass Lewis policy also states that it plans to note a concern for these directors in its report, thus providing a transition period before putting the full policy into effect. The current policy cites six boards, but in 2017 Glass Lewis’ policy also recommends voting against a director who serves on more than five boards. Further, a couple of the firms have changed their policy on the number of boards that a CEO should serve on. For example, in 2016, Egan-Jones changed its overboarding policy limiting the number of outside boards a CEO may serve on to one. Glass Lewis plans to make a similar adjustment in 2017. Glass Lewis policy states that during the 2016 proxy season, it plans to note as a concern CEOs serving on more than one outside boards, and then beginning in 2017 it will base its recommendation on this lower threshold. ISS policy recommends a vote against CEOs who sit on more than two outside boards.

- **Independent chairman/CEO.** The issue of an independent chairman/CEO is another example of an issue area covered by the proxy advisory firms’ and large institutional investor’s policy, but not addressed by the exchange listing requirements. Specifically, all five proxy advisory firms have independent chairman/CEO policies. One firm said the development of this policy was guided by feedback from institutional investor clients. Similar to the five proxy advisory firms, the large institutional investor policy we reviewed generally supports the separation of chairman and CEO when a company does not have a lead independent director.<sup>49</sup> The institutional investor policy states that support for independent leadership is important given the roles that the chairman plays, such as contributing to oversight of CEO succession planning and serving as an advisor to the CEO.
- **Proxy access.** The issue of proxy access is another area not covered by the exchange listing standards, but addressed by the proxy

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<sup>49</sup>A lead independent director has power to provide formal input on board agendas, call meetings, and preside over meetings without the presence of the CEO who serves as chairman of the board.

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advisory firm and institutional investor policies. Specifically, the five proxy advisory firms have a proxy access policy. According to market participants, the increased rise of shareholder activism also saw increased attention on the issue of proxy access. One market participant we interviewed said that proxy advisory firm policies have become more complex and nuanced, and the firms have enhanced policies on proxy access as the issues have received more attention. Similarly, the institutional investor policy we reviewed supports proxy access, stating that long-term shareholders should have the opportunity to nominate directors.

Market participants with whom we spoke generally viewed proxy advisory firms' policies on corporate governance as stricter than other industry standards but reflective of institutional investors' interests. Specifically, for select corporate governance issues, proxy advisory firm policies may call for higher standards of compliance than other industry standards, such as exchange listing requirements. Some market participants said that these stricter standards are a reflection of the higher standards for which some investors look and that in their view help promote better governance practices. They stated that exchange listing standards tend to only serve as a baseline for publicly traded companies. A few institutional investors pointed out that their policies require even higher standards of compliance than the proxy advisory firms have developed. For example, representatives of one institutional investor told us that their company's overboarding policy is stricter than both ISS's and Glass Lewis's policies. The officials added that the issue of overboarding is a case in which institutional investors were ahead of the marketplace and proxy advisory firms were just now "catching up."

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### Proxy Advisory Firms Considered Company-Specific Information in Vote Recommendations and Allowed Some Corporate Issuers Opportunities to Correct Data

Proxy advisory firms' approaches for developing vote recommendations can be case-by-case or rules based. Policy application may depend on factors such as the type of vote cast or the voting instructions provided by institutional investor clients. A more rules-based approach might be applied with some board of director issues such as board independence, which uses a time period threshold to ensure that directors with previous work history with a company have been separated long enough to be independent. However, such issues may still be subject to a case-by-case review. For example when applying the look-back period for director independence, Glass Lewis's proxy policy states that it will not automatically recommend voting against former executives of a company who have consulting agreements with the company during the look-back period.

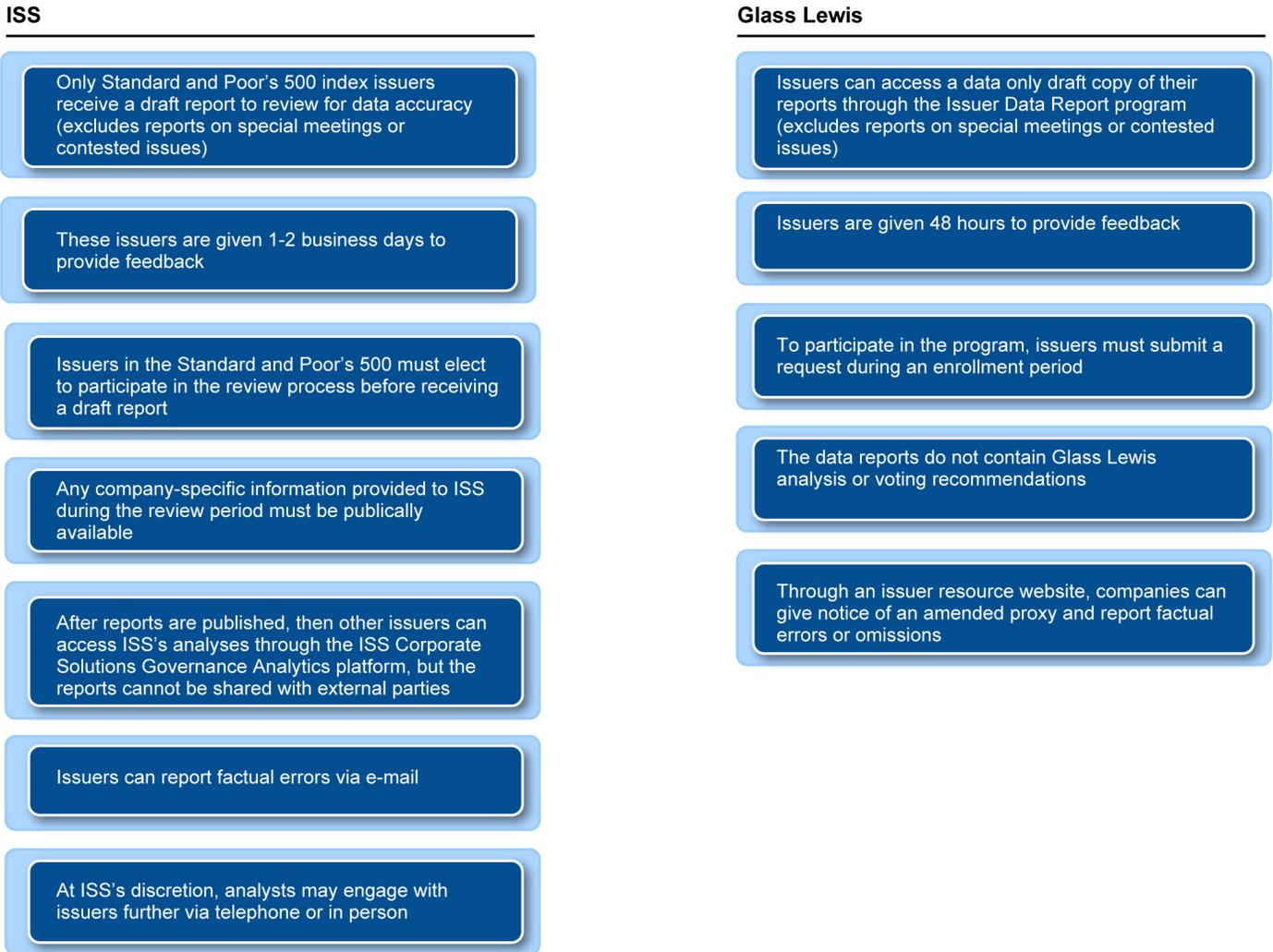
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In contrast, vote recommendations on mergers and acquisitions would always be applied on a case-by-case approach that considered the facts and circumstances of the companies involved. The proxy advisory firms state in their respective general policies that they consider the benefit that implementation of a proposal would have on shareholders of the company being evaluated. For example, in proxy reports we reviewed of a merger, both ISS and Glass Lewis evaluated the potential benefits of the merger to investors on both sides of the proposed transaction. Both ISS and Glass Lewis found that investors for one company would benefit and thus recommended in favor of the merger for investors of that company, but recommended against the merger for investors of the other company because it would not be to their benefit.

In conducting evaluations such as these, ISS and Glass Lewis officials as well as some corporate issuers we interviewed also said that the firms consider new and company-specific information. For example, in 2015 reports on this merger, ISS made adjustments to its original reports to account for company-specific information that clarified two data points, adjusting the estimated fair value of one of the companies. The updates were included in the reports and clients were notified through an alert or note—a process the proxy advisory firms use when they have updated or revised information in their reports. Proxy advisory firm officials also pointed out that while analysts have the discretion to engage with clients as well as with some corporate issuers during each proxy season, the firms only consider new or company-specific information that is publicly available to help ensure their reports and recommendations are based on the same information available to clients and the broader investing public.

Both Glass Lewis and ISS officials acknowledged that corporate issuers expressed an interest in reviewing proxy reports for accuracy in advance of proxy meetings. In addition, international regulatory organizations, such as European Securities and Markets Authority and Canadian Securities Administrators, have promoted increased engagement and transparency between corporate issuers and proxy advisory firms. Therefore, the proxy advisory firms have developed specific procedures that corporate issuers or their representatives may use to review or report errors related to the proxy reports prepared by the firms (see fig. 4).

**Figure 2: Institutional Shareholder Services' (ISS) and Glass Lewis's Review Processes for Proxy Reports, as of September 2016**



Source: GAO representation of proxy firm information. | GAO-17-47

Note: In addition to the general draft review process, ISS has a data verification process for equity plans that allows issuers with an equity plan on their ballot to preview and update data used in ISS's assessment of the plan.

Specifically, 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. These data-only versions do not contain the firm's recommendations. Companies interested in receiving a report must submit a request. Corporate issuers are given a 48-hour

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window to review the draft and provide corrections. ISS offers a similar opportunity to Standard and Poor's 500 companies and to companies in comparable large capitalization indices in some countries outside the United States.<sup>50</sup> However, unlike the data-only versions of the reports provided by Glass Lewis, these reports contain ISS's analyses and vote recommendations. Other corporate issuers have the option of requesting a copy of the published report in advance of the company's annual meeting. Standard and Poor's 500 companies have the opportunity to review ISS's draft reports and provide feedback within 1-2 business days. One stakeholder we interviewed said that this time window did not always allow corporate issuers enough time to review. However, Glass Lewis and ISS officials indicated that these time windows allow them to meet their report publishing deadlines. In addition to the draft review process, ISS officials said ISS has a Feedback Review Board that provides a mechanism for stakeholders to communicate with ISS throughout the year regarding the accuracy of data, research, and general fairness of policies.

ISS and Glass Lewis documents state that the opportunity to review advance copies of each company's specific report is only an opportunity to check data for factual errors and not a mechanism for conveying disagreement with ISS's or Glass Lewis's methodologies or analyses. Some corporate issuers stated that there are differences of opinion, conflicting points of view, and misinterpretations of the data. However, ISS documentation indicated that although the review process allows for a verification of data, it has to limit the breadth of the review because it adds operational complexity and significant time to the research production process. Glass Lewis policy states that during proxy season it has to limit discussions on its policies or recommendations to help it remain objective. However, Glass Lewis officials said that it engages with issuers extensively outside of proxy season on issuer-specific issues including specific recommendation as well as general policies. Both corporate issuers and institutional investors we interviewed said that the data errors they found in the proxy reports were mostly minor, but as we discuss below, some errors can lead to negative recommendations.

Some issuers raised other concerns regarding how policies were applied during recommendation development and that the approaches used did

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<sup>50</sup>Large-cap (large capitalization) indices are indices of companies with market capitalization values of more than \$5.3 billion.

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not always account for differences across corporate issuers. For example, ISS's and Glass Lewis's general compensation policies lay out a set of criteria they use in evaluating an executive compensation package. Corporate issuers we interviewed expressed concern that firms applied these policies in a one-size-fits-all or rules-based manner. A few corporate issuers said they had to initiate outreach to the firms to explain the corporate issuers' unique circumstances before the recommendations were reversed. Corporate issuers with whom we spoke pointed to another example of one-size-fits-all application involving overboarding policies. As mentioned earlier, ISS and Glass Lewis general policies provide a threshold (number) for public company boards on which a director can serve before being considered overextended. One small corporate issuer we interviewed said it was unsuccessful in trying to make a case for keeping a highly qualified director who contributed needed expertise but was deemed overboarded. Given the company's small size, representatives found it very important to have this individual on its board. Although a few corporate issuers with whom we spoke were frustrated that consideration has not been given for special circumstances or the effect the decision would have on the company, one proxy advisory firm's policy refers to institutional investor concerns about directors being overextended. As previously discussed, a 2013 study found limited evidence of a one-size-fits-all approach in the context of mandatory say-on-pay. The study found that proxy advisory firms take into consideration mitigating company-specific circumstances, severity of the issue, the firm's rationale, and the overall quality of the compensation plan when policies were applied during recommendation development.<sup>51</sup>

Furthermore, some corporate issuers and stakeholders would like further insight into how the proxy advisory firms arrived at their vote recommendations. A few stakeholders also told us they hire consultants with expertise on executive compensation and have developed models similar to those used by proxy advisory firms to help them better understand how firms produce their results and recommendations.

To further increase transparency into the proxy advisory firm vote recommendation process, stakeholders have proposed making the reports available to the public at some time after the annual meeting. Market participants and other stakeholders told us there are advantages

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<sup>51</sup>Yonca Ertimur, Fabrizio Ferri, and David Oesch, "Shareholder Votes and Proxy Advisors: Evidence from Say on Pay," *Journal of Accounting Research*, vol. 51, no. 5 (December 2013).

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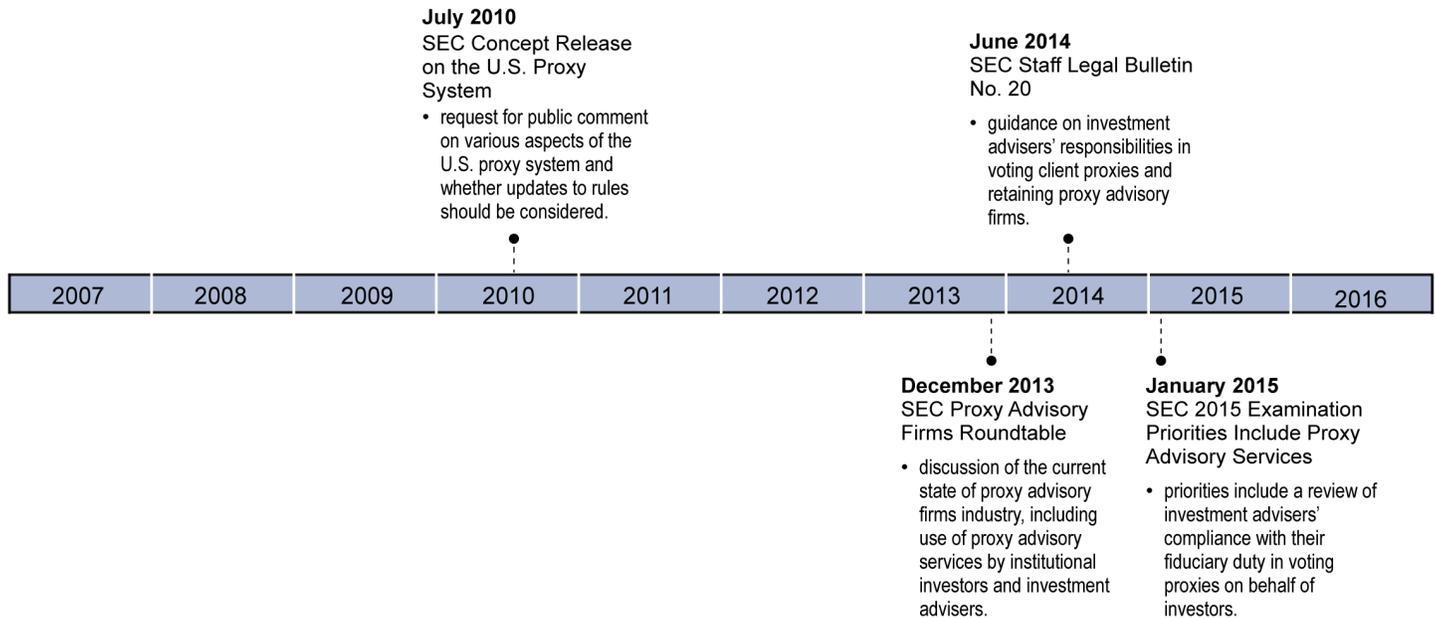
and disadvantages to making proxy advisory firm reports public at an appropriate time. For example, some market participants said a possible advantage to making the reports public is that it would allow for greater scrutiny and the ability to further evaluate the validity of proxy firm recommendations and whether the recommendations have a positive effect on shareholder value. But several stakeholders agreed that making them public would negatively affect proxy advisory firms' ability to be profitable. Proxy advisory firms did not support the idea of making their reports publicly available at no cost after the relevant shareholder meeting because it would undermine their business model. They noted that their clients use these reports throughout the year and not just as a basis for voting proxies.

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## SEC Oversight Activities of Proxy Advisory Services Have Included Information Gathering, Guidance, and Examinations

Since 2007, SEC oversight of proxy advisory firms and the services they provide has included information gathering on issues relating to the firms, issuance of guidance, and examinations of firms registered as investment advisors and of registered investment companies or investment advisers using proxy advisory services (see fig. 5).

**Figure 3: Securities and Exchange Commission (SEC) Oversight Actions Related to the Proxy Voting System and Use of Proxy Advisory Firms, 2007–2016**



Source: GAO analysis. | GAO-17-47

**Concept release.** Since our last report in 2007, SEC sought public comment on concerns that had been raised by stakeholders in the proxy advisory industry in its 2010 Concept Release on the U.S. Proxy System.<sup>52</sup> According to SEC staff, the agency occasionally publishes concept releases to raise awareness and collect the public's view on certain securities issues so the agency can better evaluate the need for future rulemaking. The 2010 concept release discusses, among other things, concerns that had been raised by corporate issuers and industry participants about the level of accuracy and transparency in how proxy advisory firms formulate voting recommendations and potential conflicts of interest. Concerns related to accuracy and transparency include that firms' voting recommendations may be based on inaccurate or incomplete data. Additionally, the 2010 concept release reiterated what we reported on in 2007, that a conflict of interest for a proxy advisory firm could arise if it provided both proxy voting recommendations to institutional investors and consulting services to companies on the same matter. And as we reported in 2007, the most commonly cited potential for conflict of interest

<sup>52</sup>Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42,982 (July 22, 2010).

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involved ISS; specifically, that ISS advises institutional investors on how to vote proxies and provides consulting services through its subsidiary, ISS Corporate Solutions, Inc., to companies seeking to improve their corporate governance. The concept release also discussed other types of potential conflicts of interest on which we reported in 2007, such as when owners or executives of the proxy advisory firm have significant ownership interest in, or serve on the board of directors of companies (corporate issuers) with matters being put to shareholder vote and on which the proxy advisory firm is offering vote recommendations.

The concept release also requested public comments on a list of potential regulatory solutions for addressing conflicts of interest and accuracy and transparency issues. For example, SEC asked for comments about revising interpretive guidance or regulations to require more specific disclosure of the presence of a potential conflict and the extent of controls and procedures ensuring the accuracy of proxy research reports provided to institutional investor clients.

SEC received about 300 comment letters on these and other issues discussed in the release. SEC staff stated these comment letters helped to inform subsequent work on proxy advisory firms (as discussed below). Furthermore, SEC staff stated that they continue to routinely review issues raised in the concept release, and have met with several stakeholders and associations representing corporate issuers, investors, and proxy advisory firms to see if the issues are still prevalent and plan to continue these discussions with various stakeholders.

**Roundtable.** In December 2013, SEC held a roundtable to discuss issues facing the proxy advisory industry. Participants included the SEC Chair as well as four SEC Commissioners and various officials and representatives from institutional investors, investment advisers, corporate issuers, academia, law firms, and proxy advisory firms. According to statements by the Chair, the roundtable continued the review of the use of proxy advisory services and related issues that were discussed in the 2010 concept release.

The roundtable discussed the use of proxy advisory firms in general and also reviewed key topics of interest, including potential conflicts of interest for proxy advisory firms and users of their services, the transparency and accuracy of the recommendations the firms make, and what the nature and extent of institutional investor reliance on proxy advisor recommendations is and should be. The Chair stated she was particularly interested in the discussion of potential conflicts of interest. One

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Commissioner also drew attention to these issues in a number of speeches in 2013 and 2014.<sup>53</sup>

**Guidance.** SEC staff addressed some of the issues discussed above through guidance. After the concept release and the roundtable, SEC staff took steps to address issues in the proxy system in a 2014 Staff Legal Bulletin.<sup>54</sup> SEC staff stated the bulletin summarized the staff's views on laws and SEC regulations related to proxy advisory firms. For example, SEC staff provided guidance that spelled out various responsibilities for disclosure of conflicts of interest. The guidance made it clear that proxy advisory firms must provide notice of the presence of a significant relationship or a material interest. In addition, according to the Staff Legal Bulletin, such disclosure should enable the recipient to understand the nature and scope of the relationship or interest, including the steps taken, if any, to mitigate the conflict. The disclosure should also provide sufficient information to allow the recipient to make an assessment about the reliability or objectivity of the recommendation.

Additionally, the bulletin clarified and restated responsibilities of investment advisers to demonstrate that proxy votes are cast in accordance with clients' best interests and the adviser's proxy voting procedures. Among other things, the guidance states that investment advisers who use proxy advisory firms should ascertain whether the proxy advisory firm has the capacity and competency to adequately analyze proxy issues. In doing so, the guidance states that investment advisers could consider, among other things, the robustness of the proxy advisory firm's policies and procedures regarding its ability to ensure that proxy voting recommendations are based on current and accurate information and to identify and address any conflicts of interest. The Staff Legal Bulletin further states that investment advisers who use the services of proxy advisory firms could also consider the adequacy and quality of the firm's staffing and personnel.

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<sup>53</sup>Commissioner Daniel M. Gallagher, remarks at national conference of Society of Corporate Secretaries and Governance Professionals (now, the Society for Corporate Governance) (Seattle, Wash.: July 11, 2013); Commissioner Daniel M. Gallagher, remarks at Transatlantic Corporate Governance Dialogue Conference, "The Realities of Stewardship for Institutional Owners, Activist Investors, and Proxy Advisors" (Washington, D.C.: Dec. 3, 2013); and Commissioner Daniel M. Gallagher, remarks to the Forum for Corporate Directors (Orange County, Calif.: Jan. 24, 2014).

<sup>54</sup>Securities and Exchange Commission, Division of Corporate Finance, Division of Investment Management Staff Legal Bulletin No. 20 (June 30, 2014).

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Institutional investors with whom we spoke told us they perform due diligence on proxy advisory firms in various ways. A few institutional investors reported conducting various types of compliance reviews of firms, including site visits and analyst interviews. For example, one institutional investor has analysts dedicated to conducting ongoing due diligence on the data quality of the proxy advisory firm's reports. This institutional investor validates the firm's data and communicates any errors it identifies to the firm. The institutional investor said that the errors found in proxy reports generally were minor and that firms typically were able to update and correct their reports.

**Examinations.** SEC staff also considered some of the issues discussed previously through examinations of proxy advisory firms registered as investment advisers and registered investment companies using proxy advisory firms. As discussed, proxy advisory firms that are registered investment advisers under the Advisers Act are subject to examination by SEC.<sup>55</sup> According to SEC staff, proxy voting issues and proxy advisory firms may not be examined on a regularly scheduled basis because SEC uses a risk-based approach to identifying examination priorities each year. As noted previously, all entities, including proxy advisory firms, that meet the statutory definition of an investment adviser (where no exclusion from the definition is available), regardless of whether they are registered with SEC, are subject to the Advisers Act's antifraud provisions. Legislation that has been proposed would require all proxy advisory firms to register as such, creating a new regulatory framework for the registration of proxy advisory firms.<sup>56</sup>

In January 2015, SEC staff announced examination priorities for 2015, which included select proxy advisory firms and how they make

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<sup>55</sup>As noted previously, ISS, Marco Consulting, and ProxyVote Plus are registered as investment advisers, citing their work as pension consultants as their basis for registering. Of the other two proxy advisory firms, Glass Lewis is not registered, and Egan-Jones is registered as a Nationally Recognized Statistical Rating Organization; therefore, SEC oversight of Egan-Jones only extends to the firm's credit ratings activities.

<sup>56</sup>See, e.g., Corporate Governance Reform and Transparency Act of 2016, H.R. 5311, 114th Cong. (2016). In addition to requiring registration, other provisions in this bill would require proxy advisory firms to provide information during registration on whether they have a code of ethics (and if not, provide reasons for not having one); establish and enforce policies and procedures to address and manage any conflicts of interest; disclose their methodology for the formulation of proxy voting policies and voting recommendations; and file financial statements with and make an annual report to SEC. Although this bill would require proxy advisory firms to register with SEC, it would not give SEC examination authority.

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recommendations on proxy voting and how they disclose and mitigate potential conflicts of interest.<sup>57</sup> The examination priorities for 2015 also included reviewing investment advisers' compliance with their fiduciary duty in voting proxies on behalf of investors. SEC staff efforts on this priority were incorporated into an ongoing Never-Before-Examined Investment Company Initiative that launched in April 2015.<sup>58</sup> This initiative involves focused, risk-based examinations in a number of higher-risk areas, including compliance programs. SEC staff announced that as one of the areas to be reviewed within the compliance program, it would review investment companies' portfolio proxy voting policies and procedures. The examination focus would include the oversight of a proxy advisory firm retained by the investment company's investment adviser, if applicable.

In determining examination priorities through a risk-based approach, SEC staff told us that the decision to examine this issue for this initiative was based on several factors, including the higher risk that these investment companies may have weaker internal controls, including procedures for overseeing proxy advisory services. As of August 2016, the initiative is ongoing. We reviewed 41 percent of the examinations completed as of August 2016 on SEC's 2015 priorities addressing proxy advisory firm issues and confirmed that SEC examined risk areas related to conflict of interest, proxy voting policies and procedures, and oversight of proxy advisory services, among other issues.<sup>59</sup> None of the examinations we reviewed resulted in serious violations leading to an enforcement action.<sup>60</sup>

SEC staff stated they may refer to the scope, process, or relevant legal resources used in the initiative for examinations that review portfolio

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<sup>57</sup> Accessed on September 10, 2015, see <https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf>.

<sup>58</sup> Accessed on September 8, 2016, see <https://www.sec.gov/about/offices/ocie/ocie-never-before-examined-registered-investment-company-initiative.pdf>.

<sup>59</sup> We are not disclosing specific numbers and results of examinations because of SEC confidentiality considerations.

<sup>60</sup> In 2012, an SEC investigation had found that an ISS employee improperly shared material, nonpublic client vote information, with a proxy solicitor and that ISS failed to establish and enforce written policies and procedures reasonably designed to prevent the misuse of material, nonpublic information such as client vote information. In 2013, SEC issued a cease and desist order against ISS and required ISS to pay a \$300,000 penalty and engage an independent compliance consultant to review its supervisory and compliance policies and procedures.

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securities proxy voting in the future, although as of August 2016 none were planned. As clarified in the Staff Legal Bulletin, due diligence obligations over proxy advisory firms on a regular basis falls predominately on the investment adviser using their services. Therefore, regardless of persisting perceptions of issues with proxy advisory firms as discussed above, it is the investment adviser's responsibility to vote the proxy in its clients' best interest.

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## Agency Comments

We provided a draft of this report to the Securities and Exchange Commission for review and comment. We also provided excerpts of the report to proxy advisory firms for technical comment. SEC staff as well as officials from each proxy advisory firm provided technical comments, which we have included, as appropriate.

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We are sending copies of this report to the appropriate congressional committees, the Chair of SEC, and other interested parties. In addition, the report will be available at no charge on the GAO website at <http://www.gao.gov>.

If you or your staff have any questions regarding this report, please contact me at (202) 512-8678 or [clementsm@gao.gov](mailto:clementsm@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs can be found on the last page of this report. Key contributors are listed in appendix II.

Sincerely yours,



Michael Clements  
Acting Director, Financial Markets and Community Investment

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# Appendix I: Objectives, Scope, and Methodology

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This report discusses (1) the demand for proxy advisory services and the extent to which firms may influence proxy voting and corporate governance practices, (2) how proxy advisory firms develop and apply voting policies to make vote recommendations and efforts to increase transparency, and (3) Securities and Exchange Commission's (SEC) oversight since 2007 related to proxy advisory firms and the services they provide.

To address all objectives, we conducted a literature review to obtain background information and identify issues related to proxy advisory firms. We used Internet search techniques and keyword search terms to identify publicly available information about proxy advisory firms, from 2008 – 2016, including the history, number of firms in the United States, types of proxy advisory services, and past or current issues facing the industry. From research databases such as ProQuest and LexisNexis, we obtained information from publicly available documents, such as journals, trade publications, periodicals, studies, white papers, and congressional testimony.

We also identified and conducted interviews with various officials and representatives with knowledge of the industry (SEC staff, 5 proxy advisory firms, 13 institutional investors, 11 corporate issuers, 4 proxy solicitation firms, 2 international agencies—European Securities Markets Authority and Canadian Securities Administrators—and 8 industry and advocacy groups). The industry and advocacy groups were the Business Roundtable, Chamber of Commerce's Center for Capital Markets Competitiveness, Council of Institutional Investors, Investment Company Institute, Mutual Fund Director's Forum, National Association of Corporate Directors, National Investor Relations Institute, and the Society of Corporate Secretaries and Governance Professionals. We also interviewed other stakeholders from the Stanford Rock Center for Corporate Governance, and the NASDAQ Stock Market and New York Stock Exchange.

We conducted the interviews to gain an understanding of issues affecting the proxy advisory industry and to obtain a variety of perspectives, as well as to corroborate the information obtained in our other sources. The views of those interviewed are not representative of all institutional investors, corporate issuers, proxy solicitors, or industry and advocacy groups. Our criteria for selecting the interviewees consisted of several factors such as participation in prior SEC events, including roundtables; recommendations from market participants and other stakeholders; participation in prior congressional hearings; appearance in our literature

reviews and Internet searches; and mentions in bibliographies of relevant papers and studies. In selecting corporate issuers (public companies that develop, register, and sell securities to the investing public to finance their operations), we used information from the Standard and Poor's Smallcap 600, Midcap 400, and Large 500 indexes to randomly select a mix of small, midsize, and large corporate issuers. In selecting institutional investors for our interviews, we obtained information from the Council for Institutional Investors and the Investment Company Institute to judgmentally select a mix of 13 institutional investors (based on asset size) and type (mutual fund companies and pension funds). We based the asset size of institutional investors on the total assets under management (AUM), or the total market value of all financial assets the institution manages for its clients or on its own behalf. To ensure a mix of large and small institutional investors, we ranked institutional investors by the total reported AUM and selected seven institutions with the highest total AUM and six institutions with the lowest total AUM. For purposes of this report, we defined "large" institutional investors as those with an AUM of \$600 billion or more and "small" institutional investors as those with an AUM of \$200 billion or less.

Throughout this report, we use certain qualifiers when describing results from interview participants, such as "few," "some," and "most." We define few as a small number but less than some (two or three); some as more than a few relative to the total number possible (at least four or more); and most as nearly all or almost everyone relative to the total number possible (at least seven or more).

To address the first objective, we reviewed and summarized literature and analyzed available information on users of proxy advisory firms and the demand for proxy advisory services, factors that may have contributed to demand, and the possible influence of firms on proxy voting and corporate governance practices. Specifically, to describe the demand for services, we identified the services provided by proxy advisory firms, users of such services, and the rationale, if any, for institutional investors, in particular, to acquire proxy advisory services. To the extent that relevant data or literature were available, we summarized information on any trends, linkages, or relationships identified in the literature.

Additionally, to address the first objective, we conducted a literature search to identify relevant academic studies and working papers on the influence of proxy advisory firms. Our criteria for selection consisted of factors such as whether the studies and papers were based on original data analysis (including data that may have been gathered by others);

published in a refereed medium; written or published in 2009–2016; and contained no serious methodological or other errors (as determined by our quality assessment and based on guidance for using external work in our engagements). We focused our analysis on published academic studies and academic working papers not yet published that involved quantitative analyses of proxy advisory firms' influence. We analyzed the content of these studies and papers for data or other information on the extent of the firms' influence. We reviewed whether the author concluded that the proxy advisory firms' research and recommendations moved at least some fraction of the votes or affected a company's governance decisions or practices. We also reviewed whether the author concluded that the firms' influence was positive or negative in the sense that it was potentially helpful or harmful to shareholders or investors.

For the second objective, we identified and analyzed available information on how proxy advisory firms develop and apply voting policies to make vote recommendations. We analyzed information on the firms' voting policies and guidelines, such as their general, custom, and specialty policies. In some instances, we focused our review on Institutional Shareholder Services (ISS) and Glass Lewis and Co. (Glass Lewis) because they have the largest number of clients in the proxy advisory firm market in the United States. We reviewed documentation issued by the SEC and its staff and international regulators such as the European Securities and Markets Authority and Canadian Securities Administrators proposing principles and guidelines related to proxy advisory firm transparency. In addition, we reviewed proxy advisory firm policies, mechanisms, and the transparency of their voting policies, procedures, and processes, including reviewing the firms' websites and whether they disclosed information about their policies and processes. We also analyzed the views of market participants and other stakeholders on these transparency efforts.

We also compared proxy advisory firms' policies for selected voting issues with related corporate governance standards developed by other entities, such as stock exchanges and institutional investors. Specifically, we reviewed four different voting policies from the five proxy advisory firms and compared them with corporate governance standards developed by the New York Stock Exchange (NYSE), NASDAQ Stock Market, and one large institutional investor. We selected NYSE and NASDAQ because they have corporate governance requirements that corporate issuers must meet to be listed on the exchange and some of these requirements are also addressed by proxy advisory firms. We also selected a large institutional investor that has developed its own voting

policies on corporate governance issues to provide an example of how proxy advisory firm policies compare to voting policies of institutional investors. We reviewed voting policies and corporate governance requirements for director independence, overboarding, independent chairman/chief executive officer, and proxy access issues. We selected these four topics based on what we learned from interviews with market participants and other stakeholders and our literature review. Although some of the proxy advisory firms have voting policies for different countries, we focused on the proxy voting policies for the United States.

Lastly, for the second objective, we analyzed the policies firms use in developing vote recommendations and identified different proxy voting issues to illustrate the process. To select voting issues, we made a judgmental selection of voting events occurring after the issuance of the June 2014 SEC Staff Legal Bulletin on proxy voting and during the 2015 proxy season. We selected events that were either discussed in our interviews with market participants or other stakeholders or publicly in the news media. The example events covered the areas of (1) board of directors' issues, (2) mergers and acquisitions, and (3) executive compensation. We also reviewed available information on the steps conducted to ensure that data used for developing vote recommendations are accurate and looked at the degree of communication between proxy advisory firms and corporate issuers before vote recommendations are finalized. Specifically, we reviewed ISS's and Glass Lewis's draft review processes and analyzed the views of market participants who have been involved with the processes.

For the third objective, we reviewed and summarized SEC oversight activities since our last report in 2007 regarding proxy advisory firms and their clients. We reviewed the SEC 2010 Concept Release on the U.S. Proxy System related to proxy advisory firms and comment letters industry stakeholders submitted to SEC on the concept release. We reviewed the transcript and comments on a roundtable SEC held about the proxy advisory industry in 2013. We also reviewed the guidance and clarification provided in the 2014 Staff Legal Bulletin of the obligations of proxy advisory firms and their clients who are registered as investment advisers. To determine whether SEC addressed 2015 examination priorities related to proxy advisory firms registered as investment advisers and the services they provide to registered investment companies, we reviewed 41 percent of the examinations related to SEC's 2015 priorities addressing proxy advisory firm and proxy voting issues completed as of August 2016.

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We conducted this performance audit from August 2015 to November 2016, in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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# Appendix II: GAO Contact and Staff Acknowledgments

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## GAO Contact

Michael E. Clements, (202) 512-8678 or [clementsm@gao.gov](mailto:clementsm@gao.gov)

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## Staff Acknowledgments

In addition to the above contact, Kay Kuhlman (Assistant Director), Michelle Bowsky (Analyst-in-Charge), Ria Bailey-Galvis, William Chatlos, Risto Laboski, Patricia Moye, Aku Pappoe, Barbara Roesmann, Jena Sinkfield and Anne Stevens made key contributions to this report.

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