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Cracking the Proxy Advisory Duopoly

Glass Lewis and ISS have a 97% market share and conflicts of interest.

By The Editorial Board Follow
July 12, 2023 6:24 pm ET

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Corporations these days face an onslaught of environmental, social, and governance (ESG) proxy resolutions from progressive investors. But the real driving force behind this campaign is the proxy advisory duopoly, Glass Lewis and Institutional Shareholder Services (ISS). On Thursday the House Financial Services Committee will shine a much-needed spotlight on these firms and their conflicted business models.

Proxy advisory firms can provide valuable services to investors. Yet Glass Lewis and ISS, both foreign-owned, boast outsize clout in U.S. corporate elections and make up an estimated 97% of the proxy advisory market. A 2018 article in the Harvard Law School Forum on Corporate Governance found the two firms can swing between 10% and 30% of shareholder votes. Another study by the American Council for Capital Formation found that 175 asset managers, controlling more than $5 trillion in assets, voted with ISS more than 95% of the time.

Both firms supported a shareholder resolution this year by New York City's pension funds requesting an audit of Starbucks's labor practices. It passed with 52% support. Last year they lent critical support to a resolution for an independent racial equity audit at McDonald's, which carried with 55%.

Both proxy firms disclose general guidelines on how they develop recommendations, but they give themselves wide discretion. Glass Lewis says "we may recommend voting against responsible directors" where it finds climate disclosures "to be absent or significantly lacking." What qualifies as "significantly lacking"?

ISS says it will "generally vote against" directors "in cases where ISS determines that the company is not taking the minimum steps needed to understand, assess, and mitigate risks related to climate change to the company and the larger economy."

Companies are left guessing what they need to do to win the duopoly's blessing. One solution: Pay ISS for advice on how to satisfy ISS. The firm has a consulting arm that advises corporations on how to "manage investor expectations" and design "ESG programs to align with company goals, reduce risk, and manage the needs of diverse stakeholders."

ISS Corporate Solutions says it helps companies "maximize your appeal to investors" and "deliver insight into what institutional investors are looking for." Its consultants know what institutional investors are looking for because its advisory firm directs them. This would be like Harvard flogging services to parents on how to get junior into Harvard.

Glass Lewis says it provides "active ownership engagement" to institutional investors "to collectively influence your companies, ensuring the highest standards of transparency and best practices in ESG are maintained." Shareholder activists also pay Glass Lewis to boost their campaigns. It's hard to believe its activist clients don't influence the firm's recommendations.

There's also a broader conflict between the financial interests of the advisory firms and those of its clients that aren't pursuing ESG goals. The latter include public pension funds that under state law are required to pursue the financial best interest of retirees.

"Each of you offers a substantial number of services related to ESG investing," 21 state Attorneys General wrote to the duopoly firms in January. "The value of these services would be undermined if you were to admit in your advisory services that ESG factors are not material to a firm's financial performance."

Glass Lewis says it discloses to clients when “there is a significant actual, potential, or perceived conflict.” ISS says it maintains a firewall between its advisory and consulting services, but it permits communications between consulting and research teams on general policy development and “new solutions.”

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Former Securities and Exchange Commission Chairman Jay Clayton sought to rein in the duopoly by defining proxy advisory recommendations as “solicitations” under securities laws. This would have allowed them to be sued for making factual errors or misleading statements. His rules also required the firms to disclose their conflicts of interest.

ISS sued to block the rule, but why oppose the rules if it is as transparent as it claims? In any case, the Democratic SEC majority under Chairman Gary Gensler rescinded the rules in 2022. The duopolists want to impose onerous reporting burdens on public companies, ranging from climate to racial equity, while avoiding accountability and disclosure themselves.

All of which means there’s an opening for Congress to codify Mr. Clayton’s reforms. The states are also on the case, with AGs noting in their letter that proxy firms may be violating their contractual obligations to pension funds to maximize the “economic value of the investments.” Strive has launched a competing proxy advisory service, and antitrust action might be warranted.

ISS CEO Gary Retelny recently wrote an apologia in the Harvard Law School Forum on Corporate Governance claiming that “our proxy advice is apolitical.” That’s not what the public record shows. Corporate boards and investment advisers can be sued if they violate their fiduciary duty. Why should the duopoly get a pass?