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OPINION | REVIEW & OUTLOOK

## *The Proxy Protection Racket*

The SEC shines some sunlight on a cozy business duopoly.

By The Editorial Board

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Jay Clayton, Chairman of the U.S. Securities and Exchange Commission, September 9. PHOTO: SHANNON STAPLETON/REUTERS

Union pension funds promote transparency and democracy in corporate governance—so we’re told, and at least when it serves their political purposes. But look who’s now opposing the Securities and Exchange Commission’s efforts to break up a corporate protection racket by proxy firm duopolists.

The SEC last week proposed regulations that would make proxy firms that provide advice to institutional investors legally liable under securities laws. Firms would also have to disclose conflicts of interest and let corporations rebut their recommendations if they want a pass from



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es and Glass Lewis control 97% of the proxy advisory market. ISS provides recommendations to 2,239 clients, including 189 pension plans, and executes 10.2 million ballots annually on their behalf. Glass Lewis, which is owned by the Ontario Teachers' Pension Plan and Alberta Investment Management Corp., has more than 1,300 clients that manage more than \$35 trillion in assets.

Studies have found that the two firms can swing 20% of votes in proxy elections. An American Council for Capital Formation review last year found that 175 asset managers with \$5 trillion of assets voted with ISS recommendations 95% of the time. Activist hedge-fund investors often enlist the proxy firms to shake up management, for better or worse.

How have these firms become so powerful? One reason is institutional investors have themselves grown to enormous size and now own 70% of the market value of U.S. public companies. The California Public Employees' Retirement System controls \$350 billion in assets. Since many companies don't have the resources to evaluate tens of thousands of proxy proposals, they farm out recommendations.

The Dodd-Frank Act also increased proxy firm clout by mandating advisory say-on-pay votes. Executives who want to win shareholder approval for their compensation thus consult proxy firms that sell advisory services. Imagine if the Federal Reserve were to sell advice to banks on how to pass its stress tests and obtain approval for dividend distributions.

A 2014 Stanford University Rock Center for Corporate Governance study found that when ISS and corporate management disagreed about pay, large money managers voted with the proxy firm about 95% of the time. Another study found that an ISS negative recommendation can reduce the share of votes in favor of management say-on-pay proposals by 25 percentage points.

No surprise then that more than 70% of public companies have reported consulting proxy firms on executive compensation. Yet ISS doesn't disclose to shareholders that it gets paid by the same folks it is rating. Nor does Glass Lewis inform clients that it is peddling advice to plaintiff attorneys suing companies. Why not?

The Securities Exchange Act of 1934 strictly regulates "solicitations" that are intended to influence shareholder votes, but the SEC has long given proxy firms a pass under the law. No more. The SEC last week proposed regulations clarifying that proxy firms like corporations can be sued if they make material misstatements. The firms will also have to inform investors if they get paid consulting fees by companies whose corporate governance they rate.

The firms will also have to let corporations review and respond to their recommendations. Corporations last year told the SEC of 45 factual or analytical errors in proxy-firm recommendations, but they often are not given a chance to set the record straight before shareholders vote. Investors thus often vote based on biased and inaccurate information.

Corporate governance is distorted when two privately held companies that don't own shares in public companies have so much sway over shareholder votes and corporate policy. This makes corporations less accountable to their actual owners.

Pension funds support the proxy firms because they tend to share a political agenda and have become a force multiplier to sway CEOs and corporate boards. Union funds are opposing the new SEC rules on proxy firms despite advocating more corporate transparency of political donations and climate policies. Credit to the SEC for taking on this politically potent and self-serving duopoly.

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