HEARING: "EXPOSING THE PROXY ADVISORY CARTEL: HOW ISS & GLASS LEWIS INFLUENCE MARKETS"

before the

SUBCOMMITTEE ON CAPITAL MARKETS OF THE COMMITTEE ON FINANCIAL SERVICES

Testimony of Professor Paul Rose

Mr. Chairman and members of the committee, thank you for the opportunity to offer testimony on an issue that I have been studying for over 20 years, the concentrated and largely unregulated power of proxy advisory firms in the U.S. capital markets.

Today, two firms—Institutional Shareholder Services (ISS) and Glass Lewis—dominate over 90% of the proxy advisory market. Their recommendations can swing vote outcomes and shape the governance of publicly traded companies, yet these firms operate without fiduciary obligations, limited transparency, and minimal accountability.

Importantly, this market dominance is not a natural result of investor demand. It is a byproduct of regulatory design—specifically the SEC's adoption of Rule 206(4)-6 under the Investment Advisers Act of 1940. This rule, adopted in 2003, requires registered investment advisers to adopt proxy voting policies and procedures and to vote client securities in their best interest. Subsequently, the SEC issued no-action letters stating that investment advisers could fulfill these obligations by relying on the guidance of independent third-party proxy advisors. By the time the SEC withdrew these no-action letters in 2018, the proxy advisory industry had grown significantly. Indeed, the proxy advisory industry would not exist at its current scale without these regulatory choices. Rule 206(4)-6 effectively transformed what had been an internal fiduciary duty into an external compliance function, fueling the growth of ISS and Glass Lewis into de facto gatekeepers of corporate governance. Hundreds of institutional investors now outsource their voting decisions to these firms.

I. The Effects of Robovoting on Shareholder Democracy

The consequences of this regulatory shift have been profound. For example, many institutional investors now engage in "robovoting," mechanically following proxy advisors' recommendations without independent analysis. In 2020, over 100 institutional investors—managing a combined $5 trillion in assets—voted in near-total alignment with ISS or Glass Lewis.

Robovoting may be attractive from a cost-efficiency perspective, but, as Mr. Nunn's draft bill implicitly notes, it potentially compromises fiduciary responsibilities. Automated voting undermines the requirement that investment advisers act in their clients' best interest by removing independent judgment from critical governance decisions. It also reduces diversity in shareholder viewpoints, leading to homogenized voting outcomes that may not reflect the full spectrum of shareholder interests.

II. Conflicts of Interest and Market Concentration

Beyond robovoting, structural conflicts of interest further complicate the role of proxy advisors. For example, ISS not only provides voting recommendations to institutional investors but also sells governance consulting services to the very companies it evaluates. This dual role presents a fundamental conflict: how can a firm offer objective assessments while simultaneously advising issuers on how to secure favorable reviews? We typically do not allow such conflicts of interest in financial services—auditors, for example, have been prohibited from engaging in potentially conflicting activities since the passage of the Sarbanes-Oxley Act. The draft bill from Mr. Fitzgerald would directly address this issue.

Market concentration exacerbates this problem. With only two firms dominating the field, companies have little recourse if they disagree with recommendations. The market lacks meaningful competition or alternative sources of advice, making oversight and transparency all the more essential. I note that Mrs. Wagner's draft bill proposes a study that could shed light on these questions.

III. Uniform Standards vs. Company-Specific Context

Another concern is the application of standardized voting policies. Proxy advisors often promote uniform governance practices across industries, ignoring the unique needs and strategic contexts of individual firms. A rigid, one-size-fits-all approach may penalize innovative or long-term strategies that deviate from so-called "best practices."

This discourages experimentation and diversity in corporate governance models. If there was strong evidence that the advice generated better returns or helped companies avoid scandal, perhaps such advice would be justified. Unfortunately, very little evidence exists supporting the specific governance recommendations of proxy advisors.

IV. The 2020 SEC Reforms and Their Rollback

In response to mounting concerns, the SEC adopted a set of reforms in July 2020. These included:

• Requiring proxy advisors to disclose conflicts of interest;

• Ensuring that issuers could review and respond to proxy advice before shareholder meetings;

• Mandating that institutional clients of proxy firms have access to those responses prior to voting;

• And reaffirming that proxy advice constitutes a "solicitation" under federal securities laws.

These changes came after a decade of careful work by the SEC staff, across a Democratic and a Republican presidential administration. They were designed to increase transparency, accuracy, and fairness in the proxy voting process. Yet in 2021, under Chairman Gensler, the Commission announced plans to suspend enforcement and revise the rules, before the rules were even fully implemented.

Such regulatory whiplash creates uncertainty for market participants. It signals that rules carefully developed through public input can be reversed without due consideration. This erodes trust in the Commission and reduces the incentives for firms to invest in compliance infrastructure.

V. Policy Recommendations

To address the challenges posed by proxy advisory firms, I offer the following recommendations. Congress should:

1. Enact legislation requiring the SEC to establish rules to ensure basic fairness, transparency, and procedural accountability in proxy voting advice.

2. Discourage robovoting by requiring institutional investors to demonstrate active, independent evaluation of proxy advice.

3. Impose fiduciary-like duties on proxy advisors, consistent with their influence over corporate decision-making.

4. Commission empirical studies on the effects of proxy advice on long-term company performance and shareholder outcomes.

The draft bills proposed by Mr. Steil, Mr. Loudermilk, Mr. Nunn, Mrs. Wagner, and Mr. Fitgerald would address these recommendations.

Conclusion

The modern proxy advisory industry was not born from market innovation but from regulatory incentives. Advocates for the proxy advisory industry maintain that proxy advisors' influence is overstated, and they perform useful function in the market. Even if we assume that is true, why should we not hold proxy advisors subject to similar fiduciary duty standards and protect investors against conflicts of interest the way that we do for other significant market actors? By imposing standards for accountability and oversight, Congress can ensure that proxy advisors serve as responsible facilitators of informed shareholder participation, not unregulated gatekeepers of corporate governance.

Thank you. I welcome your questions and continued dialogue on this important issue.

Respectfully submitted,

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