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Report to Congressional Requesters

June 2007

CORPORATE SHAREHOLDER MEETINGS

Issues Relating to Firms That Advise Institutional Investors on Proxy Voting

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GAO-07-765

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Highlights

Highlights of GAO-07-765, a report to congressional requesters

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CORPORATE SHAREHOLDER MEETINGS

Issues Relating to Firms That Advise Institutional Investors on Proxy Voting

Why GAO Did This Study

At annual meetings, shareholders of public corporations can vote on various issues (e.g., mergers and acquisitions) through a process called proxy voting. Institutional investors (e.g., mutual funds and pension funds) cast the majority of proxy votes due to their large stock holdings. In recent years, concerns have been raised about a group of about five firms that provide research and recommendations on proxy votes to their institutional investor clients.

GAO was asked to report on (1) potential conflicts of interest that may exist with proxy advisory firms and the steps that the Securities and Exchange Commission (SEC) has taken to oversee these firms; (2) the factors that may impede or promote competition within the proxy advisory industry; and (3) institutional investors' use of the firms' services and the firms' potential influence on proxy vote outcomes.

GAO reviewed SEC examinations of proxy advisory firms, spoke with industry professionals, and conducted structured interviews with 31 randomly selected institutional investors.

GAO is not making any recommendations.

GAO provided a draft of this report to SEC for its review and comment. SEC provided technical comments, which GAO incorporated, as appropriate.

www.gao.gov/cgi-bin/getrpt?GAO-07-765.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Yvonne Jones at (202) 512-8678 or jonesy@gao.gov.

What GAO Found

Various potential conflicts of interest can arise at proxy advisory firms that could affect vote recommendations, but SEC has not identified any major violations in its examinations of such firms. In particular, the business model of the dominant proxy advisory firm—Institutional Shareholder Services (ISS)—has been the most commonly cited potential conflict. Specifically, ISS advises institutional investors how to vote proxies and provides consulting services to corporations seeking to improve their corporate governance. Critics contend that corporations could feel obligated to retain ISS's consulting services in order to obtain favorable vote recommendations. However, ISS officials said they have disclosed and taken steps to mitigate this potential conflict. For example, ISS discloses the potential conflict on its Web site and the firm's policy is to advise clients of relevant business practices in all proxy vote analyses. ISS also maintains separate staff who are located in separate buildings for the two businesses. While all institutional investors GAO spoke with that use ISS's services said they are satisfied with its mitigation procedures, some industry analysts continue to question their effectiveness. SEC conducts examinations of advisory firms that are registered as investment advisers and has not identified any major violations.

Although new firms have entered the market, ISS's long-standing position has been cited by industry analysts as a barrier to competition. ISS has gained a reputation for providing comprehensive services, and as a result, other firms may have difficulty attracting clients. Proxy advisory firms must offer comprehensive coverage to compete and need sophisticated systems to provide the services clients demand. But firms interested in entering the market do have access to much of the information needed to make recommendations, such as publicly available documents filed with SEC. Competitors have attempted to differentiate themselves from ISS by, for example, providing only proxy advisory services and not corporate consulting services. While these firms have attracted clients, it is too soon to tell what their ultimate effect on enhancing competition will be.

Among the 31 institutional investors GAO spoke with, large institutions reportedly rely less than small institutions on the research and recommendations offered by proxy advisory firms. Large institutional investors said that their reliance on proxy advisory firms is limited because, for example, they have in-house staff to assess proxy vote issues and only use the research and recommendations offered by proxy advisory firms to supplement such research. In contrast, small institutional investors have limited resources to conduct their own research and tend to rely more heavily on the research and recommendations offered by proxy advisory firms. The fact that large institutional investors cast the great majority of proxy votes made by institutional investors and reportedly place relatively less emphasis on advisory firm research and recommendations could serve to limit the firms' overall influence on proxy voting results.

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Abbreviations

Egan-Jones	Egan-Jones Proxy Services
Glass Lewis	Glass Lewis & Co.
ICS	ISS Corporate Services, Inc.
ISS	Institutional Shareholder Services, Inc.
MCG	Marco Consulting Group
PGI	Proxy Governance, Inc.
PWBA	Pension Welfare Benefits Administration
SEC	Securities and Exchange Commission

United States Government Accountability Office
Washington, DC 20548

June 29, 2007

The Honorable Spencer Bachus
Ranking Member
Committee on Financial Services
House of Representatives

The Honorable Deborah Pryce
Ranking Member
Subcommittee on Capital Markets,
Insurance, and Government Sponsored Enterprises
Committee on Financial Services
House of Representatives

The Honorable Richard Baker
House of Representatives

Each year, publicly traded corporations hold shareholder meetings for director elections and to consider management and shareholder proposals that may have an effect on a corporation's operations and value, such as executive compensation, corporate governance matters, and proposed mergers and acquisitions. Most shareholders typically do not attend these meetings, opting instead to vote by mail or online, through a process known as proxy voting. According to Automatic Data Processing, Inc.—one of the largest providers of transaction services to the financial industry—most proxy votes are cast by or on behalf of institutional investors, such as mutual funds and pension plans, given the level of stocks they manage as compared to other types of investors.

In recent years, concerns have been raised about the proxy advisory industry, which is comprised of five major proxy advisory firms that help many institutional investors carry out their fiduciary responsibilities relating to proxy voting.[1] These proxy advisory firms may perform several

[1]See *Proxy Voting by Investment Advisers*, 68 Fed. Reg. 6585 (2003) (final rule) (codified in various sections of 17 C.F.R. Part 275), which requires registered investment advisers to adopt policies and procedures reasonably designed to ensure that they vote proxies in the best interests of their clients. Similarly, the Employee Retirement Income Security Act of 1974 (ERISA) has been interpreted as imposing fiduciary obligations on persons authorized to vote proxies associated with equity securities owned by ERISA plans. See 29 C.F.R. § 2509.94-2 (2006).

functions on behalf of their clients, such as offering research and recommendations on particular proxy issues (e.g., whether to approve an executive compensation plan) or casting the actual votes. Critics of proxy advisory firms, including certain industry associations and academics, contend that the proxy advisory industry suffers from significant conflicts of interest and a lack of competition and that these firms have a disproportionate influence on proxy voting. Others counter that the firms provide a valuable service for institutional investors and note that such clients are sophisticated market participants that are free to choose whether and how to employ the services of proxy advisory firms.

Under the Securities Exchange Act of 1934,[2] the Securities and Exchange Commission (SEC) regulates the proxy solicitation process with respect to publicly traded equity securities, and SEC regulates the activities of proxy advisory firms that are registered with SEC as investment advisers under the Investment Advisers Act of 1940.[3] Under SEC rules, when soliciting proxies, certain information must be disclosed in writing to shareholders, and such disclosure, referred to as a proxy statement, must be filed with the agency.[4] These proxy statements must include important facts about the issues on which shareholders are asked to vote. Under the Investment Advisers Act and related SEC rules, registered investment advisers are required to take a variety of steps designed to help protect their clients. For example, an investment adviser must disclose information about its business practices and potential conflicts of interest to clients and potential clients. SEC monitors compliance with the laws and rules through, among other means, periodic examinations of registered investment advisers. Based on examination findings, SEC may send letters to investment advisers requiring them to correct identified deficiencies. SEC may also take enforcement actions for more serious violations, as deemed appropriate, such as seeking civil fines in federal district court.

Because of your interest in helping to ensure the integrity of proxy voting, you asked us to provide an overview of proxy advisory firms and SEC's oversight of this industry. This report (1) identifies potential conflicts of interest that may exist with proxy advisory firms and the steps that SEC

[2] 15 U.S.C. §§ 78a et seq.

[3] Most, but not all, of the major proxy advisory firms have registered as investment advisers with SEC, as will be discussed in this report.

[4] See section 14 of the Securities Exchange Act of 1934 (codified as amended at 15 U.S.C. § 78n) and related rules.

has taken to oversee these firms; (2) discusses the factors that might impede or promote competition in this industry; and (3) analyzes institutional investors' use of proxy advisory services to help vote proxies and the influence proxy advisory firms may have on proxy voting.

To address these objectives, we conducted a literature review and examined studies relating to the proxy advisory industry. In addition, we identified and interviewed various professionals (experts, academics, industry association representatives, and others) with knowledge of the industry. To gain an understanding of SEC's oversight of proxy advisory firms, we reviewed relevant investment adviser regulations and examination reports and interviewed agency officials. Further, we conducted structured interviews with 31 institutional investors selected randomly by type, including mutual funds, corporate pension funds, government pension funds, and union pension funds, as well as some asset management institutions, to gain an understanding of the ways in which they use proxy advisory firms and the influence that such firms have on proxy voting.[5] Our sample was derived from Standard & Poor's Money Market Directories (January 2006), and consisted of a population of institutional investors with over $1 billion in assets, including large and small institutional investors from each type above this asset level. We defined "large" and "small" institutional investors as the top and bottom 15 percent of each investor type. Large and small institutional investors account for over 72 percent of the managed assets held by all of the institutional investors with over $1 billion in assets. Although we randomly selected these institutional investors, the size of the sample was small and might not have been representative of the universe of institutional investors. As a result, we could not generalize the results of this effort.

We conducted our work in Washington, D.C., between September 2006 and June 2007 in accordance with generally accepted government auditing standards. See appendix I for more information on our scope and methodology.

Results in Brief

Various potential conflicts of interest exist among proxy advisory firms that could affect vote recommendations, but SEC has not identified any

[5]For purposes of this report, the term "institutional investor" refers to both the institution that owns the securities as well as an asset manager delegated the authority to vote proxies on behalf of the investors as the context requires.

major violations in its examinations of such registered firms. In particular, the business model of the dominant advisory firm—Institutional Shareholder Services, Inc. (ISS)—has been cited by industry participants and analysts as creating a significant potential conflict of interest. ISS advises institutional investor clients on how to vote their proxies and at the same time provides consulting services to help corporations develop management proposals and improve their corporate governance. Because it provides both types of services, ISS could, for example, help a corporate client develop an executive compensation proposal to be submitted for shareholder approval while at the same time making a recommendation to investor clients on how to vote for this proposal. ISS's critics also contend that this could lead corporations to feel obligated to retain ISS's consulting services in order to obtain favorable proxy vote recommendations. However, ISS officials said that they have disclosed and taken steps to help mitigate this potential conflict. For example, ISS publicly discloses information about the potential conflict on its Web site and firm policy requires relevant disclosures to its institutional investor clients. In addition, ISS officials explained that the proxy advisory and corporate consulting businesses have separate staff, operate in separate buildings, and use segregated office equipment and information databases. While all institutional investors we spoke with that use ISS's services said they are satisfied with the steps ISS has taken to mitigate this potential conflict, some industry analysts we contacted said there remains reason to question the steps' effectiveness. We also identified other potential conflicts associated with proxy advisory firms. For example, owners or executives of proxy advisory firms may have a significant ownership interest in or serve on the board of directors of corporations that have proposals on which the firms are offering vote recommendations. In its oversight capacity, SEC conducts examinations of proxy advisory firms that are registered as investment advisers, including, among other things, assessing compliance with requirements of the Investment Advisers Act and related rules, including the requirement that investment advisers identify, disclose, and mitigate conflicts of interest. To date, SEC has not identified any major violations and has not initiated any enforcement action against proxy advisory firms.

ISS's long-standing position in the proxy advisory industry has been cited as a potential barrier to competition in this industry, although new firms have entered the market in recent years. Since it began operating in 1985, ISS has gained a reputation with institutional investors for providing comprehensive proxy voting research and recommendations. Consequently, other providers may have difficulty attracting ISS's institutional client base of over 1,700 firms. According to industry participants, proxy advisory firms must offer comprehensive coverage of public companies in order to compete, because institutional investors may not be interested in subscribing to limited service offerings. Firms also need to develop sophisticated information systems to provide the research and vote-processing capabilities clients demand. But industry analysts also explained that firms interested in entering the market do have access to much of the information needed to conduct research, including the annual and quarterly reports companies file with SEC. In addition, various academics told us that once a firm has acquired the necessary technology and research processes, the marginal cost of providing services to additional clients and of updating and maintaining these services is relatively low. Competitors that have entered the market in recent years have attempted to differentiate themselves from ISS by, for example, emphasizing that they provide only proxy advisory services and not corporate consulting services. While these firms have attracted institutional clients, it is too soon to tell what their ultimate effect will be on enhancing industry competition.

Among the 31 institutional investors we spoke with, large institutions reportedly relied less than small institutions on the research and specific recommendations offered by proxy advisory firms to help decide how to vote proxies. Specifically, large institutional investors reported that their reliance on proxy advisory services is limited because these institutional investors (1) conduct their own research and analyses to make voting decisions and use the research and recommendations offered by proxy advisory firms only to supplement such analyses; (2) might develop their own voting policies, which the advisory firms would be responsible for executing; and (3) might contract with more than one advisory firm to gain a broader range of information on proxy issues. In contrast, small institutional investors reported that they have limited resources to conduct their own research and tend to rely more heavily on the research and recommendations of proxy advisory firms. Like large institutional investors, however, representatives of small institutions said that they are ultimately responsible for proxy voting decisions and retain the right to override recommendations made by advisory firms. While the institutional investors we contacted might not have been representative of all institutional investors, many industry analysts we spoke with agreed that large institutions would place less emphasis than small institutions on proxy advisory firms' research and recommendations when deciding how to vote. The fact that large institutional investors cast the great majority of proxy votes made by institutional investors and reportedly place less emphasis than small institutions on such research and recommendations could serve to limit the overall influence advisory firms have on proxy voting results.

We provided a draft of this report to SEC for its review and comment. SEC provided technical comments, which we incorporated, as appropriate. We also provided relevant sections of the draft to the proxy advisory firms for a technical review of the accuracy of the wording and made changes, as appropriate, based on the firms' comments.

Background

According to ISS, over 28,000 publicly-traded corporations globally send out proxy statements each year that contain important facts about more than 250,000 separate issues on which shareholders are asked to vote. Votes are solicited on a variety of key issues that could potentially affect the corporations' value, such as the election of directors, executive compensation packages, and proposed mergers and acquisitions, as well as other, more routine, issues that may not affect value, such as approving an auditor and changing a corporate name. The proxy statement typically includes a proxy ballot (also called a proxy card) that allows shareholders to appoint a third party (proxy) to vote on the shareholder's behalf if the shareholder decides not to attend the meeting. The shareholder may instruct the proxy how to vote the shares or may opt to grant the proxy discretion to make the voting decision. The proxy card may be submitted to the company via the mail or online.

The proxy advisory industry has grown over the past 20 years as a result of various regulatory and market developments. The management of a mutual fund's or pension plan's assets, including the voting of proxies, is often delegated to a person who is an investment adviser subject to the Investment Advisers Act of 1940.[6] In a 1988 letter, known as the "Avon Letter," the Department of Labor took the position that the fiduciary act of managing employee benefit plan assets includes the voting of proxies

[6]To the extent a mutual fund or pension plan has delegated the voting of its proxies to an asset manager, the proxy voting process is subject to the Investment Advisers Act of 1940 and the Employee Retirement Income Security Act of 1974 (ERISA). For purposes of this report, the term "asset manager" is used to refer both to investment advisers of registered investment companies, as well as to managers of pension plan assets. Registered investment companies are also required to disclose the policies and procedures that they use to determine how to vote proxies relating to portfolio securities and must file with SEC an annual report on its proxy voting record. See 17 C.F.R. § 270.30b1-4 and SEC Forms N-1, N-2, N-3 and N-CSR (adopted under the Investment Company Act of 1940 (codified as amended at 15 U.S.C. § 80a-1 et seq.)).

associated with shares of stock owned by the plan.[7] According to industry experts, managers of employee retirement plan assets began to seek help in executing their fiduciary responsibility to vote proxies in their clients' best interests. Consequently, the proxy advisory industry—particularly ISS, which had been established in 1985—started to grow. According to industry experts, ISS's reputation and dominance in the proxy advisory industry continued to grow in the 1990s and early 2000s, fueled by the growing fiduciary requirements of institutional investors and increased shareholder activism. This increased shareholder activism has been attributed in part to reaction by investors to the massive financial frauds perpetrated by management of public companies, including the actions that led to the bankruptcies of Enron and WorldCom. Many institutional investors sought the services of proxy advisory firms to assist in their assessments of the corporate governance practices of publicly traded companies and to carry out the mechanics of proxy voting. Finally, in 2003, SEC adopted a rule and amendments under the Investment Advisers Act of 1940 that requires registered investment advisers to adopt policies and procedures reasonably designed to ensure that proxies are voted in the best interests of clients, which industry experts also cited as a reason for the continued growth of the proxy advisory industry.[8]

Today, the proxy advisory industry is comprised of five major firms, with ISS serving as the dominant player with over 1,700 clients. The other four firms—Marco Consulting Group (MCG), Glass Lewis & Co. (Glass Lewis), Proxy Governance, Inc. (PGI), and Egan-Jones Proxy Services (Egan-Jones)—have much smaller client bases and are relatively new to the industry: Glass Lewis, PGI, and Egan-Jones were all created within the past 6 years.

- Founded in 1985, ISS serves clients with its core business, which includes analyzing proxy issues and offering research and vote recommendations. ISS also provides Web-based tools and advisory

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[7]The Deputy Assistant Secretary of the Pension Welfare Benefits Administration (PWBA, now known as the Employee Benefits Security Administration) issued the Avon letter to Mr. Helmuth Fandl, Chairman of the Retirement Board of Avon Products, Inc., on February 23, 1988. Current U.S. Comptroller General David M. Walker was the Assistant Secretary of Labor for the PWBA from 1987 to 1989. The Department of Labor subsequently issued Interpretative Bulletin No. 94-2 (codified at 29 C.F.R. § 2509-94-2), which, among other things, set forth the department's interpretation of ERISA as it applies to the voting of proxies on securities held by employee benefit plan investment portfolios. The bulletin essentially restates the views set forth in the Avon Letter.

[8]See *Proxy Voting by Investment Advisers.*

services to corporate issuers through ISS Corporate Services, Inc. a separate division established in 1997 which was spun-out into a wholly-owned subsidiary in 2006. RiskMetrics Group, a financial risk management firm, acquired ISS in January 2007. RiskMetrics Group provides risk management tools and analytics to assist investors in assessing risk in their portfolios.

- MCG was established in 1988 to provide investment analysis and advice to Taft-Hartley funds and has since expanded its client base to public employee benefit plans.[9]

- Glass Lewis, established in 2003, provides proxy research and voting recommendations and was acquired by Xinhua Finance Limited, a Chinese financial information and media company, in 2007.

- Established in 2004, PGI offers proxy advice and voting recommendations and is a wholly-owned subsidiary of FOLIOfn, Inc., a financial services company that also provides brokerage services and portfolio management technology for individual investors and investment advisers.

- Egan-Jones was established in 2002 as a division of Egan-Jones Ratings Company, which was incorporated in 1992. Egan-Jones provides proxy advisory services to institutional clients to facilitate making voting decisions.

Of the five major proxy advisory firms, three—ISS, MCG, and PGI—are registered with SEC as investment advisers and are subject to agency oversight, while according to corporate officials, the other two firms are not. In their SEC registration filings, the three registered firms have identified themselves as pension consultants as the basis for registering as

[9]The Labor Management Relations Act, also known as the Taft-Hartley Act, allows for the establishment of multiemployer trust funds, known as Taft-Hartley funds, for the purpose of providing pension and welfare benefits to employees and their families. Act of June 23, 1947, ch. 120, 61 Stat. 136 (1947) (codified as amended at 29 U.S.C. §§ 141 et seq.). These funds, or benefit plans, are financed in whole or part by employer contributions and are administered jointly by labor and management. These funds are subject to ERISA and regulated by the U.S. Department of Labor. Accordingly, managers of Taft-Hartley fund assets have a fiduciary obligation to protect plan assets as required by ERISA.

investment advisers under the Investment Advisers Act.[10] Although Glass Lewis initially identified itself as a pension consultant and registered with SEC as an investment adviser, it withdrew its registration in 2005. According to SEC officials, an investment adviser is not required to disclose a reason for its decision to withdraw its registration in the notice of withdrawal filed with SEC. Officials from Glass Lewis and Egan-Jones did not elaborate on their decisions not to be registered with SEC as investment advisers, other than to note that their decisions were made with advice from their respective counsel.

Potential Conflicts of Interest Exist among Proxy Advisory Firms That Could Affect Their Vote Recommendations, but SEC Has Not Identified Any Major Violations in Its Examinations of Registered Firms

In the proxy advisory industry, various conflicts of interest can arise that have the potential to influence the research conducted and voting recommendations made by proxy advisory firms. The most commonly cited potential for conflict involves ISS, which provides services to both institutional investor clients and corporate clients. Several other circumstances may lead to potential conflicts on the part of proxy advisory firms, including situations in which owners or executives of proxy advisory firms have an ownership interest in or serve on the board of directors of corporations that have proposals on which the firms are offering vote recommendations. Although the potential for these types of conflicts exists, in its examinations of proxy advisory firms that are registered as investment advisers, SEC has not identified any major violations, such as a failure to disclose a conflict, or taken any enforcement actions to date.

ISS's Business Model Has Been Identified as the Major Potential Conflict of Interest

Industry professionals and institutional investors we interviewed cited ISS's business model as presenting the greatest potential conflict of interest associated with proxy advisory firms because ISS offers proxy advisory services to institutional investors as well as advisory services to corporate clients. Specifically, ISS provides institutional investor clients

[10]Section 203A of the Investment Advisers Act prohibits state-regulated investment advisers who have less than $25 million in assets under management from registering with SEC, unless the person is an investment adviser to a registered investment company, like a mutual fund. SEC Rule 203A-2(b), exempts certain pension consultants from this general prohibition and permits them to register with SEC. 17 C.F.R. § 275.203A-2(b). An investment adviser is a pension consultant for purposes of Rule 203A-2(b), if he or she provides investment advice relating to assets of certain employee benefit plans having an aggregate value of at least $50 million.

with recommendations for proxy voting and ratings of companies' corporate governance. In addition, ISS helps corporate clients develop proposals to be voted on and offers corporate governance consulting services to help clients understand and improve their corporate governance ratings.

Because ISS provides services to both institutional investors and corporate clients, there are various situations that can potentially lead to conflicts. For example, some industry professionals stated that ISS could help a corporate client design an executive compensation proposal to be voted on by shareholders and subsequently make a recommendation to investor clients to vote for this proposal. Some industry professionals also contend that corporations could feel obligated to subscribe to ISS's consulting services in order to obtain favorable proxy vote recommendations on their proposals and favorable corporate governance ratings. One industry professional further believes that, even if corporations do not feel obligated to subscribe to ISS's consulting services, they still could feel pressured to adopt a particular governance practice simply to meet ISS's standards even though the corporations may not see the value of doing so.

ISS has disclosed and taken steps to help mitigate situations that can potentially lead to conflicts. For example, on its Web site, ISS explains that it is "aware of the potential conflicts of interest that may exist between [its] proxy advisory service … and the business of ISS Corporate Services, Inc. [ICS]." The Web site also notes that "ISS policy requires every ISS proxy analysis to carry a disclosure statement advising the client of the work of ICS and advising ISS's institutional clients that they can get information about an issuer's use of ICS's products and services." In addition, some institutional investors we spoke with noted that ISS has on occasion disclosed to them, on a case-by-case basis, the existence of a specific conflict related to a particular corporation.

In addition to disclosure, ISS has implemented policies and procedures to help mitigate potential conflicts. For example, according to ISS, it has established a firewall that includes maintaining separate staff for its proxy advisory and corporate businesses, which operate in separate buildings and use segregated office equipment and information databases in order to help avoid discovery of corporate clients by the proxy advisory staff. ISS also notes on its Web site that it is a registered investment adviser and is subject to the regulatory oversight of SEC. In addition, according to ISS's Web site, corporations purchasing advisory services sign an agreement acknowledging that use of such services does not guarantee preferential treatment from ISS's division that provides proxy advisory services.

All of the institutional investors—both large and small—we spoke with that subscribe to ISS's services said that they are satisfied with the steps that ISS has taken to mitigate its potential conflicts. Most institutional investors also reported conducting due diligence to obtain reasonable assurance that ISS or any other proxy advisory firm is independent and free from conflicts of interest. As part of this process, many of these institutional investors said they review ISS's conflict policies and periodically meet with ISS representatives to discuss these policies and any changes to ISS's business that could create additional conflicts. Finally, as discussed in more detail later in this report, institutional investors told us that ISS's recommendations are generally not the sole basis for their voting decisions, which further reduces the chances that these potential conflicts would unduly influence how they vote.

Although institutional investors said they generally are not concerned about the potential for conflicts from ISS's businesses and are satisfied with the steps ISS has taken to mitigate such potential conflicts, some industry analysts we contacted said there remains reason to question the steps' effectiveness. For example, one academic said that while ISS is probably doing a fair job managing its conflicts, it is difficult to confirm the effectiveness of the firm's mitigation procedures because ISS is a privately-held company, thereby restricting information access. Moreover, according to another industry analyst, because ISS's recommendations are often reported in the media, the corporate consulting and proxy advisory services units could become aware of the other's clients.

Other Potential Conflicts May Arise on the Part of Proxy Advisory Firms

In addition to the potential conflict of interest discussed above, several other situations in the proxy advisory industry could give rise to potential conflicts. Specifically:

- Owners or executives of proxy advisory firms may have a significant ownership interest in or serve on the board of directors of corporations that have proposals on which the firms are offering vote recommendations. A few institutional investors told us that such situations have been reported to them by ISS and Glass Lewis, both of which, in order to avoid the appearance of a conflict, did not make voting recommendations.

- Institutional investors may submit shareholder proposals to be voted on at corporate shareholder meetings. This raises concern that proxy advisory firms will make favorable recommendations to other institutional investor clients on such proposals in order to maintain the business of the investor clients that submitted these proposals.

- Several proxy advisory firms are owned by companies that offer other financial services to various types of clients, as is common in the financial services industry, where companies often provide multiple services to various types of clients. This is the case at ISS, Glass Lewis, and PGI, and may present situations in which the interests of different sets of clients diverge.

SEC Has Not Identified Any Major Violations in Its Oversight of Proxy Advisory Firms That Are Registered as Investment Advisers

SEC reviews registered investment advisers' disclosure and management of potential conflicts, as well as proxy voting situations where a potential conflict may arise. Specifically, SEC's Office of Compliance Inspections and Examinations monitors the operations and conducts examinations of registered investment advisers, including proxy advisory firms. An SEC official stated that, as part of these examinations, SEC may review the adequacy of disclosure of a firm's owners and potential conflicts; particular products and services that may present a conflict; the independence of a firm's proxy voting services; and the controls that are in place to mitigate potential conflicts.[11] As discussed previously, three of the five proxy advisory firms (ISS, MCG, and PGI) are registered as investment advisers while Glass Lewis and Egan-Jones are not. According to SEC, to date, the agency has not identified any major violations of applicable federal securities laws in its examinations of proxy advisory firms that are registered as investment advisers and has not initiated any enforcement action against these firms.[12]

[11]We did not attempt to assess the adequacy of these examinations.

[12]We cannot disclose the specific results of examinations because of SEC confidentiality considerations.

Analysts Cite ISS's Long-standing Position in the Industry as a Potential Barrier to Competition, Although Firms Have Entered the Market in Recent Years

As the dominant proxy advisory firm, ISS has gained a reputation with institutional investors for providing reliable, comprehensive proxy research and recommendations, making it difficult for competitors to attract clients and compete in the market. As shown below in table 1, ISS's client base currently includes an estimate of 1,700 institutional investors, more than the other four major firms combined. Several of the institutional investors we spoke with that subscribe to ISS's services explained that they do so because they have relied on ISS for many years and trust it to provide reliable, efficient services. They said that they have little reason to switch to another service provider because they are satisfied with the services they have received from ISS over the years. Because of ISS's clients' level of satisfaction, other providers of proxy advisory services may have difficulty attracting their own clients. In addition, because of its dominance and perceived market influence, corporations may feel obligated to be more responsive to requests from ISS for information about proposals than they might be to other, less-established proxy advisory firms, resulting in a greater level of access by ISS to corporate information that might not be available to other firms.

Table 1: Overview of the Major Proxy Advisory Firms

Firm	Founded	Estimated number of employees	Estimated number of clients	Estimated clients' equity assets (dollars)[a]
Institutional Shareholder Services (ISS)	1985	630	1,700	25.5 trillion
Marco Consulting Group (MCG)	1988	70	350	85 billion
Glass Lewis & Company (Glass Lewis)	2003	70	300	15 trillion
Proxy Governance, Inc. (PGI)	2004	31	100	1 trillion
Egan-Jones Proxy Services (Egan-Jones)	2001	Not available	400	Not available

Source: GAO presentation of information provided by proxy advisory firms.

[a]Clients' equity assets refers to the total assets under management by the firms' institutional investor clients. There is overlap between proxy advisory firms' clients' equity assets since, as will be discussed later in this report, some clients use the services of several proxy advisory firms.

Industry analysts explained that, in addition to overcoming ISS's reputation and dominance in the proxy advisory industry, proxy advisory firms must offer comprehensive coverage of corporate proxies and implement sophisticated technology to attract clients and compete. For instance, institutional investors often hold shares in thousands of different corporations and may not be interested in subscribing to proxy advisory firms that provide research and voting recommendations on a limited portion of these holdings. As a result, proxy advisory firms need to provide thorough coverage of institutional holdings, and unless they offer comprehensive services from the beginning of their operations, they may have difficulty attracting clients. In addition, academics and industry experts we spoke with said that new firms need to implement a sophisticated level of technology to provide the research and proxy vote execution services that clients demand. The initial investment required to develop and implement such technology can be a significant expense for firms.

Although newer proxy advisory firms may face challenges attracting clients and establishing themselves in the industry, several of the professionals we spoke with believed that these challenges could be overcome. For example, while firms may need to offer comprehensive coverage of corporate proxies in order to attract clients and although ISS might have access to corporate information that other firms do not, much of the information needed to conduct research and offer voting recommendations is easily accessible. Specifically, anyone can access corporations' annual statements and proxy statements, which are filed with SEC, are publicly available, and contain most of the information that is needed to conduct research on corporations and make proxy voting recommendations. Also, although developing and implementing the technology required to provide research and voting services can be challenging, various industry professionals told us that once a firm has done so, the marginal cost of providing services to additional clients and of updating and maintaining such technology is relatively low.

Some of the competitors seeking to enter the proxy advisory industry in recent years that we spoke with have offered their services as alternatives to ISS. Specifically, they have attempted to differentiate themselves from ISS by providing only proxy advisory services to institutional investor clients. ISS's competitors have chosen not to provide corporate consulting services in part to avoid the potential conflicts that exist at ISS. Proxy advisory firms have also attempted to differentiate themselves from the competition on the basis of the types of services provided. For example, some firms have started to focus their research and recommendation services on particular types of proxy issues or on issues specific to individual corporations.

The institutional investors we spoke with had a variety of opinions about the level of competition in the industry. Some questioned whether the existing number of firms is sufficient, while others questioned whether the market could sustain the current number of firms. However, many of the institutional investors believe that increased competition could help reduce the cost and increase the range of available proxy advisory services. For example, some institutional investors said that they have been able to negotiate better prices with ISS because other firms have recently entered the market. While some of these newer proxy advisory firms have attracted clients, it is too soon to tell what the firms' ultimate effect on competition will be.

Large Institutional Investors Reportedly Rely Less Than Small Institutional Investors on Advisory Firms, Limiting the Influence These Firms Have on Proxy Voting Results

We conducted structured interviews with 31 randomly selected institutional investors to gain an understanding of the ways in which they use proxy advisory firms and the influence that such firms have on proxy voting. Of the 20 large institutional investors we interviewed, 19 reported that they use proxy advisory services in one or more ways that may serve to limit the influence that proxy advisory firms have on proxy voting results (see table 2), while only 1 reported relying heavily on a proxy advisory firm's research and recommendations.[13]

Table 2: Reliance of Large Institutional Investors on Proxy Advisory Firms

	Use proxy advisory firm to supplement in-house research	Use proxy advisory firm to execute customized voting policy	Subscribe to several proxy advisory firms
Number of large institutional investors (out of 20 interviewed)[a]	15	14	8

Source: GAO analysis of structured interviews with 20 large institutional investors.

[a]Many of the large institutional investors we spoke with explained that, although they subscribe to a customized voting policy, they may also continue to use their proxy advisory firm to supplement their own in-house research, subscribe to several proxy advisory firms, or both. This results in overlap among the three categories of how these institutional investors use proxy advisory firms, as shown in the table.

[13]Of the 20 large institutional investors we spoke with, 7 were asset management institutions that vote proxies on behalf of their clients. Many large and small institutional investors we initially attempted to contact reported that they do not vote their own proxies. Instead, these institutional investors said that companies that provide asset management services also vote proxies on their behalf. We added these asset management institutions, which were referred to us by pension funds, to our sample in order to understand the extent to which they rely on proxy advisory services.

The following summarizes several of the reasons that large institutional investors' reliance on proxy advisory firms' research and recommendations is limited:

- Most of the large institutional investors we spoke with (15 out of 20) reported that they generally rely more on their own in-house research and analyses to make voting decisions than on the research and recommendations provided by their proxy advisory services providers. These institutional investors tend to have their own in-house research staffs, and their in-house research reportedly drives their proxy voting decisions. They explained that they use the research and recommendations provided by proxy advisory firms to supplement their own analysis and as one of many factors they consider when deciding how to vote.

- In addition, many (14) of the large institutional investors we contacted reported that they subscribe to a customized voting policy that a proxy advisory firm executes on the institutions' behalf. These institutional investors develop their own voting policies and guidelines that instruct the advisory firm how to vote on any given proxy issue. In such instances, the proxy advisory firms simply apply their clients' voting policies, which then drive the voting decisions.

- Further, 8 of the large institutional investors we contacted explained that they subscribe to more than one proxy advisory firm to help determine how to vote. These institutional investors said that they consider multiple sets of proxy advisory firm research and recommendations to gain a broader range of information on proxy issues and to help make well-informed voting decisions.

We also interviewed representatives from 11 smaller institutional investors, and the results of these interviews suggest that proxy advisory firm recommendations are of greater importance to these institutions than they are to the large institutional investors we spoke with. In particular, representatives from smaller institutional investors were more likely to say that they rely heavily on their proxy advisory firm and vote proxies based strictly on the research and recommendations of their firm, given these institutions' limited resources. Consequently, the level of influence held by proxy advisory firms appears greater with these smaller institutional investors.

However, whether large or small, all of the institutional investors we spoke with explained that they retain the fiduciary obligation to vote proxies in the best interest of their clients irrespective of their reliance on proxy advisory firms. Institutional investors emphasized that they do not delegate this responsibility to proxy advisory firms and retain the right to override any proxy advisory firm recommendations, limiting the amount of influence proxy advisory firms hold. In addition, large and small institutional investors reported that they tend to provide greater in-house scrutiny to, and rely even less on, proxy advisory firm recommendations about certain high-profile or controversial proxy issues, such as mergers and acquisitions or executive compensation.

Institutional investors' perspectives on the limited influence of proxy advisory firms reflected what we heard from professionals that we spoke with who have knowledge of the industry. Many of these industry analysts and academics agreed that large institutional investors would be less likely than small institutional investors to rely on proxy advisory firms, because large institutions have the resources available to conduct research and subscribe to more than one proxy advisory service provider. These professionals also thought that large institutional investors would be likely to use proxy advisory firms as one of several factors they consider in the research and analysis they perform to help them decide how to vote proxies. Further, several believed that small institutional investors would be more likely to vote based strictly on proxy advisory firms' recommendations, because they do not have the resources to conduct their own research.

The results of our work suggest that the overall influence of advisory firms on proxy vote outcomes may be limited. In particular, large institutional investors, which cast the great majority of proxy votes made by all institutional investors with over $1 billion in assets, reportedly place relatively less emphasis on the firms' research and recommendations than smaller institutional investors. However, we could not reach a definitive conclusion about the firms' influence because the institutional investors we contacted were not necessarily representative of all such investors. Further, we could not identify any studies that comprehensively isolated advisory firm research and recommendations from other factors that may influence institutional investors' proxy voting.[14]

Agency Comments

We provided a draft of this report to SEC for its review and comment. SEC provided technical comments, which we incorporated into the final report, as appropriate. We also provided relevant sections of the draft to the proxy advisory firms for a technical review of the accuracy of the wording and made changes, as appropriate, based on the firms' comments.

As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution of this report until 30 days from the report date. At that time we will provide copies of this report to the Chairman and Ranking Member, Senate Committee on Banking, Housing, and Urban Affairs; the Chairman, House Committee on Financial Services; the Chairman, House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services; other interested committees; and the Chairman of the Securities and Exchange Commission (SEC). We will also make copies available to others upon request. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov. If you or your staffs have any questions about this report, please contact me at (202) 512-8678

[14]We identified a study—"The Role of Advisory Services in Proxy Voting," by Cindy R. Alexander, Mark A. Chen, Duane J. Seppi, and Chester S. Spatt (Dec. 14, 2006)—that examined the extent to which recommendations can influence vote outcomes and stock prices by focusing on recommendations made by ISS that were reported in the media. The authors documented "significant stock price movements around recommendation dates, indicating that proxy advice brings new information to the market," as well as "a robust association between recommendations and contest outcomes after controlling for differences in contest characteristics, voting rules, dissidents, and incumbents." As the authors note, "although not all ISS recommendations are reported in the media, restricting attention to the newsworthy cases ensures that our sample consists of contests in which the underlying issues are significant and the recommendation is most likely to play an important role." However, most of the institutional investors we spoke with reported that they tend to provide greater in-house scrutiny to, and rely even less on, proxy advisory firm recommendations about high-profile or controversial proxy issues, which are the recommendations that would be more likely to appear in the media.

or jonesy@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix II.

Yvonne D. Jones
Director, Financial Markets
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Appendix I: Scope and Methodology

Our objectives were to (1) identify potential conflicts of interest that exist with proxy advisory firms and the steps that the Securities and Exchange Commission (SEC) has taken to oversee these firms; (2) review the factors that might impede or promote competition in this industry; and (3) analyze institutional investors' use of proxy advisory services to help vote proxies and the influence proxy advisory firms may have on proxy voting.

To determine the types of potential conflicts of interest that could arise in the proxy advisory industry, we conducted a literature review and examined studies relating to potential conflicts that may arise in this industry. Further, we interviewed various professionals with knowledge of the proxy advisory industry, including industry experts, academics, industry association representatives, and proxy advisory firm representatives, as well as institutional investors and officials at SEC. We selected these professionals based, in part, on literature searches we conducted on topics relating to proxy advisory and corporate governance services, as well as referrals by several of the professionals we met with. The professionals we spoke with represent a wide range of perspectives, and include experts from academia, business, government, and professional organizations. We did not attempt to assess any of the proxy advisory firms' conflict mitigation policies or procedures and, therefore, did not come to any conclusions about the adequacy of these policies or procedures. To gain an understanding of SEC's oversight of proxy advisory firms, we reviewed relevant investment adviser regulations and examinations conducted by SEC since 2000 and interviewed agency officials. We did not attempt to assess the adequacy of SEC's oversight.

To identify the factors that might impede or promote competition in this industry, we reviewed the relevant literature and examined studies relating to the level of competition in the industry, and we spoke with various industry professionals. We did not attempt to evaluate the level of competition in this industry and, therefore, did not come to any conclusions about the extent to which competition exists.

Finally, to explore institutional investors' use of proxy advisory services to help vote proxies and the influence proxy advisory firms may have on proxy voting, we conducted structured interviews with 31 institutional investors selected randomly by type, including mutual funds, corporate pension funds, government pension funds, and union pension funds, as well as asset management institutions. Our sample included several of the largest institutional investors and was derived from Standard & Poor's Money Market Directories (January 2006). The sample consisted of a population of mutual funds and pension funds with over $1 billion in assets, and included large and small institutional investors from each investor type. We defined “large” and “small” institutional investors as the top and bottom 15 percent of each institutional investor type. In total, these large and small institutional investors accounted for over 72 percent of assets under management held by mutual funds and pension funds with over $1 billion under management. Although we randomly selected these institutional investors, the size of the sample was small and may not necessarily be representative of the universe of institutional investors. As a result, we could not generalize the results of our analysis to the entire population of institutional investors.

We conducted structured interviews with 20 large and 11 small institutional investors. Initially, we had contacted a total of 126 mutual funds and pension funds that were randomly selected from our sample of institutional investors and 20 (13 large and 7 small institutions) reported using proxy advisory firm services and agreed to participate in our structured interviews. The other 106 institutional investors we had initially contacted declined to participate in the structured interviews for several reasons. In particular, many of these institutions said that they do not vote proxies themselves, but rather hire asset management institutions to both manage their investment portfolios and vote proxies on their behalf. We conducted interviews with 11 (7 large and 4 small institutions) of these asset management institutions, which were referred to us by several of the pension funds we had initially contacted. The results of these asset manager interviews are included among the total of 20 large and 11 small institutional investors that we interviewed. In addition, some of the 106 institutional investors declined to participate because they vote proxies themselves or do not vote proxies at all, while others refused to participate or could not be reached.

In our structured interviews with the 31 institutional investors, we spoke with officials from the organizations who are responsible for proxy voting activities. We asked these officials a variety of questions relating to their institutions’ policies on proxy voting and use of proxy advisory firms. Further, we asked the officials to comment on potential conflicts of interest associated with proxy advisory firms, steps taken to mitigate such potential conflicts, and the level of competition in the proxy advisory industry.

Finally, we spoke with various industry professionals discussed earlier to gain their perspectives on the influence of proxy advisory firms. We could not identify any studies that comprehensively measured the influence that these firms have on proxy voting.

We conducted our work in Washington, D.C., between September 2006 and June 2007 in accordance with generally accepted government auditing standards.

Appendix II: GAO Contact and Staff Acknowledgments

GAO Contact

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Staff Acknowledgments

In addition to the above contact, Wes Phillips, Assistant Director; Emily Chalmers; Rudy Chatlos; Eric Diamant; Fred Jimenez; Yola Lewis; and Omyra Ramsingh made key contributions to this report.

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