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REDUCING CONFLICTS OF INTEREST: A "GLASS-STEAGALL" SPLIT OF ADVISORY AND CONSULTING SERVICES OF PROXY ADVISORY FIRMS

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ABSTRACT

This Note explores a solution to the potential problem with proxy advisory firms that involves an inherent conflict of interest arising from the structure of two services—advisory and consulting services—offered at certain proxy advisory firms in the United States. The solution proposed in this paper applies a Glass-Steagall framework to breakup these two services of the proxy advisory firms. In theory, this would eliminate the inherent conflicts of interest.

INTRODUCTION

Shareholders[1] of a public corporation are the cornerstone of corporate governance in the United States. Corporate governance decisions are typically voted by shareholders through a "proxy," which is an individual or instrument that has legal authorization to vote on behalf of a shareholder at a public corporation's annual shareholder meeting.[2] Due to the increasing number of corporations that have multiple proxy proposal issues on which to vote every year, the voting process has become more complex.[3] The rise of the complicated voting process has necessitated the need for assistance in the process.[4] Proxy advisory firms—companies that research shareholder issues and provide investors with recommendations on the best way to vote—have

1. A shareholder (also referred to as a stockholder) is an owner in a corporation. Specifically, a "shareholder is a person, company, or institution that owns at least one share of a company's stock, which is known as equity." Because they are owners in a corporation, they make money when the business succeeds, but lose money when the business fails. In accordance to a corporation's charter and bylaws:

> shareholders traditionally enjoy the following rights: the right to inspect the company's books and records; to power to sue the corporation for misdeeds of its directors and/or officers; the right to vote on key corporate matters, such as naming board directors and deciding whether or not to greenlight potential mergers; the entitlement to receive dividends; the right to attend annual meetings, either in person or via conference calls; the right to vote on key matters by proxy, either through mail-in ballots, or online voting platforms, if they're unable to attend voting meetings in person; the right to claim a proportionate allocation of proceeds if a company liquidates its assets.

Adam Hayes, *Shareholder,* INVESTOPEDIA, https://www.investopedia.com/terms/s/shareholder.asp (last visited Nov. 15, 2019).

2. *See Shareholder Proxy: Everything You Need to Know*, UPCOUNSEL, https://www.upcounsel.com/shareholder-proxy (last visited Feb. 3, 2021).

3. *See* Edward B. Rock, *Institutional Investors in Corporate Governance*, FAC. SCHOLARSHIP PENN (July 21, 2015), http://scholarship.law.upenn.edu/faculty_scholarship/1458.

4. *See* Chester S. Spatt, *Proxy Advisory Firms, Governance, Failure, and Regulation*, HARV. L. SCH. FORUM ON CORPORATE GOVERNANCE (June 25, 2019), https://corpgov.law.harvard.edu/2019/06/25/proxy-advisory-firms-governance-failure-and-regulation/.

greatly reduced the time and money that institutional investors[5] need to spend.[6] However, given the dual-nature of these proxy advisory firms providing both consulting services and voting advisory services to the same companies, the potential for conflicts of interests has increased.[7]

To avoid these conflicts of interests, this Note proposes that Congress should apply a framework that will split up these proxy advisory firms by forcing these established firms to choose consulting services or advisory services, but not both.[8] Part I of this Note discusses the current state of proxy advisory firms, including both the advisory and the consulting aspects of the industry. Part II discusses the basis for the recommendation, drawing from the history and rationale of the Glass-Steagall Act. Part III discusses the final recommendation, focusing on how applying a framework that splits up proxy advisory firms will reduce conflicts of interests and produce more competition within the proxy advisory market.

I. CURRENT STATE OF ADVISORY AND CONSULTING SERVICES IN PROXY ADVISORY FIRMS

The public corporation shareholder voting process can be complicated. Corporate governance is anchored on the concept of shareholder engagement with public corporations to hold management and the board of directors accountable for their performance.[9] Shareholders vote on many issues that directly impact the trajectory of a public corporation's performance, both financially and culturally.[10] Some examples of the many issues on which shareholders vote include elections of the company's board of directors, changes in internal operations, shifts in company priorities, restructurings, executive compensation, and mergers or acquisitions of other companies.[11] Although there are still active retail investors (i.e., individual investors), the majority of investors have their ownership tied up in institutional investors that manage securities on behalf of individual investors.[12] These institutional

5. *See* Sam Bourgi, *Who Are Institutional Investors?*, MUTUAL FUND EDUC. (Dec. 18, 2018), https://mutualfunds.com/education/who-are-institutional-investors/.

6. *See* David Larker, *The Big Thumb on the Scale: An Overview of the Proxy Advisory Industry*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 14, 2018), https://corpgov.law.harvard.edu/2018/06/14/the-big-thumb-on-the-scale-an-overview-of-the-proxy-advisory-industry/.

7. *See* Timothy Doyle, *The Conflicted Role of Proxy Advisors*, AM. COUNCIL FOR CAP. FORMATION (May 2018), http://accfcorpgov.org/wp-content/uploads/2018/05/ACCF_The-Conflicted-Role-of-Proxy-Advisors.pdf.

8. *See* Kimberly Amadeo, *Glass Steagall Act of 1933, Its Purpose and Repeal*, BALANCE (July 10, 2019), https://www.thebalance.com/glass-steagall-act-definition-purpose-and-repeal-3305850.

9. Edward B. Rock, *Institutional Investors in Corporate Governance*, FAC. SCHOLARSHIP PENN (July 21, 2015), http://scholarship.law.upenn.edu/faculty_scholarship/1458.

10. Spatt, *supra* note 4.

11. *How Does the Shareholder Voting Process Work?*, MAIN ST. INVS. COALITION (Dec. 10, 2018), https://mainstreetinvestors.org/how-does-the-shareholder-voting-process-work/.

12. Bourgi, *supra* note 5.

investors include firms such as hedge funds, mutual funds, pension funds, and insurance companies.[13]

A. PURPOSE OF PROXY ADVISORY FIRMS

Following the passage of The Employee Retirement Income Security Act of 1974 (ERISA),[14] institutional investors that handle shares for private investors are required to vote at all shareholder meetings.[15] Clients that have their assets tied up in institutional investors give those institutional investors the right to vote on shareholder proposals on their behalf.[16] In 2014, the Securities and Exchange Commission (SEC or Commission) issued Staff Legal Bulletin No. 20 that confirmed that these institutional investors have a fiduciary duty to support shareholder voting by stating, "as a fiduciary, an investment advisor owes each of its clients a duty of care and loyalty with respect to services undertaken on the client's behalf, including proxy voting."[17] Proxy voting involves one person or firm voting on behalf of a shareholder of a corporation who may not be able to attend a shareholder meeting.[18] This SEC guidance encourages advisers to take a more active role in fulfilling shareholders' voting responsibilities by pushing advisers to reassess and review compliance and proxy voting policies to ensure that they comply with the Proxy Voting Rule[19] and are effective.[20] The Proxy Voting Rule stems from a 2003 SEC regulation that requires institutional investors to disclose all of their proxy voting policies, along with all of their vote counts on all proxy proposals.[21]

Proxy voting by institutional investors comes at a cost to both the institutional investor and the client.[22] It requires a significant amount of

13. *Id.*

14. Doyle, *supra* note 7.

15. *Id.*

16. Spatt, *supra* note 3.

17. SEC Staff Legal Bulletin No. 20 (IM/CF), Proxy Voting: Proxy Voting Responsibilities of Investment Advisors and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms, (June 30, 2014), https://www.sec.gov/interps/legal/cfslb20.htm#_ftn1 [hereinafter SEC Staff Legal Bulletin No. 20]. In this context, "investment advisor" is the role of the institutional investor.

18. Will Kenton, *Proxy Vote*, INVESTOPEDIA, https://www.investopedia.com/terms/p/proxy-vote.asp (last visited Dec. 26, 2019).

19. *See* Rule 206(4)-6 under the Advisers Act. In the Proxy Voting Rule, the SEC states that "it is a fraudulent, deceptive, or manipulative act, practice, or course of business for an investment advisor registered or required to be registered with the Commission to exercise voting authority with respect to client securities unless the adviser, among other things, adopts and implements written policies and procedures that are reasonably designed to ensure that the investment advisor votes proxies in the best interest of its clients." Staff Legal Bulletin No. 20, *supra* note 17.

20. *See* David A. Katz, *Important Proxy Advisor Developments*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Sept. 29, 2014), http://perma.cc/7LKJ-UYHG.

21. David Larcker, *The Big Thumb on the Scale: An Overview of the Proxy Advisory Industry*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 14, 2018), https://corpgov.law.harvard.edu/2018/06/14/the-big-thumb-on-the-scale-an-overview-of-the-proxy-advisory-industry/.

22. *Id*.

resources, such as time and expertise, that many small or mid-size institutional investor firms do not have.[23] The largest institutional investors, such as BlackRock, Vanguard Asset Management, State Street Global Advisors, BNY Mellon Investment Management, EMEA Limited, and J.P. Morgan Asset Management, are large enough to have the resources to properly research various shareholder proposals, but even these large firms require assistance.[24] Specifically, working through the vast amounts of data can be time-consuming and burdensome, causing many institutional investors to look to third-party validators to consolidate the available data to make it easier to understand.[25] To assist in this data problem and in the proxy voting processes, many institutional investors require the services of proxy advisory firms to act as the third-party validator.[26]

Institutional investors require proxy advisory firms more now than ever before. The impact of institutional investors has steadily increased, as they now own more than seventy percent of the stock in over one thousand of the United States' largest corporations.[27] Additionally, institutional investors have a higher voter participation rate at a ninety-one percent voting rate compared with regular retail investors who vote at a rate of twenty-nine percent.[28] With the "ever-widening assortment of corporate, social, and political issues" on which shareholders can vote, the need for proxy advisory firms has become more prevalent.[29]

B. MAIN PLAYERS IN THE PROXY ADVISORY BUSINESS

The two largest U.S. proxy advisory firms, Glass Lewis & Co. (Glass Lewis) and Institutional Shareholder Services Inc. (ISS), dominate the industry and together control ninety-seven percent of the market share.[30] Both of these firms offer advisory services that assist registered corporations in evaluating data on topics such as voting behavior, compensation plans, risk management, and corporate governance.[31]

23. *Id*.

24. *Largest Institutional Investors*, WALL ST. PREP, https://www.wallstreetprep.com /knowledge/largest-institutional-investors/ (last visited Oct. 17, 2019).

25. Doyle, *supra* note 7.

26. Spatt, *supra* note 4.

27. Sharon Hannes, *Brave New World: A Proposal for Institutional Investors*, 16 THEORETICAL INQ. L. 245, 248-49 (2015).

28. Larcker, *supra* note 6.

29. Katz, *supra* note 20.

30. Andrew Ackerman, *SEC Takes Action Aimed at Proxy Advisers for Shareholders*, WALL ST. J. (Aug. 21, 2019, 2:03 PM), https://www.wsj.com/articles/sec-to-take-action-aimed-at-proxy-advisers-for-shareholders-11566399808.

31. Stephen J. Choi et al., *Director Elections and the Role of Proxy Advisors*, 82 S. CAL. L. REV. 649, 653 (2009).

1. Glass Lewis

Glass Lewis has an extensive client base, including the world's largest pension funds, mutual funds, and asset managers that collectively manage over $35 trillion in assets.[32] It provides data analytics and research reports, along with voting recommendations to its large institutional investor clients.[33] It also offers services such as advisory of share recall programs,[34] but its core product is the proxy advisory service.[35] It currently holds approximately thirty-seven percent of the proxy advisory market share and is the second largest proxy advisory firm in the country.[36] Glass Lewis describes its business as "a leading, independent governance services firm that provides proxy research and vote management services to more than 1,300 clients throughout the world," and states that "[w]hile institutional investor clients use Glass Lewis research primarily to help them make proxy voting decisions, they also use Glass Lewis research when engaging with companies before and after shareholder meetings."[37]

2. ISS

The ISS proxy advisory business is similar to Glass Lewis, but differs in that ISS has an additional component to its business that has become a "hot bed" for potential conflicts of interest: a consulting services arm.[38] ISS has a dominant position in the market, claiming "over 1,700 institutional clients managing $26 trillion in assets, including 24 of the top 25 mutual funds, the top 25 asset managers and 17 of the top 25 public pension funds."[39] It

32. *Company Overview*, GLASS LEWIS, https://www.glasslewis.com/company-overview/ (last visited Oct. 13, 2019).

33. *Id*.

34. "Powered by [its] objective analysis of corporate governance issues, economic and financial matters and M&A transactions, the Glass Lewis Share Recall service enables lenders to maximize their share-lending program by facilitating the selective recall of shares for important proxies. Share Recall empowers [clients] to efficiently maximize the value of [their] share-lending program, while still being able to vote on key meetings. Every day, Share Recall's proprietary algorithm calculates the materiality of the most-recently announced meetings of approximately 5,000 companies. After weighing the meeting type and a variety of governance factors, [Glass Lewis classifies] each meeting into one of three materiality categories based on the level of importance. Subscribers to the Share Recall service receive a daily email or XML data feed alert notifying them when a company in their holdings issues a proxy with a record date in the next 20 days, as well as the materiality score of the company, providing institutional investors time to cost-effectively recall shares." *Share Recall*, GLASS LEWIS, https://www.glasslewis.com/share-recall/ (last visited Jan. 7, 2021).

35. Doyle, *supra* note 7.

36. *Glass Lewis*, CTR. ON EXEC. COMP., http://www.execcomp.org/Issues/Issue/proxy-advisory-firms/glass-lewis (last visited Feb. 1, 2021).

37. *See Best Practice Principles for Providers of Shareholder Voting Research & Analysis: Glass Lewis Statement of Compliance for the Period of 1 January 2019 through 31 December 2019*, GLASS LEWIS (May 2020), http://www.glasslewis.com/wp-content/uploads/2019/02/GL-Compliance-Statement-2019.pdf.

38. Doyle, *supra* note 7.

39. Stephen J. Choi et al., *Director Elections and the Role of Proxy Advisors*, 82 S. CAL. L. REV. 649, 652–53 (2009).

currently claims to have approximately sixty percent of the total market share.[40]

The nature of proxy advisory firms can lead to potential conflicts of interest, specifically around ISS providing proxy voting advisory recommendations while simultaneously offering consulting services to the same companies.[41] Glass Lewis does not offer consulting services, so there is less potential for conflicts of interest.[42] There are genuine concerns that ISS could potentially rate or give a negative recommendation to a company, and then turn around and push its consulting services onto the same company, which now seeks to increase its rating or recover from a negative voting recommendation imposed by ISS.[43] Ira Millstein, an expert on corporate governance, vividly described the flawed business structure:

> It provides structural "standards" for corporate governance, privately prepared by unidentified people, pursuant to unidentified processes, and asks us to take its word that it is all fair and balanced. I tried to dig behind the soothing assurances, but couldn't find enough detail to convince me that a devil didn't lie in the details of how this private standard-setting was put together. And then ISS provides company ratings, based on these privately-set standards, creating a tendency on the part of those that have received a poor rating to pay for a consultancy by the private standard setter, on how to improve that rating. I see this as a vicious cycle.[44]

ISS even acknowledged this perceived conflict in its RiskMetrics[45] 2009 10-k by stating:

> [T]here may be a perceived conflict of interest between the services we provide to institutional clients and the services, including our Compensation Advisory Services, provided to certain corporate clients. For example, when we provide corporate governance services[46] to a corporate client and at the same time provide proxy vote recommendations to institutional clients

40. Doyle, *supra* note 7.

41. *Id*.

42. *Id*.

43. *Id*.

44. CTR. ON EXEC. COMP., A CALL FOR CHANGE IN THE PROXY ADVISORY INDUSTRY STATUS QUO 7 (2011), http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf [hereinafter A Call for Change].

45. In January of 2007, RiskMetrics Group, a financial risk management firm, acquired Institutional Shareholder Services Inc. (ISS). In March of 2010, MSCI Inc. (formerly Morgan Stanley Capital International and MSCI Barra) acquired RiskMetrics, and thus owned ISS. *See* Press Release, *RiskMetrics Group Acquires of Institutional Shareholder Services*, Spectrum Equity (Jan. 2007), https://www.spectrumequity.com/news/riskmetrics-group-acquires-of-institutional-shareholder-services. *See* Press Release, MSCI to buy RiskMetrics for $1.55 billion, Thomson Reuters (Mar. 1, 2010, 6:33 AM), https://www.reuters.com/article/us-riskmetrics-msci-idUSTRE6201S420100301.

46. In this context, "corporate governance services" refers to the consulting services offered by ISS. RiskMetrics Group, Inc., 2009 10-K form, Retrieved from https://www.sec.gov/Archives/edgar/data/1295172/000104746909001976/a2190980z10-k.htm [23-24].

> regarding that corporation's proxy items, there may be a perception that we may treat that corporation more favorably due to its use of our services.[47]

Further, if a public client of ISS that utilizes the proxy voting services does not also purchase its consulting services, ISS could potentially "retaliate through their recommendations against operating companies that do not purchase their services."[48]

C. OTHER BIG INDUSTRY PLAYERS

BlackRock, Vanguard, and State Street are three of the largest institutional investors in the world.[49] These firms specialize in indirect passive investing, specifically in exchange-traded funds (ETF), which are entities that pool together many different investments and are "tracked" to an index (e.g., the S&P 500).[50] Essentially, an individual or institutional investor is investing in an index that contains many stocks rather than picking and choosing specific stocks.[51] These three investing firms manage $14 trillion in index investments and cast approximately a quarter of the votes of all S&P 500 companies in the U.S.[52] As more money generally pours into index investments, index investment firms like BlackRock, Vanguard, and State Street vote more proxies per year in the largest S&P 500 corporations.[53] As these firms gain more influence in proxy votes, they look to proxy advisory firms like Glass Lewis and ISS.[54] Proxy advisory clients are increasingly following the recommendations of both ISS and Glass Lewis.[55] For example, State Street voted for 88.2% of ISS's "For" Recommendations and for 80.3% of ISS's "Against" recommendations in 2017.[56] This indicates a high correlation between the votes of these larger ETF investment firms (including BlackRock, Vanguard, and State Street) and the recommendations of both Glass Lewis and ISS.[57] Though it is possible that these ETF firms would have voted the same way as the proxy advisory firm recommendations even if they were not clients of Glass Lewis or ISS, one can infer an increasing influence

47. *Id.* [RiskMetrics Group, Inc., 2009 10-K form, Retrieved from https://www.sec.gov/Archives/edgar/data/1295172/000104746909001976/a2190980z10-k.htm [23-24].]

48. Spatt, *supra* note 4.

49. *Largest Institutional Investors*, WALL ST. PREP, https://www.wallstreetprep.com/knowledge/largest-institutional-investors/ (last visited Oct. 17, 2019).

50. Dan Caplinger, *What is an ETF?*, MOTLEY FOOL (Aug. 7, 2019, 3;57 PM), https://www.fool.com/investing/etf/what-is-an-etf-exchange-traded-fund.aspx.

51. *Id*.

52. Owen Walker, *BlackRock, Vanguard and SSGA Tighten Hold on US Boards*, FIN. TIMES (June 15, 2019), https://www.ft.com/content/046ec082-d713-3015-beaf-c7fa42f3484a.

53. Doyle, *supra* note 7.

54. *Id*.

55. *Id*.

56. *Id*.

57. *Id*.

from the proxy advisory firms through the high correlation of voting patterns.[58]

D. REGULATION OF PROXY ADVISORY FIRMS

Proxy advisory firms are subject to very little regulation despite their increasingly important role within large corporations' governance practices.[59] On August 21, 2019, the SEC held an open meeting to address the problem of the increasing reliance on proxy advisory firms by institutional investors that could lead to further dominance of proxy advisory firms over corporations.[60] In its guidance, the SEC stated that proxy advisory firms need to be more transparent about how they reach their recommendations regarding shareholder proposals.[61] The guidance focused on what constitutes a "solicitation" under Section 14 of the Securities Exchange Act of 1934[62] (the "Exchange Act," and specifically the "federal proxy rules").[63] An investment advisor who typically hires a proxy advisory firm like Glass Lewis or ISS is considered a fiduciary by the SEC and therefore owes its investor a duty of care and loyalty regarding all actions it performs on its investors' behalf, including proxy voting.[64] Proxy advisory firms assist in fulfilling institutional investors' fiduciary duty to their clients.[65] The SEC has a continued view that proxy voting advice provided by the proxy advisory firms constitutes a "solicitation" under the Exchange Act.[66] Rule 14a-1 of the Exchange Act states that a "solicitation" includes a "communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy."[67] By interpreting "solicitation" to include proxy advisory firms' advice to their clients, the SEC is subjecting proxy advisory firms to the federal proxy advisory rules in the Exchange Act.[68]

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58. *Id*.

59. Spatt, *supra* note 4.

60. 17 C.F.R. pt. 241 (2012), *Comm'n Interpretation & Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice*, Exchange Act Release No. 86721, 2019 WL 8587445 (Aug. 21, 2019).

61. Brian Croce, *SEC lays out proxy advisory firms' responsibilities*, PENSION & INVS. (Aug. 21, 2019 03:16 PM), https://www.pionline.com/regulation/sec-lays-out-proxy-advisory-firms-responsibilities.

62. 17 C.F.R. § 240.14a-2; *See* Croce, *supra* note 60.

63. Croce, *supra* note 61.

64. Investment advisor Proxy Voting Guidance, 17 CFR Parts 271 and 276, SEC Guidance (Aug. 21, 2019).

65. 17 C.F.R. pt. 241 (2012), *Comm'n Interpretation & Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice*, Exchange Act Release No. 86721, 2019 WL 8587445 (Aug. 21, 2019).

66. *Id*.

67. Securities and Exchange Act of 1934, 17 C.F.R. § 240.14a-1.

68. *See* Croce *supra* note 60. The SEC recognized that proxy voting advice likely falls within the definition of a solicitation and instead chose to exempt such solicitations from the information and filing requirements of the proxy rules. *See generally*, Shareholder Participation Adopting

The primary legal framework that governs proxy advisory firms is The Investment Advisors Act of 1940 (the 1940 Act).[69] Under the 1940 Act, a firm is considered an "Investment Advisor" if they get paid compensation to provide advice on anything relating to the selling or buying securities or general analysis of securities.[70] In the SEC's 2010 guidance, it stated that "proxy advisory firms receive compensation for providing voting recommendations and analysis on matters submitted for a vote at shareholder meetings" and that they "meet the definition of investment advisor because they, for compensation, engage in the business of issuing reports or analyses

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Release, enacting what is now Exchange Act Rule 14a-2(b)(3) to exempt the furnishing of proxy voting advice by any advisor to any other person with whom the advisor has a business relationship from the informational and filing requirements of the federal proxy rules, provided the conditions of the rule are met. 17 C.F.R. § 240.14a-2(b)(3). Rule 14a-2(b)(3) requires that:

(i) the advisor renders financial advice in the ordinary course of his business;

(ii) the advisor discloses to the recipient of the advice any significant relationship with the registrant or any of its affiliates, or a security holder proponent of the matter on which advice is given, as well as any material interests of the advisor in such matter;

(iii) the advisor receives no special commission or remuneration for furnishing the proxy voting advice from any person other than a recipient of the advice and other persons who receive similar advice under this subsection; and

(iv) the proxy voting advice is not furnished on behalf of any person soliciting proxies or on behalf of a participant in an election subject to the provisions of § 240.14a-12(c).

69. 15 U.S.C.A. § 80b-1.

70. 15 U.S.C.A. § 80b-2(a)(11), which codifies Investment advisors Act of 1940, § 202(a)(11), and states:

> "Investment advisor" means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; but does not include (A) a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956 which is not an investment company, except that the term "investment advisor" includes any bank or bank holding company to the extent that such bank or bank holding company serves or acts as an investment advisor to a registered investment company, but if, in the case of a bank, such services or actions are performed through a separately identifiable department or division, the department or division, and not the bank itself, shall be deemed to be the investment advisor; … (C) any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor; … (E) any person whose advice, analyses or reports relate to no securities other than securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, or securities issued or guaranteed by corporations in which the United States has a direct or indirect interest which shall have been designated by the Secretary of the Treasury, pursuant to section 3(a)(12) of the Securities Exchange Act of 1934, as exempted securities for the purposes of that Act; (F) any nationally recognized statistical rating organization, as that term is defined in section 3(a)(62) of the Securities Exchange Act of 1934, unless such organization engages in issuing recommendations as to purchasing, selling, or holding securities or in managing assets, consisting in whole or in part of securities, on behalf of others;;1 (G) any family office, as defined by rule, regulation, or order of the Commission, in accordance with the purposes of this subchapter; or (H) such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order.

concerning securities and providing advice to others as to the value of securities."[71] Additionally, investment advisors typically have to register with the SEC if they manage $25 million or more of assets.[72] Proxy advisory firms do not fall into this category because they typically do not manage their clients' assets, but they still may choose to register with the SEC if they fall into one of the exemptions from registration prohibition provided in Rule 203A-2 under the Act.[73] Proxy advisory firms can make a valid argument that it should fall under the exemption by having at least one pension fund plan, and would therefore qualify as a "Pension Consultant."[74]

There is a growing sense among experts in the voting industry that the concentration of proxy advisory firms has led to the firms becoming "shadow regulators."[75] Shadow regulators are "entities that have enough influence in the system that they can dictate major changes in business practices with significant effect but little responsibility."[76] This occurs when one entity in a complex industry system can drive significant change through the whole system or network of that particular industry.[77] Because proxy advisory firms control so much of the voting process, they are known as shadow regulators.[78]

Due to this concern of shadow regulation, many scholars and heads of businesses have spoken out against allowing proxy advisory firms to be shadow regulators. For example, former SEC commissioner Daniel M. Gallagher stated in the 2013 that:

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71. SEC, *Concept Release on the U.S. Proxy System*, Release No. 34-62495 (July 14, 2010).

72. Advisers Act Section 203A, 15 U.S.C.A. § 80b-3a.

73. 15 U.S.C.A. § 80b-3a, which codifies, Section 203A(a) of the Act, states:

(a) Advisers subject to State authorities

(1) In general

No investment advisor that is regulated or required to be regulated as an investment advisor in the State in which it maintains its principal office and place of business shall register under section 80b-3 of this title, unless the investment advisor—

(A) has assets under management of not less than $25,000,000, or such higher amount as the Commission may, by rule, deem appropriate in accordance with the purposes of this subchapter.

74. 17 C.F.R. § 275.203A-2, which codifies Advisers Act Rule 203A-2(b), states:

(1) An investment advisor that is a "pension consultant," as defined in this section, with respect to assets of plans having an aggregate value of at least $200,000,000.

(2) An investment advisor is a pension consultant, for purposes of paragraph (a) of this section, if the investment advisor provides investment advice to:

(i) Any employee benefit plan described in section 3(3) of the Employee Retirement Income Security Act of 1974 ("ERISA") [29 U.S.C. 1002(3)];

(ii) Any governmental plan described in section 3(32) of ERISA (29 U.S.C. 1002(32)); or

(iii) Any church plan described in section 3(33) of ERISA (29 U.S.C. 1002(33)).

75. Doyle, *supra* note 7.

76. John Strong, *Submission to the Productivity Commission on the Study of Regulator Behaviour with Small Business*, STRONG STRATEGIES (Mar. 19, 2013), https://www.pc.gov.au/inquiries/completed/small-business/submissions/submissions-test/submission-counter/sub019-small-business.pdf.

77. *Id*.

78. *See* Doyle, *supra* note 7.

> I believe that the Commission should fundamentally review the role and regulation of proxy advisory firms and explore possible reforms, including, but not limited to, requiring them to follow a universal code of conduct, ensuring that their recommendations are designed to increase shareholder value, increasing the transparency of their methods, ensuring that conflicts of interest are dealt with appropriately, and increasing their overall accountability. I am not alone in raising these issues…what European policymakers and our own Congress have highlighted is that changes need to be made so that proxy advisors are subject to oversight and accountability commensurate with their role. [79]

One of the largest problems with this "quasi-regulator" status is the cost on the companies that are the clients of proxy advisory firms. [80] Proxy advisory firms are constantly changing and updating policies and recommendations around social and environmental issues, making it difficult for client companies to stay up to date on the changes.[81] When proxy advisory firms make a policy on environmental or social issues that affect many of their clients in many different industries, client companies can scramble to try to adhere to that policy change.[82] In doing so, client companies can bear tremendous costs, and can potentially lose sight of shareholder value in the process.[83]

Politically charged proxy proposals by proxy advisory firms such as environmental, social, and governance solutions can hinder shareholder returns and inadvertently turn corporate policy-making political.[84] A 2017 study by Harvard University professor Joseph Kalt and economist Adel Turki focused on the impact climate change policies have had on proxy shareholder proposals in recent years.[85] The study showed that companies that adhered to the recommendation of proxy advisory firms on political proposals such as climate change do not perform better based on market indices both in the short-term and long-term.[86] Over one hundred million retail investors, who hold more than $16.9 trillion in assets, [87] are particularly hurt by these

79. Daniel M. Gallagher, *Remarks at Society of Corporate Secretaries & Governance Professionals*, SEC (July 11, 2013), https://www.sec.gov/news/speech/spch071113dmghtm.

80. *See* Doyle, *supra* note 7.

81. *Id*.

82. *Id*.

83. *Id*.

84. *See* Jeff Patch, *Curb the Power of Shady Proxy Advisory Firms!*, WASH. EXAMINER (July 16, 2018, 5:00 AM), https://www.washingtonexaminer.com/weekly-standard/curb-the-power-of-shady-proxy-advisory-firms.

85. *See* Joseph Kalt, *Political, Social, and Environmental Shareholder Resolutions: Do they Create or Destroy Shareholder Value?*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 17, 2018), https://corpgov.law.harvard.edu/2018/06/17/political-social-and-environmental-shareholder-resolutions-do-they-create-or-destroy-shareholder-value/.

86. *Id*.

87. Patch, *supra* note 84.

political proxy proposals that proxy advisory firms are recommending because they are not given an adequate voice.[88] The majority of proxy recommendations are followed because institutional investors, who hold thirty-eight percent of the shareholder votes,[89] tend to follow the proxy advisory firm's recommendation.[90] If the majority of these proxy proposals have an underlying political agenda, then there is a good chance they will be passed leading to shareholders, particularly retail investors, losing value.[91]

II. HISTORY AND RATIONALE OF GLASS-STEAGALL ACT

Prior to 1933, a single bank could perform both retail banking functions and investment banking functions.[92] To better understand Glass-Steagall and the reasoning for the legislation, a basic understanding of investment banking and retail banking is required.

A. INVESTMENT BANKING BACKGROUND

Investment banking functions include underwriting, mergers & acquisitions (M&A) advisory, sales & trading, equity research, and asset management services.[93] Investment bankers perform underwriting services by assisting in raising capital for corporations (e.g., through initial public offerings[94]) by selling bonds or stocks of the corporation to multiple investors.[95] M&A advisory includes helping corporations—both on the "sell-side" (representing the company being purchased) and "buy-side" (representing the company doing the purchasing)—evaluate and negotiate with the other party during an acquisition of another company.[96] Sales & Trading involves buying and selling securities on the secondary market (i.e., investors buy and sell securities they already own or have previously been purchased during an IPO).[97] Equity research groups provide research reports that can be purchased by investors and corporations to assist in making

88. *Id*.
89. Patch, *supra* note 84.
90. *See* Doyle, *supra* note 7.
91. Patch, *supra* note 84.
92. Amadeo, *supra* note 8.
93. *Investment Banking: Overview of the investment banking industry*, CORPORATE FIN. INST., https://corporatefinanceinstitute.com/resources/careers/jobs/investment-banking-overview/ (last visited Feb. 1, 2021).
94. An initial public offering (IPO) refers to the process of offering shares of a private corporation to the public in a new stock issuance. This usually entails listing the stock on one of the major exchanges. Jason Fernando, *Initial Public Offering (IPO)*, INVESTOPEDIA (Mar. 1, 2021), https://www.investopedia.com/terms/i/ipo.asp.
95. CORPORATE FIN. INST, *supra* note 93.
96. *Id*.
97. *Id*.

investment decisions.[98] Asset managers provide investment strategies for institutions and investors that best utilize their investments.[99]

Investment banking functions differ from retail banking functions. Retail banking provides services to consumers such as individuals and families, primarily through credit (e.g., underwriting a loan), deposits, and money management.[100] Retail bankers provide individual consumers with credit products such as mortgages, credit cards, and car loans.[101] Retail bankers also assist in setting up deposit accounts for consumers such as savings accounts or certificates of deposits.[102] Consumers can also purchase money management products such as checking accounts and debit cards from retail bankers.[103]

B. HISTORY OF THE GLASS-STEAGALL ACT

In the aftermath of the stock market crash in 1929 that kicked off the Great Depression, Congress became concerned that the consumer deposits from the retail function of the banks were put in an unnecessarily risky position as bankers on the investment banking side continually sold, bought, and underwrote inherently risky securities.[104] From the time of the stock market crash in 1929 to 1932, approximately 5,795 banks failed with an additional 4,000 failures in 1933.[105] Consumers were withdrawing their money from banks at a rapid speed. President Franklin D. Roosevelt declared a four-day bank holiday, closing the entire U.S. banking system, and subsequently passed the Emergency Banking Act of 1933[106] to help restore

98. *Id*.
99. *Id*.
100. Amadeo, *supra* note 8.
101. *Id*.
102. Kimberly Amadeo, *Retail Banking, Its Types and Economic Impact*, BALANCE (Nov. 30, 2020), https://www.thebalance.com/what-is-retail-banking-3305885.
103. *Id*.
104. Joseph Jude Norton, *Up Against "The Wall": Glass-Steagall and the Dilemma of a Deregulated ("Reregulated") Banking Environment*, 42 BUS. LAW. 327, 329 (1987).
105. Oonagh McDonald, *The Repeal of the Glass-Steagall Act: Myth and Reality*, CATO INST., POL'Y ANALYSIS NO. 804 (Nov. 16, 2016), https://www.cato.org/publications/policy-analysis/repeal-glass-steagall-act-myth-reality.
106. The Act, which also broadened the powers of the president during a banking crisis, was divided into five sections:

> Title I expanded presidential authority during a banking crisis, including retroactive approval of the banking holiday and regulation of all banking functions, including 'any transactions in foreign exchange, transfers of credit between or payments by banking institutions as defined by the President, and export, hoarding, melting, or earmarking of gold or silver coin.'
>
> Title II gave the comptroller of the currency the power to restrict the operations of a bank with impaired assets and to appoint a conservator, who 'shall take possession of the books, records, and assets of every description of such bank, and take such action as may be necessary to conserve the assets of such bank pending further disposition of its business.'

public confidence in the banking system.[107] Many consumers returned much of the money that was previously withdrawn, but widespread public pessimism still existed with regard to the banks in the United States.[108] To address this risk that contributed to the stock market crash and to restore public confidence in banks, Congress enacted the Glass-Steagall Act in 1933.[109] One of the primary reasons for passing the Glass-Steagall Act was to counteract the potential risks that could arise when commercial banks representing consumers partake in the risky securities business of which investment banks focus, particularly when consumer deposits are used to partake in the investment activity.[110]

Section 16 of the now-repealed Glass-Steagall legislation, which describes four provisions of the United States Banking Act of 1933 separating commercial and investment banking,[111] focuses on the major divide that famously separates the retail and investment banking functions of a bank.[112] 12 U.S.C. § 24 (Seventh), which codifies section 16 of United States Banking Act of 1933, states:

> The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for

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> Title III allowed the secretary of the treasury to determine whether a bank needed additional funds to operate and 'with the approval of the President request the Reconstruction Finance Corporation to subscribe to the preferred stock in such association, State bank or trust company, or to make loans secured by such stock as collateral.'
>
> Title IV gave the Federal Reserve the flexibility to issue emergency currency—Federal Reserve Bank Notes—backed by any assets of a commercial bank.
>
> Title V made the act effective.

Stephen Greene, *Emergency Banking Act of 1933*, FED. RESERVE HISTORY, https://www.federalreservehistory.org/essays/emergency_banking_act_of_1933 (citing Federal Reserve Bank of St. Louis. "Documents and Statements Pertaining to the Banking Emergency, Presidential Proclamations, Federal Legislation, Executive Orders, Regulations, and Other Documents and Official Statements, Part 1, February 25 - March 31, 1833." 1933, https://fraser.stlouisfed.org/scribd/?item_id=23564&filepath=/docs/historical/federal%20reserve%20history/bank_holiday/bank_emerg_pt1_19330225.pdfOffsite link.).

107. McDonald, *supra* note 105.

108. *Id*.

109. *Id*.

110. John S. Zieser, *Security Under the Glass-Steagall Act: Analyzing the Supreme Court's Framework for Determining Permissible Bank Activity*, 70 CORNELL L. REV. 1194, 1195–96 (1985).

111. David H. Carpenter and Maureen M. Murphy, *Permissible Securities Activities of Commercial Banks Under the Glass–Steagall Act (GSA) and the Gramm-Leach-Bliley Act (GLBA)*, Congressional Research Service Report (R41181) (April 12, 2010), https://web.archive.org/web/20120804064833/http://assets.opencrs.com/rpts/R41181_20100412.pdf ("1999's landmark financial services legislation, the Gramm-Leach-Bliley Act (GLBA), repealed certain provisions of the Banking Act of 1933, commonly referred to as the Glass-Steagall Act (GSA).").

112. Roberta Karmel, *Glass-Steagall: Some Critical Reflections*, 97 BANKING L. J. 631, 632 (1980).

> its own account, and the association shall not underwrite any issue of securities of stock; *Provided*, That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe. . . . The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to obligations of the United States, or general obligations of any State or of any political subdivision thereof . . .[113]

This section applies to national banks and state banks through the Federal Reserve Act.[114] The Federal Deposit Insurance Corporation (FDIC) stated that banks are not subject to the Glass-Steagall separation restrictions if the particular restricted securities activities are carried out through a subsidiary instead of the parent company bank.[115] This leaves room for a loophole for proxy advisory firms if a Glass-Steagall structure is adopted. A proxy advisory firm could decide to only have its consulting business come from a subsidiary instead of from the parent company.[116]

Section 20 of the now defunct Glass-Steagall Act stated:

> After one year from June 16, 1933, no member bank shall be affiliated in any manner described in subsection (b) of section 221a of this title[117] with

113. 12 U.S.C.A. § 24 (West) (1982) (emphasis added).

114. The Federal Reserve Act, codified in 12 U.S.C.A. § 335 (West 1999): Dealing in investment securities; limitations and conditions, effectively states:
State member banks shall be subject to the same limitations and conditions with respect to the purchasing, selling, underwriting, and holding of investment securities and stock as are applicable in the case of national banks under paragraph "Seventh" of section 24 of this title. This section shall not apply to any interest held by a State member bank in accordance with section 24a of this title and subject to the same conditions and limitations provided in such section.

115. *See* FDIC, Statement of Policy on Applicability of Glass-Steagall Act to Securities Activities of Subsidiaries of Insured Nonmember Banks, 47 Fed. Reg. 38,984 (1982).

116. *See Id*.

117. 12 U.S.C.A. § 221a (West 1982) defines an FRS member "affiliate" and states:
(b) Except where otherwise specifically provided, the term "affiliate" shall include any corporation, business trust, association, or other similar organization—
(1) Of which a member bank, directly or indirectly, owns or controls either a majority of the voting shares or more than 50 per centum of the number of shares voted for the election of its directors, trustees, or other persons exercising similar functions at the preceding election, or controls in any manner the election of a majority of its directors, trustees, or other persons exercising similar functions; or
(2) Of which control is held, directly or indirectly, through stock ownership or in any other manner, by the shareholders of a member bank who own or control either a majority of the shares of such bank or more than 50 per centum of the number of shares voted for the election of directors of such bank at the preceding election, or by trustees for the benefit of the shareholders of any such bank; or
(3) Of which a majority of its directors, trustees, or other persons exercising similar functions are directors of any one member bank; or
(4) Which owns or controls, directly or indirectly, either a majority of the shares of capital stock of a member bank or more than 50 per centum of the number of shares voted for the election of directors of a member bank at the preceding election, or controls in any manner the election of a majority of the directors of a member bank, or for the benefit of whose shareholders or members all or substantially all the capital stock of a member bank is held by trustees.

> any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities . . .[118]

This section covers all banks, including Federal Reserve System-member state banks, that are "principally engaged" in providing securities services.[119]

Section 21 of Glass-Steagall states that any business that is "engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities" cannot engage in commercial banking as well.[120] Because of this new rule, banks had to choose one function or the other, and they could not participate in both securities trading and taking in consumer deposits.[121]

Section 32 prevents interlocking of management by stating that no person "shall serve the same time as an officer, director, or employee of any member bank."[122] At the time of enacting Glass-Steagall in the aftermath of the 1929 stock market crash, Congress was concerned about the potential conflicts of interest in having the same management team in charge of both functions.[123] For example, Congress thought it may be difficult for management of a retail bank to extend credit impartially and simultaneously advise on investments impartially because, in theory, managers could be tempted to (1) "favor customers who borrowed funds to purchase securities from investment affiliates, and (2) to promote securities offered by investment affiliates to bank customers and correspondent banks."[124]

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118. 12 U.S.C.A. § 377 (West) (repealed 1999).

119. Norton, *supra* note 104, at 328.

120. 12 U.S.C. § 378, which is the codification of § 21, states:

(a) After the expiration of one year after June 16, 1933, it shall be unlawful—

(1) For any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits . . . Provided, That the provisions of this paragraph shall not prohibit national banks or State banks or trust companies (whether or not members of the Federal Reserve System) or other financial institutions or private bankers from dealing in, underwriting, purchasing, and selling investment securities, or issuing securities, to the extent permitted to national banking associations by the provisions of section 24 of this title . . .

121. Norton, *supra* note 104, at 332.

122. 12 U.S.C. § 78 (1982), which is the codification of § 32, provides:

No officer, director, or employee of any corporation or unincorporated association, no partner or employee of any partnership, and no individual, primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities, shall serve the same time as an officer, director, or employee of any member bank except in limited classes of cases in which the Board of Governors of the Federal Reserve System may allow such service by general regulations when in the judgment of the said Board it would not unduly influence the investment policies of such member bank or the advice it gives its customers regarding investments (repealed 1999).

123. Norton, *supra* note 104, at 333-34.

124. *Id*.

Congress ultimately repealed Glass-Steagall in 1999, due to many factors that rendered Glass-Steagall practically ineffective.[125] By the 1980's, section 20 of Glass-Steagall became ineffective when the Federal Reserve provided guidance on what is considered to be "principally engaged" in the securities business.[126] Bank Holding Companies (BHC)[127] were only allowed to partake in limited investment banking activities through subsidiaries that were separate capitalized from the holding company, which eventually become known as "Section 20 subsidiaries."[128] By 1999, the Federal Reserve approved forty-one Section 20 subsidiaries and allowed them to underwrite and perform other limited investment banking activities.[129] As more Federal Reserve decisions blurred the lines of Glass-Steagall, more investment banking activities were permitted.[130] Eventually in 1997 Bankers Trust (then owned by Deutsche Bank) became the first U.S. bank to acquire a securities firm (focused primarily on investment banking activities) with the purchase of Alex Brown & Company.[131] Additionally, the Federal Reserve relaxed other Glass-Steagall firewalls, such as allowing directors to be a part of the parent company and subsidiary and allowing more intercompany transactions.[132] These "blurred lines" of Glass-Steagall paved the way for the inevitable Gramm-Leach-Bliley Act of 1999.[133]

The Gramm-Leach-Bliley Act repealed sections 20 and 32 of Glass-Steagall.[134] It allowed for commercial banks and investment banks to affiliate with each other and allowed overlapping management relationships between consumer banks and securities firms.[135] However, section 16 of Glass-Steagall,[136] which prohibits banks from underwriting securities or engaging

125. McDonald, *supra* note 105.

126. *Id*.

127. A bank holding company ("BHC") is "a corporation that owns a controlling interest in one or more banks but does not itself offer banking services." These holding companies do not focus on the day-to-day operations of the bank, but they do have discretion over strategy and management. All bank holding companies are regulated by the Federal Reserve. Julia Kagan, *Bank Holding Company*, INVESTOPEDIA, https://www.investopedia.com/terms/o/one-bank-holding-company.asp (last visited Nov. 15, 2019).

128. McDonald, *supra* note 105.

129. *Id*.

130. *See id*.

131. *See id*.

132. *See id*.

133. *See* Gramm–Leach–Bliley Financial Modernization Act, Pub.L. No. 106–102, 113 Stat. 1338 (Nov. 12, 1999) (codified as amended in scattered sections of 12, 15, 16 and 18 U.S.C.).

134. The Gramm-Leach Bliley Act did not allow banks to offer all securities products, nor did it allow securities firms to take deposits. It implemented a new form of BHC called a financial holding company, which allowed the parent holding companies of banks to also include investment bank and insurance subsidiaries. Additionally, if a bank invests into its investment bank (i.e., securities firm) subsidiary, it cannot be recorded as an asset on the balance sheet. McDonald, *supra* note 105.

135. *Id*.

136. *Id*.

in proprietary trading,[137] and section 21, which prohibits broker-dealers from accepting consumer deposits,[138] were not repealed.[139]

III. RECOMMENDATION

This Note proposes that the solution to the potential conflict of interest in proxy advisory firms can be solved by applying a similar Glass-Steagall framework that splits the consulting functions and voting advisory functions. A financial market observer in Martin Mayer's book, *The Bankers: a Major Exploration of the Great World of Modern Banking*, stated, "[i]n 1933, the Glass-Steagall Act forbade commercial banks to own common stock or to underwrite and sell stock or corporate bonds to their customers or depositors; and the banks slowly, grumblingly, returned to banking."[140] In this case, when a Glass-Steagall framework is applied to proxy advisory firms, they will "slowly, grumblingly" return to their main function: shareholder voting advisory.[141]

A. FRAMEWORK RATIONALE COMPARISONS

Section 21 of Glass-Steagall forced banks to choose investment banking functions or retail banking functions, and prohibited banks from performing both functions.[142] By preventing investment banks from taking on consumer deposits, the risk of obtaining runnable debt was mitigated, therefore reducing the chances of another bank "panic."[143] Similarly, applying a section 21-like concept to proxy advisory firms would force these firms to choose either shareholder proxy voting advisory or consulting services.[144] These firms will have sole discretion on which business they choose to pursue.

Just as section 32 of Glass-Steagall helped resolve the conflicts of interest that arise with having the same management team for the different functions of a bank, a similar concept could resolve potential conflicts of interests that may arise with having the same management team of a proxy advisory firm's consulting function and its voting advisory function.[145] In enacting Glass-

137. *Id*. "Proprietary trading" refers to the act of trading financial products such as foreign exchange currencies, commodities, bonds and stocks, with the firm's own money by leveraging the firm's own assets to support the risky activities. *See Proprietary Trading: What It Is & Related Strategies*, DAY TRADE WORLD, https://www.daytradetheworld.com/trading-blog/proprietary-trading-your-complete-guide/ (last visited Nov. 15, 2019).

138. 12 U.S.C. § 378.

139. *See* McDonald, *supra* note 105.

140. MARTIN MAYER, THE BANKERS: A MAJOR EXPLORATION OF THE GREAT WORLD OF MODERN BANKING, 52 (1974).

141. *See id*.

142. *See* 12 U.S.C. § 378, which is the codification of § 21.

143. John Crawford, *A Better Way to Revive Glass-Steagall*, 70 STAN. L. REV. ONLINE 1, 2 (2017).

144. *See* 12 U.S.C. § 378, which is the codification of § 21.

145. See 12 U.S.C. § 78 (1982), which is the codification of § 32 (repealed 1999).

Stegall, Congress repeatedly worried about the "subtle hazards that arise when a commercial bank goes beyond the business of acting as fiduciary or managing agent and enters the investment banking business either directly or by establishing an affiliate to hold and sell particular investments."[146] One of the most important "subtle hazards" that could stem from banks performing both functions is the potential of loss of customer good will.[147] Just as Congress worried that consumer bank depositors might rely on the relationship it has with a banker to purchase bad investment products when it passed Glass-Steagall, a similar possibility exists today with proxy advisory firms.[148] In banking, "pressures are created because the bank and the affiliate are closely associated in the public mind, and should the affiliate fare badly, public confidence in the bank might be impaired."[149] Similarly, in proxy advisory firms, and particularly with ISS, consulting services and the voting advisory service are also closely associated in the eyes of the public.[150] For banks, "public confidence is essential to the solvency of a bank, so there might exist a natural temptation to shore up the affiliate through unsound loans or other aid."[151] In contrast to proxy advisory firms, there might be a natural temptation for a firm to push unnecessary consulting services on a client that also uses the firm's voting advisory services.[152] Glass-Stegall was implemented because of Congress' fears that a "bank's salesman's interest might impair its ability to function as an impartial source of credit."[153] A similar framework applied to proxy advisory firms would alleviate this same fear of impartiality that many experts and members of the public have today.[154]

Congress was also concerned that bank consumer depositors would suffer losses on their investments if they bought other banking products in reliance on the relationship between the retail bank and the investment securities affiliate.[155] Similarly, if ISS's clients rely on their relationship with ISS's proxy voting branch to also utilize ISS's consulting branch, the potential conflict of interest could lead to shareholders losing value.[156] Congress also feared that the promotion of investment banking services, which rely heavily on market trends, could lead commercial banks to lend credit to potentially unworthy customers with the hope that the loan would influence the consumer to also purchase investment banking services—such

146. Inv. Co. v. Camp, 401 U.S. 617, 630 (1971).
147. *See* 77 Cong.Rec. 4028 (remarks of Rep. Fish).
148. *See Camp*, 401 U.S. at 631.
149. *Id.*
150. Doyle, *supra* note 7.
151. *Camp*, 401 U.S. at 631.
152. Doyle, *supra* note 7.
153. *Camp*, 401 U.S. at 631.
154. Doyle, *supra* note 7.
155. *See* 77 Cong.Rec. 4028 (remarks of Rep. Fish).
156. Doyle, *supra* note 7.

as stocks or bonds.[157] This same issue of proxy advisory firms utilizing its voting advisory services to facilitate clients to also use its consulting services still exists today in a similar capacity. During the process leading up to Glass-Steagall in 1932, Senator Bulkley summed up the potential conflict of interest of having the same banker fulfilling the role of investment banker and commercial banker in a well-articulated manner:

> Obviously, the banker who has nothing to sell to his depositors is much better qualified to advice disinterestedly and to regard diligently the safety of depositors than the banker who uses the list of depositors in his savings department to distribute circulars concerning the advantages of this, that, or the other investment on which the bank is to receive an originating profit or an underwriting profit or a distribution profit or a trading profit or any combination of such profits.[158]

Similarly, ISS is "better qualified to advise disinterestedly" if it does not have a consulting service to offer and can focus solely on offering well-researched proxy voting recommendations to increase shareholder value.[159] A framework based on sections 21 and 32 of Glass-Steagall could alleviate some of these fears.[160]

B. CHOOSING ONE OR THE OTHER

The Center of Executive Compensation's 2011 report suggests the SEC take a different approach to solve these conflicts of interests by recommending that "the SEC should ban proxy advisory firms, or their affiliates, from providing advisory services to institutional investors, while at the same time providing consulting services to corporate issuers on the matters of proxy votes."[161] This approach would essentially result in the same outcome as a split of the consulting and advisory functions of a proxy advisory firm and would open the market to more competition in both the voting service and the consulting service industries.[162] Regardless of what method is chosen to split up the advisory and consulting services of the proxy advisory firms, doing so is a step in the right direction to return power to the average investor and to stop the conflicting operating practices of proxy advisory firms, specifically ISS.[163]

157. *See* S.Rep.No.77, 73d Cong., 1st Sess., 9—10.

158. *Sec. Indus. Ass'n v. Bd. of Governors of Fed. Rsrv. Sys.*, 468 U.S. 137, 156, 104 S. Ct. 2979, 2989, 82 L. Ed. 2d 107 (1984)

159. *See id*. [*Sec. Indus. Ass'n v. Bd. of Governors of Fed. Rsrv. Sys.*, 468 U.S. 137, 156, 104 S. Ct. 2979, 2989, 82 L. Ed. 2d 107 (1984)]

160. 12 U.S.C. § 378, which is the codification of § 21; 12 U.S.C. § 78 (1982), which is the codification of § 32 (repealed 1999).

161. A Call for Change, *supra* note 44, at 85.

162. *See id*.

163. Patch, *supra* note 84.

By forcing banks to choose one function or another, Glass-Steagall spurned more competition in both the retail bank fields and the investment bank fields.[164] Because Glass Lewis and ISS together control about thirty-eight percent of shareholder votes, they have become so influential that some experts have proxy advisory firms as on the same level as regulators, specifically relating to effectiveness in swinging proxy votes.[165] Though they do not technically have any statutory authority, proxy advisory firms can swing proxy votes by as much as thirty percent.[166]

In the 2007 Government Accountability Office report, the government stated that:

> [B]ecause 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.[167]

Some of the largest barriers of entry for smaller proxy advisory firms are matching the extensive services provided by the large players in the industry, along with "the development, implementation and maintenance of sophisticated technology platforms; and the costs for clients of switching vote execution services."[168] Proxy Governance Inc., a former ISS competitor who was bought out by Glass Lewis, wrote a letter to the SEC outlining its concerns about possible antitrust issues by stating:

> [i]f there is one issue on which virtually all market participants (with the possible exception of RiskMetrics/ISS) would seem to agree, it is that there should be more than one proxy advisor and that the perpetuation of the near monopoly status of RiskMetrics/ISS is not in the long-term interests of investors or our capital markets.[169]

One could argue that Glass-Steagall stopped retail and commercial banks from providing investment banking activities, therefore protecting Wall Street banks like Bear Stearns, Lehman Brothers, and Goldman Sachs from

164. See Gillian B. White and Bourree Lam, *Could Reviving a Defunct Banking Rule Prevent a Future Crisis?*, ATLANTIC (Aug. 23, 2016), https://www.theatlantic.com/business/archive/2016/08/glass-steagall/496856/.

165. Ike Brannon, *Diminishing the Power of Proxy Advisory Firms*, FORBES (July 11, 2019, 8:11 PM), https://www.forbes.com/sites/ikebrannon/2019/07/11/diminishing-the-power-of-proxy-advisory-firms/#78f158e9452c.

166. *Id*.

167. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-765, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING 13 (2007).

168. A Call for Change, *supra* note 44, at 77.

169. Letter from Michael Ryan, Jr., President & Chief Operating Officer, Proxy Governance, to Meagan Thompson-Mann, Millstein Inst. for Corporate Governance & Performance 7 (July 23, 2008), https://www.proxygovernance.com/content/pgi/img/2008MillsteinResponse.pdf.

other competition, which allowed those investment banks to increase their influence.[170]

IV. COUNTERARGUMENTS

One of the main arguments against further regulation for proxy advisory firms is that they are not as powerful as critics believe.[171] Additionally, critics of regulations say that further regulating proxy advisory firms will not do much anyway because most of the proposed regulations focus on more disclosure and transparency around the methodology of their recommendations.[172] They argue that further regulation will drive up the costs of their services, making institutional investor clients less likely to use their services.[173] They argue that proxy advisory firms reduce the expenses for institutional investors in regards to research, development, and workflow management.[174]

This argument against further regulation of proxy advisory firms hinges on what "corporate purposes" institutions should focus on.[175] One vision of corporate purposes states that a business is a "vehicle for long-term value creation," and that "value" does not necessarily only include purely financial terms, but also includes social prosperity.[176] The competing view is that the purpose of a corporation and the purpose of a shareholder vote is wealth-maximization because that is the most likely way an investment advisor representing thousands of shareholders can come close to representing the preferences of their individual investors.[177] The idea is that driving up proxy advisory costs would be a detriment to shareholders.[178] The main worry here is that proxy advisory firms may turn America's large corporations into "vehicles for social engineering" and may force businesses from continuing to maximize the wealth of the shareholder, arguably the largest trigger of the U.S. economic growth.[179] However, proxy advisory firms give a voice to those who want to stand up to excessive compensation of executives and of

170. White, *supra* note 164.

171. Stephen Gandel, *SEC Should Leave Proxy Advisory Firms Alone*, BLOOMBERG OP. (Dec. 10, 2018, 5:00 AM), https://www.bloomberg.com/opinion/articles/2018-12-10/sec-should-leave-proxy-advisory-firms-alone.

172. *Id*.

173. *Id*.

174. David Katz and Laura McIntosh, *Proxy Voting and the Future of Corporations*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 30, 2018), https://corpgov.law.harvard.edu/2018/11/30/proxy-voting-and-the-future-of-corporations/.

175. *Id*.

176. *Id*.

177. *Id*.

178. *Id*.

179. *See* Stephen Gandel, *SEC Should Leave Proxy Advisory Firms Alone*, BLOOMBERG OP. (Dec. 10, 2018, 5:00 AM), https://www.bloomberg.com/opinion/articles/2018-12-10/sec-should-leave-proxy-advisory-firms-alone.

boards of directors.[180] Additionally, corporations tend to win shareholder votes regardless of what the proxy advisory firm recommends, so further regulation might not be as necessary.[181]

CONCLUSION

Proxy advisory firms have greatly reduced the time and money that institutional investors[182] need to spend.[183] However, given the dual-nature of these proxy advisory firms providing both consulting services and voting advisory services to the same companies, the potential for conflicts of interests has increased.[184] This Note proposes that to avoid these conflicts of interests, Congress should apply the Glass-Steagall framework that will split up these proxy advisory firms, forcing these established firms to choose consulting services or advisory services, but not both.[185] Doing so will reduce conflicts of interests and produce more competition within the proxy advisory market.

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180. *See id*.
181. *See id*.
182. Bourgi, *supra* note 5.
183. Larcker, *supra* note 6.
184. Doyle, *supra* note 7.
185. Amadeo, *supra* note 8.

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