SUPPORT
HB 4079 by Leach
SB 2337 by Hughes

Stop Conflicts of Interest by Proxy Advisors

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About 70-80 percent of the outstanding shares of U.S. publicly traded companies are owned by institutional investors, such as mutual funds, pension funds, hedge funds, and index funds. Individual investors account for the remainder. When it comes to voting on proposals affecting corporate decision-making, institutional investors account for more than 91 percent of the voted shares. Individual investors, by contrast, only vote about 29 percent of the shares they own, meaning that institutional investors overwhelmingly influence what corporate boards and management actually do.

This oversized presence of institutional investors in corporate decisions has given rise to third-party proxy advisory firms. Investors hire proxy advisors to assist them in evaluating so-called "proxy" or company proposals and make recommendations on how a particular investor should vote its shares. In an article published by the Rock Center for Corporate Governance at Stanford University (and again in a subsequent paper published by the Harvard Law School Forum on Corporate Governance),[i] the authors determined that "proxy advisors have a material, if unspecified, influence over institutional voting behavior and therefore also voting outcomes. An extensive review of the empirical evidence shows that an *against* recommendation is associated with a reduction in the favorable vote count by 10 to 30 percent."

While the use of proxy advisors is not in itself a bad thing (for regulatory compliance, for example), it becomes problematic when the two largest proxy advisory firms control approximately 97 percent of the proxy advisory services market, allowing them to have outsized control over board rooms across the country. This, coupled with internal metrics that are not strictly based on objective financial criteria, ultimately begs the question of who is really making the decisions that drive our economy. ***One particularly concerning example is where they contract with different subsets of investors within the same company and make conflicting recommendations on how to vote on the same proposal. By definition, these conflicting recommendations cannot both be in the best financial interest of the shareholders.***

How can this happen? First, proxy advisory firms owe no fiduciary duties, so they do not have to prove that their recommendations are in the best financial interests of the shareholders of the company—yet their clients *do* owe fiduciary duties and *rely* on these proxy advisory firms in satisfying the same. Second, they do not have to disclose who pays them, so we have no way of knowing what information they use to model their recommendations or who has access to that information. Third, they do not publish their various recommendations, which are only available to clients who purchase such services. But even then, only the services for a particular client group are provided to an individual client; if the firm has provided different recommendations to a different client group (which is itself not public information), then those services must somehow be separately purchased. In short, without more information about how these firms arrive at their recommendations—let alone how they can reach conflicting conclusions about the *same* company or proxy proposal—a company faced with a proxy fight largely based on those conclusions has no way of knowing what is actually happening and why.

HB 4079/SB 2337 addresses this problem by mandating that proxy advisors must either make recommendations solely in the best financial interest of shareholders or otherwise provide conspicuous warnings to their consumers. It further requires that, to be considered solely in the best financial interest of shareholders, the recommendations be based on quantitative, impartial standards. Proxy advisory firms must disclose to the company and to its clients if their recommendation does not meet the "best financial interest of the shareholders" standard and immediately notify the target company of the basis of their recommendations. A firm making conflicting recommendations on the same proposal does not meet the standard and must notify each recipient shareholder and the target company in writing of the conflicting advice and its basis.

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[i] James Copland, David F. Larcher, and Brian Tavan, "The Big Thumb on the Scale: An Overview of the Proxy Advisory Industry," *Rock Center for Corporate Governance at Stanford University Closer Look Series, Issues and Controversies in Corporate Governance No. CGRP-72*, 4 January 2018. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3188174; last accessed March 11, 2025.