The Corporate Governance Industry

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This Article considers the role of the corporate governance industry as a voluntary regulator. The corporate governance industry influences (and in some cases effectively controls) the votes of trillions of dollars of equity, and affects the governance policies and fortunes of thousands of companies through proxy voting recommendations and governance ratings. This Article considers the increasing influence of the corporate governance industry, and argues that potential conflicts of interest within some governance firms cast doubt on the reliability of their proxy advice and governance ratings. Additionally, governance firms may be overstepping their expertise in proxy voting decisions and in governance rating, in part because of their reliance on "good governance metrics" for which there is little evidentiary support. Finally, erroneous governance metrics (and indeed, a reliance on one-size-fits-all governance checklists) promoted by influential governance advisers not only affect important shareholder voting decisions and decisions on whether to invest in or divest from a particular company, but may also have a more general, harmful effect on corporate governance regulation. A number of academics have argued that federal expansion into corporate governance issues has significant negative consequences. Perhaps most importantly, Sarbanes-Oxley mandates specific governance policies rather than setting broad standards, thereby eliminating some vital flexibility in corporate governance. This Article argues that the corporate governance industry may have similarly harmful effects by pressuring companies to adopt a homogenized set of governance rules which may not be suited to the companies' respective requirements.

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I. INTRODUCTION

There is no specific set of corporate governance rules, standards, and principles to which every U.S. corporation must adhere. Rather, corporations are directed by a variety of sources, some public, some private, which develop and enforce governance rules. Several intertwined factors explain why we do not have a single rule set, source, and regulator of corporate governance. The first is our federalist system of government, which reserves to the states the powers not delegated to the federal government by the Constitution,[1] and among the powers traditionally reserved to the states is the ability to charter and regulate corporations and other business forms.[2] But while the states are the primary corporate regulators, state legislatures have left much of the substantive regulation of corporations to companies themselves by creating enabling rules that allow companies to fashion their own governance structures within a broad statutory framework.[3] Roberta Romano has argued that the regulation of corporations primarily by states rather than federal regulators is the "genius" of American corporate law: states compete for incorporations and are thus incented to offer corporate codes that will appeal to businesses.[4] Companies also have an incentive to self-regulate as a competitive response to limited available capital—like state regulators; companies will generally

1. U.S. CONST. amend. X ("The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.").

2. Under modern Commerce Clause jurisprudence, however, the regulation of corporate governance issues would justifiably fall under federal jurisdiction, so it is largely due to both tradition and federal restraint that the federal government leaves much of the regulation of corporations to the states and other regulators, such as stock exchanges.

3. Because of the generally flexible nature of state corporate codes, much of the regulation of corporations by the states occurs not through statutes, but through statutory interpretation provided by state courts. *See infra* Part II.B. Perhaps the best-known example of this common law tradition of regulation is the "business judgment rule," which holds that business decisions made in good faith and on the basis of reasonable investigation are not actionable. *See, e.g.*, Shlensky v. Wrigley, 237 N.E.2d 776, 781 (Ill. App. 1968) (holding that a decision not to play night games at Wrigley Field was not actionable); Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 812 (N.Y. Gen. Term 1976) (holding as not actionable a decision to forego tax savings in order to grant a dividend and thereby demonstrate an appearance of earnings).

4. ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 1 (1993) ("The genius of American corporate law is in its federal organization.").

attempt to encourage investment by offering an attractive corporate governance structure. In addition, as a condition to listing their securities on a stock exchange, public companies will subject themselves to exchange listing standards. Given that investors will often not have the time and resources to undertake a sophisticated analysis of a company's governance structure, and recognizing that companies will often have competing incentives that may result in suboptimal governance structures, exchanges also regulate via listing standards that are designed to promote investor confidence by providing minimum standards for listed companies. The recognition by industry that regulators—even relatively restrained federal agencies like the Securities and Exchange Commission (SEC)—abhor a regulatory vacuum also provides another motivation for self regulation.[5]

After WorldCom, Enron, and the other turn-of-the-millennium financial scandals, this loose structure of federal/state/exchange and self regulation was regarded by many to be an unreliable motivator of adequate corporate governance. The Sarbanes-Oxley Act of 2002 was one response to this perceived failure, and has since been the subject of considerable academic interest, not least because it federalized several areas of corporate law that had been left to the states or simply to the discretion of the board and management. Another response, which has received relatively little attention, is the increasing role of what this Article refers to as the "corporate governance industry": governance advisers, governance rating firms, and proxy advisers (sometimes operating as business units of a single company).[6]

The corporate governance industry plays a major corporate governance policy-making role, and, because of its influence with institutional investors, effectively acts as a voluntary corporate regulator. Some executives believe that corporate governance industry market leader Institutional Shareholder Services (ISS) may control a third or more of the shareholder votes.[7] According to a recent interview reported in the *Washington Post*, John M. Connolly, president and chief executive of ISS, acknowledges that 15%-20% of ISS clients use a service that automatically votes according to ISS recommendations, although clients can override it.[8] As a measure of influence, consider that ISS has over 1700 institutional clients, and the clients' assets under management exceed $25 trillion.[9] ISS claims to advise "24 of the top 25" and "81 of the top 100" mutual funds, all "25 of the top 25" asset managers, and "17 of the top 25" public pension funds.[10] ISS advice has been cited as a decisive factor in a number of major corporate events, including the approval of the Hewlett-Packard/Compaq merger and the

5. The industry group Business Roundtable was created, among other reasons, to reduce "unwarranted intrusion by government into business affairs." *See* Business Roundtable, About Us, http://www.businessroundtable.org/aboutUs/history.html (last visited Apr. 3, 2007).

6. As this Article argues below, however, the evolution of the corporate governance industry is only partly attributable to the scandals.

7. Dean Starkman, *A Proxy Adviser's Two Sides: Some Question Work of ISS for Companies It Scrutinizes*, WASH. POST, Jan. 23, 2006, at D1 (citing a statement by Susan E. Wolf, vice president at Schering-Plough Corp. and chairman of the Soc'y of Corporate Sec'ys and Governance Prof'ls).

8. *Id.*

9. *See* INST. S'HOLDER SERVS., THE BUSINESS OF CORPORATE GOVERNANCE IS GLOBAL, http://www.issproxy.com/pdf/Locations.pdf (last visited Apr. 7, 2007).

10. *See* INST. S'HOLDER SERVS., EXPERIENCE MATTERS: A GUIDE TO SELECTING THE RIGHT PROXY VOTING PARTNERS 9 (2007), http://www.issproxy.com/pdf/GuidetoSelectingtheRightProxyVotingPartner.pdf.

shareholder vote that ousted Michael Eisner from his role of chairman at Walt Disney Co.[11] Another measure of the growing importance of the industry is the fact that, just five years ago, market leader ISS was acquired for around $40 million.[12] On November 1, 2006, RiskMetrics acquired ISS for an estimated $550 Million.[13]

The influence of ISS and other proxy advisers may increase even more with passage of rules by the New York Stock Exchange (NYSE), scheduled to take effect in January 2008,[14] which would eliminate broker discretionary voting in director elections.[15] According to Wachtell, Lipton, Rosen & Katz attorneys David Katz and Laura McIntosh, "an estimated 70 to 80 percent of all public companies' shares are held in 'street name' . . . by brokers . . . [and] depositories . . ." on behalf of beneficial owners,[16] and under NYSE rules brokers are given discretionary voting power over such shares only for "routine matters";[17] if the rules under consideration are enacted, uncontested elections would be considered "non-routine." Katz and McIntosh argue that "[i]f, in the aftermath of NYSE rule changes as proposed, issuers indeed are unable to contact or obtain voting instructions from large numbers of individual shareholders, the effect will be a massive shift of voting power from brokers to institutions, and, therefore, to proxy advisory services such as ISS, Glass, Lewis & Co., and Proxy Governance."[18] As an indication of how this shifts power to the corporate governance industry, Katz and McIntosh note that a 2002 study found that "ISS recommended that shareholders vote against over 78 percent of the proposals that the authors estimated to have been determined by broker discretionary votes."[19] While the general purpose of the new rule would be to increase shareholder power with respect to director elections,[20] the influence of the corporate governance industry generally, and proxy advisers particularly, has prompted the NYSE to propose a formal SEC investigation into the role of these firms in the proxy process.[21]

Given the industry's tremendous influence over corporate governance and, more directly, the proxy voting mechanism that shapes corporate governance decision-making,

11. Starkman, *supra* note 7. For a recent discussion of ISS' role in hedge fund activism, see Thomas Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. (forthcoming 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=911072.

12. David S. Hilzenrath, *Investor Advisor ISS Is Sold to RiskMetrics*, WASH. POST, Nov. 2, 2006, at D1.

13. *Id*.

14. *See* Press Release, New York Stock Exch., NYSE Adopts Proxy Working Group Recommendation to Eliminate Broker Voting In 2008 (Oct. 24, 2006), *available at* http://www.nyse.com/press/1161166307645.html?sa_campaign=/rss/newsreleases/NYSE.comRuleProposalsNewsReleases.

15. *See* PROXY WORKING GROUP, NEW YORK STOCK EXCH., REPORT AND RECOMMENDATION OF THE PROXY WORKING GROUP OF THE NEW YORK STOCK EXCHANGE 21 (2006), http://www.nyse.com/pdfs/REVISED_NYSE_Report_6_5_06.pdf [hereinafter NYSE PROXY REPORT].

16. *See id.* at 10.

17. Giving Proxies by Member Organization, NEW YORK STOCK EXCH. REP. § 452 (2007).

18. DAVID A. KATZ & LAURA A. MCINTOSH, CORPORATE GOVERNANCE: A SEISMIC SHIFT IN THE MECHANICS OF ELECTING DIRECTORS 3 (2006), http://www.realcorporatelawyer.com/pdfs/wlrk072806_02.

19. *Id.* at 3 (citing Jennifer E. Bethel & Stuart L. Gillan, *The Impact of the Institutional and Regulatory Environment on Shareholder Voting* 2 (Ctr. for Corp. Governance, Working Paper No. 2002-002, 2002), *available at* http://www.lerner.udel.edu/ccg/research_files/CCGWP2002-2.pdf).

20. Katz and McIntosh note in this respect that brokers tend to vote as recommended by management. *Id.* at n.2.

21. *See, e.g.*, NYSE PROXY REPORT, *supra* note 15, at 29.

it is imperative to scrutinize the manner in which this influence is exercised. It is also crucial to scrutinize the assumptions underlying the advice. Some observers, including Rep. Richard Baker (R-Louisiana), have raised concerns over potential conflicts of interest within some governance firms that cast doubt on the reliability of their proxy advice and governance ratings.[22] ISS, for example, sells advice on proxy voting and sells corporate governance ratings, but it also provides advice to companies on how to improve their ratings.[23] Because of ISS' market power, Rep. Baker has argued that "conflicts of interest and a lack of competition in the industry could lead firms to provide biased advice,"[24] and a study is currently being undertaken by the Government Accountability Office at his request.[25]

Additionally, governance firms may be overstepping their expertise in proxy voting decisions,[26] and in governance rating,[27] in part because of their reliance on "good governance metrics," for which there is little evidentiary support. Erroneous governance metrics (and indeed, a reliance on one-size-fits-all governance checklists) not only affect important shareholder decisions and decisions on whether to invest in or divest from a particular company, but may also have a more general, harmful effect on corporate governance regulation. A number of academics have argued that the federal expansion into certain corporate governance issues has significant negative consequences, including the loss of the competitive benefits provided by the market for incorporations;[28] as opposed to a having a choice of relatively flexible enabling state laws, Sarbanes-Oxley requires companies to adopt several specific corporate governance policies rather than tailor their governance structures for their particular requirements. As I will argue below, the corporate governance industry may have similarly harmful effects on the competition for capital by pressuring companies to adopt a homogenized set of governance rules which may be ill-suited to the companies' respective situations.

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22. *See* Kaja Whitehouse, *U.S. Legislator Seeks Report on Corporate Vote Consultants*, DOW JONES NEWSWIRES, Oct. 5, 2006, http://www.djnewswires.com.

23. As discussed in Part II.B.1, *infra*, this is accomplished through an interactive web interface.

24. See Whitehouse, *supra* note 22.

25. *Id.*

26. ISS recently received criticism for its advice to reject Fifth Third Bank's CEO, George A. Schaefer Jr., for reelection to the board:

> On Mar. 16, Richard X. Bove of investment bank Punk Ziegel & Co. fired off a research note calling ISS' advice "totally inappropriate" and pointing out that Fifth Third's assets have increased tenfold since Schaefer took over in 1990. Nell Minow, a former president of ISS who now runs governance researcher The Corporate Library LLC, warns that ISS may create "incentive for earnings manipulation that may not be in the shareholders' long-term interest" -- precisely the sort of activity good governance is supposed to prevent.

Emily Thornton, *ISS Looks Like It's Channeling Icahn: The Proxy Advisory Firm Says Fifth Third's CEO Should Go Despite Stellar Governance*, BUS. WEEK ONLINE, Apr. 3, 2006, http://www.businessweek.com/magazine/content/06_14/b3978031.htm?campaign_id=rss_magzn.

27. See Part III, *infra*, discussing the limitations of ISS and other advisers' governance ratings methodology.

28. *See, e.g.*, Larry Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 61 (2003) (arguing the case for new regulation in the wake of the Enron scandal "has not been made"); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1602 (2005) (examining Sarbanes-Oxley and concluding that it was misconceived and unlikely to improve performance).

This Article proceeds as follows. In Part II, I will provide a brief review of the existing federal, state, and exchange regulatory framework and how it has provided sufficient space for the corporate governance industry to grow into an increasingly influential and powerful voluntary regulator. I will then briefly describe the development of the corporate governance industry, and will describe the major firms in the corporate governance industry, which is composed of both non-profit and for-profit sectors. In Part III, I will focus on problematic methodologies and policies of certain corporate governance firms, with a view to how these methodologies and policies are influencing companies and corporate governance practices. In Part IV, I will offer some preliminary thoughts on whether the increasing power of the corporate governance industry should be constrained by the SEC.

II. AN INTRODUCTION TO THE CORPORATE GOVERNANCE INDUSTRY

A. The Development of the Corporate Governance Industry

The development of the corporate governance industry has been dependent on two factors. The first is structural: the existing regulatory regimes affecting corporate governance are structured with sufficient regulatory space so that an industry providing corporate governance advice has room to grow, but regulatory space only provides an answer to how the corporate governance industry could develop. The second factor, market demand from institutional investors, explains why the corporate governance industry developed.

1. The Structure of Corporate Governance Regulation

Public company corporate governance regulation in the United States comes from both public and private sources. Public sources include, on a state level, legislatures and courts, and on the federal level, the SEC and, to a lesser extent, other federal agencies.[29] Since its inception, the SEC has often tested the bounds of its federal mandate to regulate merely the purchase and sale of securities.[30] The SEC's interest in corporate governance

29. For instance, the Office of Federal Housing Enterprise Oversight and the Commodities Futures Trading Commission each prescribe governance structures and rules specific to the types of companies and industries they regulate.

30. For a comprehensive review of the SEC's efforts to regulate corporate governance, see Roberta Karmel, *Realizing the Dream of William O. Douglas-The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79 (2005). Besides the SEC's efforts, the judicial branch has also indirectly set out limited governance rules. The Federal Sentencing Guidelines (FSG) set out general guidelines for corporate governance, with a particular emphasis on legal compliance, in a section called "Effective Compliance and Ethics Program." U.S. SENTENCING GUIDELINES MANUAL § 8C2.5(f) (2006), *available at* http://www.ussc.gov/2006guid/8c2_5.html. A corporation is allowed more leniency in white collar criminal matters if the corporation can show that it had an effective ethics and compliance program. Although as a result of the *Booker* and *Blakely* decisions the guidelines in the ethics and compliance program are viewed as "advisory" rather than "mandatory," they are still viewed as authoritative guidance for companies wishing to minimize potential criminal liability risk. *See* United States v. Booker, 543 U.S. 220, 221 (2005) (holding that the federal sentencing guidelines are merely advisory provisions that recommend, rather than require, a particular sentencing range); Blakely v. Washington, 542 U.S. 296, 313 (2004) (holding that any fact, other than a prior conviction, that raises the penalty beyond the statutory maximum must be submitted to the jury and

flows naturally from its mission to "protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[31] The SEC occasionally encourages exchanges to enact governance rules as a means to promote investor protection,[32] and has also attempted more direct regulation of governance matters, although this typically takes place through disclosure regulation rather than explicit governance requirements. For example, SEC rules enacted pursuant to Sarbanes-Oxley require specific management participation in the evaluation and certification of such internal controls.[33] The internal controls requirements and, more specifically, the certification of the internal controls are in effect specific governance requirements.[34]

When the SEC has attempted to enact governance reform without a specific congressional mandate, such as Sarbanes-Oxley, generally it has not fared well. The best known case is the 1990 decision *Business Roundtable v. SEC*.[35] *Business Roundtable* dealt with an SEC rule requiring exchanges to bar the listing of a domestic corporation's securities if the issuer "acted disparately" to reduce the per share voting rights of existing stockholders. The court pushed back against the SEC expansion into governance matters, finding that the rule "directly controlled the substantive allocation of powers among classes of shareholders,"[36] and therefore exceeded the SEC's authority under section 19 of the 1934 Act.[37] Although the ruling did not entirely eliminate the ability of the SEC to create governance rules with respect to proxy voting,[38] the practical effect of the decision for future SEC efforts to regulate governance through listing standards is that SEC authority over corporate governance listing standards is reviewed on a case-by-case basis with respect to a specific congressional statutory purpose.[39]

found beyond a reasonable doubt). *See also* Douglas A. Berman, *Conceptualizing* Blakely, 17 FED. SENT'G REP. 89, 93 (2004) (stating a dialogue on sentencing is overdue).

31. Sec. & Exch. Comm'n, The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, http://www.sec.gov/about/whatwedo.shtml (last visited Apr. 4, 2007).

32. See *infra* note 34 and accompanying text.

33. Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Rates, Exchange Act Release Nos. 33-8238 & 34-47,986, 68 Fed. Reg. 36,636 (June 5, 2003), *available at* http://www.sec.gov/rules/final/33-8238.htm.

34. This has been especially true since the SEC began urging reporting companies to make use of the internal controls framework of the Committee of Sponsoring Organizations of the Treadway Commission (COSO). COSO has fairly specific oversight and governance mechanisms, which are more broadly applicable than simple financial reporting controls. *See* COMM. OF SPONSORING ORGS. OF THE TREADWAY COMM'N, INTERNAL CONTROL—INTEGRATED FRAMEWORK (1994).

35. Bus. Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990).

36. *Id*. The court concluded the following:

> the Exchange Act cannot be understood to include regulation of an issue that is so far beyond matters of disclosure (such as are regulated under § 14 of the Act), and of the management and practices of self-regulatory organizations, and that is concededly a part of corporate governance traditionally left to the states.

Id. at 408.

37. *Id.* at 406.

38. *See, e.g.*, Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 WASH. U. L.Q. 565, 596-602 (1991) (examining the implications of *Business Roundtable* on the SEC's regulations).

39. Special Study Group, *Special Study on Market Structure, Listing Standards and Corporate Governance*, 57 BUS. LAW. 1487, 1525 (2002). Relying in part on the authority of the *Business Roundtable* decision, industry recently pushed back an SEC proposal that would, under certain circumstances, require

Although Sarbanes-Oxley demonstrates that the federal government will enact corporate governance regulations when it deems them to be necessary (or, perhaps when it feels compelled to do so by public outcry), public corporate governance regulations have been and primarily continue to be within the province of state legislatures and, to a large degree, the state courts petitioned to interpret these regulations. State regulation, like exchange regulation, has developed in a kind of give-and-take with both exchange regulation and federal regulation, with perhaps more give than take. Indeed, as Mark Roe has argued, states in general, and Delaware in particular, essentially regulate within the limits granted by the federal government.[40] As Professors Kahan and Rock have noted,[41] Delaware's legislature has been strikingly absent in the recent corporate governance debates: "Delaware has been largely mute: no legislation; no rule-making; no criminal investigations; few headlines."[42] An explanation for this seeming lack of interest may be found in Delaware's classical model of corporate law-making. Kahan and Rock note that Delaware corporate law is largely judge-made, and that Delaware's statutory law is relatively narrow. Given that Delaware operates within a federalist system in which Delaware's regulatory powers co-exist with, and can be constrained by, the powers of the federal government, Delaware seeks to maintain an "apolitical gloss" over its corporate law by effectively making law only when required to do so by litigants.[43] Delaware's

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companies to include in their proxy materials security holder nominees for election as director. *See* Letter from Henry A. McKinnell, Chairman, The Bus. Roundtable, to Jonathan Katz, Sec'y, Sec. & Exch. Comm'n (Dec. 22, 2003), *available at* http://www.sec.gov/rules/proposed/s71903/s71903-381.pdf (providing a business organization's view on the SEC's "proposal to require companies to include shareholder nominees for director in company proxy materials under certain circumstances"). For a discussion of the suspect applicability of the *Business Roundtable* decision to the shareholder access proposal, see Jill E. Fisch, Professor of Law & Dir. Of the Center for Corp. Sec., and Fin. Law at Fordham Univ., Prepared Statement Before the SEC Roundtable Discussion on Proposed Security Holder Director Nomination Rules (March 12, 2004), *available at* http://www.sec.gov/spotlight/dir-nominations/fisch031204.pdf; Stephen M. Bainbridge, *A Comment on the SEC Shareholder Access Proposal*, 1 (Univ. of Cal., Los Angeles, Sch. of Law, Law & Econ., Research Paper No. 03-22, 2003), *available at* http://ssrn.com/abstract=470121; SHAREHOLDER ACCESS TO THE CORPORATE BALLOT (Lucian Bebchuk, ed. 2005).

40. *See, e.g.*, Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2498-99 (2005) (discussing Delaware's corporate law in relation to the federal government); Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 590 (2003) (arguing the debate over whether states are racing to the bottom or top in corporate law governance is misconceived because of the federal government's ability to govern issues of top importance). The most important federal constraint on state action is perhaps the National Securities Markets Improvement Act of 1996 (NSMIA), which fixed the SEC's role as the regulator of offerings of nationally traded securities and securities of registered investment companies. Generally, however, NSMIA leaves states jurisdiction over traditional state roles, such as common law fraud actions and most corporate governance issues.

41. Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1574 (2005).

42. Marcel Kahan & Edward B. Rock, *Our Corporate Federalism and the Shape of Corporate Law* 5 (Univ. of Penn. Law Sch. Inst. for Law & Econ., Research Paper No. 04-12, 2004), *available at* http://ssrn.com/abstract=564685.

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> Faced with the recent corporate scandals, calls for action, and Sturm und Drang, Delaware reacted accordingly: Basically, it does nothing until cases are brought. Any more pro-active response by Delaware actors would have threatened to undermine the political legitimacy achieved by Delaware's commitment to the classical common law model.

Id.

status as a front-runner in the incorporations race also explains why it does not attempt to innovate with respect to corporate governance regulation.[44]

The most significant private constraints on public company corporate governance come from the exchanges on which the companies are listed. Indeed, most externally-imposed corporate governance rules were first imposed not by the SEC or states, but by stock exchanges via exchange listing requirements. In the early 1900s, for example, the NYSE began requiring listed companies to distribute annual reports to investors and to hold annual meetings. While there has been some debate on the ability of exchanges to effectively regulate listed companies,[45] exchanges continue to provide many substantive governance rules. However, the exchanges' ability to regulate is limited by the SEC's oversight of the exchanges. Despite their label of "self-regulatory organizations" (SROs), in practice the SROs operate under significant SEC supervision, and have done so since the inception of the Exchange Act. Congress expanded the SEC's control over the SROs in 1975 by granting the SEC the ability to reject or amend SRO rule changes, including listing standards changes. Ordinarily, however, the SEC does not attempt to restrict the exchanges' ability to add additional or more restrictive governance requirements on listed companies; rather, the SEC effectively restricts the exchanges' latitude by pushing the exchanges to synchronize standards across the exchanges, when possible.[46] The SEC also will press for higher and more restrictive standards as it deems necessary.[47]

Despite the many regulators overseeing the governance of public companies—the SEC, states, and the exchanges—corporations still enjoy a great deal of flexibility in devising substantive rules and governance structures. With state and exchange corporate governance regulation, the lack of numerous mandatory rules is explained by market incentives: exchanges compete with one another for listings, while states compete with one another for incorporations. The result of this competition is a flexible set of

44. As Michael Abramowicz has argued, Delaware easily could mimic any corporate law innovation by another state, so it does not face any real competition from other states as far as corporate law is concerned (other states like Nevada may be attractive for other reasons, such as tax rates). Michael Abramowicz, *Speeding up the Crawl to the Top*, 20 YALE J. ON REG. 139, 157 (2003).

45. *See, e.g.*, Marcel Kahan, *Some Problems with Stock Exchange-Based Securities Regulation*, 83 VA. L. REV. 1509, 1510-14 (1997) (addressing the proposition that regulatory authority should be applied to the stock exchanges); Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1454 (1997) (arguing benefits of mobile capital "will be better realized through regulatory decentralization than greater centralization"); A.C. Pritchard, *Markets As Monitors: A Proposal to Replace Class Actions with Exchanges As Securities Fraud Enforcers*, 33 SEC. L. REV. 255, 255-57 (2001) (originally published under the same title in 85 VA. L. REV. 925, 925-27) (discussing reform aimed at class action lawsuits against corporations).

46. This effort was evident in the exchanges' large-scale governance efforts in 2003, which culminated in revised listing standards for the NYSE and Nasdaq. The exchanges and the SEC worked together for months to finally arrive at a compromise on the form of the regulations to be set out in the listing standards, with the final NYSE and Nasdaq versions identical on essentially every point.

47. The SEC worked extensively with the NYSE and Nasdaq in formulating enhanced governance listing standards in November 2003. The new listing standards primarily deal with board composition, and include rules setting standards for board independence, as well as standards for audit, compensation, and governance committees. The NYSE and Nasdaq also require listed companies to disclose their corporate governance guidelines, which must discuss director qualification standards, director responsibilities, board access to management, director compensation, director orientation and continuing education, management succession, and annual performance evaluations of the board. For a discussion of the listing standards and a review of the rulemaking process, see NASD and NYSE Rulemaking: Relating to Corporate Governance, Exchange Act Release No. 34-48,745, 68 Fed. Reg. 64,154 (Nov. 4, 2003) (addressing the proposed rule change).

governance requirements, imposing very few mandatory governance procedures and structures. With respect to federal regulation of corporate governance, a traditional deference by Congress and the courts to state and exchange regulation of corporate governance matters (Sarbanes-Oxley notwithstanding) has limited SEC efforts to create substantive governance requirements.

2. The Market for a Corporate Governance Industry

Corporate governance inevitably receives attention and calls for its reinvention following upheavals in the financial markets. Although the corporate governance industry received a significant boost because of Enron and WorldCom, the seeds of the modern corporate governance industry were sown in the 1970s, in response to the corporate dimensions of the Watergate scandal. In response to the public outcry over Watergate and to ward off potential SEC regulation, the Business Roundtable (an executive industry group) began to address corporate governance issues by setting out best practices for public companies.[48] Other prominent non-profit groups also developed and continue to provide governance guidelines, including the Council of Institutional Investors (CII) and the National Association of Corporate Directors (NACD). Although these groups often take similar positions on various corporate governance issues, they each act as policy vessels for management, institutional investors, and directors, respectively, and therefore sometimes differ in their recommendations. All of the positions taken by these groups are non-binding guidelines, and most of the guidance remains at a level of generality that allows for considerable flexibility in governance (e.g., "small boards often work more effectively than large boards,"[49] says the Business Roundtable).[50] In some cases, a group will take a more specific position; as might be expected, this is more often the case with the institutional investor mouthpiece, the CII. For instance, the CII recommends that all directors be elected annually, and that directors should be elected by a majority of the votes cast.[51]

More recently, quasi-governmental and international industry groups such as the Organisation of Economic Co-opertation and Development (OECD) and the International Corporate Governance Network (ICGN)[52] have offered best practices, policy positions,

48. "The executives who created the Roundtable believed that the U.S. economy would be healthier, there would be less unwarranted intrusion by government into business affairs, and the interest of the public would be better served if there were more cooperation and less antagonism." Business Roundtable, Business Roundtable History, http://www.businessroundtable.org//aboutUs/history.aspx (last visited Apr. 3, 2007).

49. BUS. ROUNDTABLE, BUSINESS ROUNDTABLE PRINCIPLES OF CORPORATE GOVERNANCE 13 (2005) [hereinafter BUSINESS ROUNDTABLE GUIDELINES].

50. *See, e.g.*, COUNCIL OF INST. INVESTORS, CORPORATE GOVERNANCE POLICY (2006), http://www.cii.org/policies/2006%20(April)%20CII%20Policies%20(2).pdf [hereinafter CII GUIDELINES]. CII states that the guidelines are structures that CII "has found to be appropriate in most situations." *Id.* at 2. Business Roundtable is careful to note that "no one structure is right for every corporation." BUSINESS ROUNDTABLE GUIDELINES, *supra* note 49, at 15.

51. CII GUIDELINES, *supra* note 50, at 2.

52. The non-binding OECD Corporate Governance Principles are designed to complement any applicable legal requirement—they are what the OECD sees as "best practices" for multinational companies, rather than legal rules that could conflict with state or federal law. For a comparison between these guidelines and the OECD guidelines, see Kathryn Gordon, *The OECD Guidelines (for Multinational Enterprises) and Other Corporate Responsibility Instruments: A Comparison* (OECD Working Paper on Int'l Inv., No. 2001/5, 2001),

and other kinds of soft law in an effort to develop common standards of adequate governance that will, among other benefits, encourage cross-border investment.[53]

Perhaps more significantly, the rise of the modern corporate governance movement is tied to the increasing importance of the institutional investor. In 1965, institutional investors held 16% of U.S. equities; by 2001, institutional investors held 61%.[54] The increasing numbers of institutional investors meant a lucrative, developing market for corporate governance advisers. A corporate governance adviser may be able to conduct research relatively cheaply, and spread its costs across hundreds of institutional clients. ISS, for instance, has been known to use relatively unskilled temporary employees to conduct governance reviews, which focus on publicly-filed SEC disclosure documents.[55] Unless an institutional investor believes that it can conduct research for less, or that more expensive but discerning research will enable it to obtain better returns (after subtracting its own research costs), the investor may be better off outsourcing its corporate governance research. Additionally, given the huge amount of information that is available on issuers, through news media, sell-side analysts, and Internet sources, and the speed at which information is disseminated, it is not surprising that institutional investors would seek to outsource some of their research load.

The link between institutional investors and the corporate governance industry was also strengthened by an increasing regulatory focus on proxy voting. In the 1990s the Department of Labor advised pension funds that proxy voting constituted part of the funds' fiduciary duties to investors.[56] In 2003, the SEC enacted rules requiring mutual fund managers to vote proxies in the best interests of clients, and also required disclosure of voting policies and actual votes.[57]

Shareholders have long attempted to exercise influence through precatory

available at http://oecd.org/dataoecd/46/36/2075173.pdf. The ICGN, however, is generally more specific in its requirements than the OECD, which may produce conflict with certain state or exchange standards. However, in most cases the ICGN standards simply represent a higher standard than most countries require, and opting for a higher standard is generally not prohibited by governance regulators. For a brief discussion of the differences between the OECD guidelines and the ICGN guidelines, see Int'l Corp. Governance Network, ICGN Statement on Global Corporate Governance Principles, http://www.icgn.org/organisation/documents/cgp/revised_principles_jul2005.php (last visited Apr. 3, 2007) [hereinafter ICGN Statement]. Other significant international corporate governance guidelines, as cited by the OECD, include the following: the Caux Principles for Business; the Global Reporting Initiative; Global Sullivan Principles; the Principles for Global Corporate Responsibility: Benchmarks; Social Accountability 8000 (SA 8000); and the United Nations Global Compact.

53. ORG. FOR ECON. CO-OPERATION AND DEV., THE OECD GUIDELINES FOR MULTINATIONAL ENTERPRISES (rev. 2000), http://www.oecd.org/dataoecd/56/36/1922428.pdf.

54. SECS. INDUS. ASS'N, SECURITIES INDUSTRY FACTBOOK 64 (2002), http://www.sia.com/research/pdf/2002Fact_Book.pdf.

55. Eleanor Laise, *Is This the Most Influential Man on Wall Street?*, SMARTMONEY MAG., Oct. 16, 2002, http://www.smartmoney.com/mag/index.cfm?story=oct02-influential.

56. 29 C.F.R. § 2509.94-2 (2006).

57. *See* Proxy Voting by Investment Advisers, Investment Advisers Act Release No. 2106, 68 Fed. Reg. 6585 (Feb. 7, 2003) (adopting Investment Advisers Act Rule 206(4)-6, 17 C.F.R. § 275.206(4)-6 (2006)); Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Securities Act Release No. 8188, 68 Fed. Reg. 6564 (Feb. 7, 2003) (adopting Investment Company Act Rule 30b1-4, 17 C.F.R. § 270.30b1-4 (2006), and related amendments to the applicable Investment Company Act forms).

shareholder resolutions,[58] and these resolutions are still one of the primary means for shareholders to influence corporate governance. However, shareholder-led governance movements struggle against collective action problems—shareholders generally will not make an effort to effect governance changes unless the benefits resulting from the efforts equal or exceed the costs of such an effort. Even when such efforts are made, the benefits may only inure to a particular shareholder or a small group of shareholders.[59] However, the corporate governance industry, primarily through the proxy voting process, is able to present a relatively cohesive front to management and the board of directors. ISS, by influencing perhaps a third or more of a company's securities, may be the de facto voice of the institutional investor.[60]

B. The For-Profit Governance Industry: Proxy Advisers, Governance Ratings Agencies, and Governance Advisers

The for-profit corporate governance industry sells corporate governance advice through a number of products, including corporate governance ratings and proxy advice. Corporate governance ratings companies affect governance decisions in at least two ways. First, governance policies are necessarily built into the rating company's analysis. Rather than advocating specific governance policies, governance ratings agencies affect corporate governance simply by rewarding or penalizing various corporate governance policies. Because many institutional investors, including large pension funds, use the governance ratings to decide whether or not to invest in or divest from a company, companies must pay attention to the ratings.

As noted above, proxy advisory work helped drive the initial development of the corporate governance industry. ISS, the market leader, provides both governance ratings and proxy voting recommendations. Proxy advisers generally base their decisions on corporate governance standards that are derived from the same policies as those used to formulate governance ratings and related governance advice. Because of the influence proxy advisers like ISS have with institutional investors (and, as discussed below, given that they are in some cases directly empowered by clients to vote shares according to their policies), proxy advisers play a more direct role in effecting corporate governance changes than firms that only rate governance.

There are about a half-dozen well-established firms in the U.S. corporate governance industry, and a few others who operate in Asia and Europe.[61] The following

58. Securities Exchange Act of 1934 § 14a-8, 17 C.F.R. § 240.14a-8 (2006).

59. This is one of the concerns with the recent spate of hedge fund activism. While hedge funds may seek to encourage governance changes that benefit shareholders generally, hedge fund interests may not always coincide with other shareholders' interests to the extent that hedge funds have a different investment horizon. *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control* (Univ. of Penn. Law Sch. Inst. for Law & Econ., Research Paper No. 06-16, 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=919881.

60. For a discussion of the influential role of the ISS as a proxy adviser, see Briggs, *supra* note 11, at 14-15.

61. The significant U.S. market players include: the Corporate Library and its subsidiary, Board Analyst; Glass Lewis; GovernanceMetrics International; ISS; Proxy Governance, Inc.; and the credit rating agencies, Egan-Jones, Moody's Inc. and Standard & Poor's. European governance service providers include CoreRatings/DNV and Deminor Ratings. Asian governance providers include CRISIL Ltd. (India) Governance and Value Creation Ratings and ICRA Limited.

sections will focus attention on the policies of the most prominent U.S. proxy advisers and governance ratings firms.

1. Institutional Shareholder Services

ISS is the dominant firm in the corporate governance industry, and ISS affects corporate governance decisions in several ways. The major portion (65%) of ISS' business is proxy advisory services.[62] As a proxy adviser (generally to institutional investors, such as mutual funds), ISS reviews the various company and shareholder proposals put up for a vote at the annual election of shareholders of various companies. ISS will analyze the proposal and offer advice on how the advisee should vote, although in some cases the client empowers ISS to vote on its behalf in accordance with ISS recommendations. Because ISS has such a large clientele, both in terms of the number of institutional and other investors that it represents, as well as in terms of the market capitalization held by these investors, ISS' recommendations may make the difference between success and failure of a proposal.

While ISS' core business is built around a standard "best practices" proxy advisory service, it also offers specialized proxy advice for clients interested in effecting social responsibility initiatives[63] (Social Advisory Services), for public funds that would like to be active "on issues like majority vote standard, classified boards, performance-based equity awards, voting power dilution, ratification of auditors, corporate social responsibility, terrorism states and other matters impacting the public good"[64] (Public Fund Advisory Services), and for clients who have a fiduciary obligation to protect plan assets as required by the U.S. Department of Labor and the Employee Retirement Income Security Act of 1974[65] (Taft-Hartley Advisory Services). ISS also offers customizable proxy voting services,[66] M & A analysis services,[67] and international proxy voting services.[68] Additionally, ISS sells "non-recommendation research" on various social[69] and international issues[70] for clients that analyze proxies on a case-by-case basis.

Another component of ISS' business model is its corporate governance ratings service. Since 2002, ISS has rated companies with a proprietary analysis that results in a

62. *See* ISS' disclosure on Form ADV (Uniform Application for Investment Adviser Registration), *available at* http://www.issproxy.com/pdf/NewFormADVII.pdf (last visited Apr. 3, 2007).

63. Inst. S'holder Servs., Social Advisory Services, http://www.issproxy.com/institutional/research/sirsresearch.jsp (last visited Apr. 20, 2007).

64. Inst. S'holder Servs., Public Fund Advisory Services, http://www.issproxy.com/institutional/research/publicfund.jsp (last visited Apr. 3, 2007).

65. Inst. S'holder Servs., Taft-Hartley Advisory Services, http://www.issproxy.com/institutional/research/tafthartleyresearch.jsp (last visited Apr. 20, 2007).

66. Inst. S'holder Servs., Custom Proxy Advisory Services, http://www.issproxy.com/institutional/research/customresearch.jsp (last visited Apr. 20, 2007).

67. Inst. S'holder Servs., M&A Insight, http://www.issproxy.com/institutional/research/mainsight.jsp (last visited Apr. 20, 2007).

68. Inst. S'holder Servs., Int'l Proxy Advisory Services, http://www.issproxy.com/institutional/research/globalresearch.jsp (last visited Apr. 20, 2007).

69. Inst. S'holder Servs., Social Advisory Services, http://www.issproxy.com/institutional/research/socialissues.jsp (last visited Apr. 20, 2007).

70. Inst. S'holder Servs., US and Int'l Governance Research Services, http://www.issproxy.com/institutional/research/globalgovernanceresearch.jsp (last visited Apr. 20, 2007).

"Corporate Governance Quotient" (CGQ) for the company. ISS gathers relevant company information primarily from SEC filings, although in some instances ISS will obtain information directly from the company. The variables are structured so that they can be analyzed through simple "yes" or "no" indicators (or, in some cases, simply "not disclosed), i.e., "the Company has made a material restatement to year-end financial results during the past 24 months for any prior period."[71]

The CGQ currently covers approximately 7500 companies and is based on approximately 65 criteria for U.S. companies and 55 criteria for non-U.S. companies.[72] The variables ISS uses to analyze companies fall under four general governance areas: board, compensation, anti-takeover, and audit. ISS has weighted the variables of each category according to their importance to governance so that the variables under the "board" category make up 40% of the CGQ score, and the variables under the "compensation," "anti-takeover," and "audit" categories make up 30%, 20%, and 10% of the CGQ, respectively. Although the exact variables (and how they are weighted) are proprietary, ISS has disclosed the eight most important variables in the CGQ in terms of their effect on the overall CGQ score:

1. The audit committee is comprised totally of independent outsiders.

2. The average annual burn rate [which measures a company's annual cost of granting equity to executives and employees] over the past three fiscal years is 2% or less, or is within one standard deviation of the industry mean.

3. All of the audit committee members are "financial experts," based on the SEC definition of "financial expert".

4. Board is controlled by a supermajority of over 90% independent outsiders.

5. Board has only one non-independent director.

6. Directors are subject to stock ownership requirements.

7. Board is controlled by a supermajority of between 75%-90% independent outsiders.

8. Company is incorporated in a state without any state anti-takeover provisions.[73]

From time to time ISS will review the CGQ factors and add, eliminate, or change the value and interrelationships of various factors.[74] In June 2005, ISS announced an

71. INST. S'HOLDER SERVS., CORPORATE GOVERNANCE QUOTIENT METHODOLOGY UPDATE FACT SHEET (2006), http://www.issproxy.com/pdf/CGQFactSheet.pdf [hereinafter CGQ UPDATE].

72. A very basic description of these criteria may be found at INST. S'HOLDER SERVS., EXPLAINING THE CGQ METHODOLOGY CHANGE PROCESS (2005), http://www.issproxy.com/pdf/CGQevolvingmethodologyWP.pdf [hereinafter CGQ METHODOLOGY]. A more detailed listing of the variables (which have been updated as of June 21, 2005) may be found in Renna Aggarwal & Rohan Williamson, *Did New Regulations Target the Relevant Corporate Governance Attributes?* 32 (Geo. Univ. Working Paper Series, 2006), *available at* http://ssrn.com/abstract=859264.

73. CGQ METHODOLOGY, *supra* note 72.

74. ISS explains that the revision of its latest CGQ variables was spurred on by the growing body of

increased focus on executive compensation issues and has added new variables to reflect "new requirements [e.g., Sarbanes-Oxley related requirements], emerging best practices and their correlation to financial performance."[75] ISS' research also led it to revise a number of variables "to better clarify their impact on financial performance,"[76] and ISS has eliminated six variables, either because, according to ISS, no evidence indicates that a particular variable has any effect on firm performance, or because new regulations have

research that has attempted to find a link between corporate governance and firm performance:

> A team of ISS quantitative analysts built on the work of numerous researchers. . . . An outcome of the research review and analysis, in addition to 4,000 statistical tests run against financial metrics, resulted in addition, modification or elimination of CGQ variables. . . . The ISS Quantitative Analysis team used an exhaustive "bottoms up" approach to assess the rating variables, reviewing governance data from 2002 through 2004. For each year's data, each rating issue was statistically tested against each of 16 performance measures that address profitability (ROIC, ROE, ROI, EBITDA margin, etc.); valuation (Price to Book, Cash Flow, and Earnings); market (TSR, Tobin's Q); and, risk (Volatility and Z Score). In all, more than 4,000 statistical tests were run over the two-year evaluation period.
>
> The goal of the revised methodology was to align the rating variables with objective performance measures. The underlying weights, or points, were then determined by the degree of correlation between each factor and the various performance measures. Specifically, the higher the rating factor correlation is to the performance measures, the relatively higher weight it has been allocated in the revised methodology. Conversely, the lower the rating factor correlation significance is to the performance metrics, the lower the weight assigned to that factor. The end result is a revised group of variables whose weightings are based on those most closely correlated with business outcomes.

Id. at 1-3 (emphasis omitted). As I discuss below, the reliability of ISS' variables as a predictor of good governance are the subject of significant debate.

75. *Id*. These variables include: related party transactions, other than the CEO (evaluates whether there are related party transactions with directors or officers other than the CEO); financial expert (analyzes the number of financial experts on the audit committee); performance-based compensation (awards points to companies that grant awards based on performance criteria and disclosed hurdle rates, i.e., companies that grant indexed options or awards not earned or vested unless specific performance measures are met are rewarded in this category); individual director performance reviews (awards points to companies that perform periodic performance reviews of individual directors); mandatory holding periods for options and restricted stock (awards points to companies that require their executives to retain a meaningful portion of their earned restricted shares or performance shares for a specified period after exercise or after the stock awards vest); takeover defenses (awards points for companies that do not have a poison pill); and capital structure (awards points to companies that are not authorized to issue blank check preferred stock).

76. *Id.* These revised variables include: board composition (awards points when at least two-thirds of board members are independent outsiders); number of boards served on, other than CEO (this variable was expanded to include three categories of board service of outsiders, presumably taking into consideration the fact that, for example, service as an audit committee member is more demanding than simply serving as a board member without committee responsibilities); chairman/CEO separation (awards points to companies that have separated the roles of chairman and CEO and have an independent director serving as chairman); governance guidelines (awards points for putting the company's governance guidelines on the company web site); audit fees (awards points for additional detail on audit fees); capital structure—dual class (reduces the penalty for dual class capital structures where anyone can buy shares of the super-voting stock); option repricing (incorporates recent updates to NYSE and NASDAQ listing standards that option repricing may not be implemented without shareholder approval unless a company's option plans specifically permit repricing); director education (awards points if directors attended accredited programs within previous two years); and key committee independence and board access to advisers (awards points when committees are independent and the board has access to its own advisers).

made a variable superfluous. The superfluous variables that have been eliminated include variables analyzing the disclosure of a policy on auditor rotation, the company's history of option repricing, pension plans for non-employee directors, and corporate loans to insiders.[77] ISS dropped variables relating to director term limits and mandatory retirement ages because it could find no link between these variables and financial performance or risk.[78]

In November 2006, ISS again adjusted the CGQ to "better reflect current market trends in corporate governance, as well as more closely align with overall ISS policies."[79] ISS now analyzes "the presence and strength of a majority vote standard for members of a company's board of directors,"[80] penalizes companies that restate financials, penalizes companies that have had to make a material restatement to year-end financial results for any period and/or who have been subject to an enforcement action as a result of options backdating,"[81] and penalizes companies if one or more of its directors have been the subject of an ISS withhold voting recommendation for either the most recent annual meeting or the next annual meeting.[82] ISS also modified existing ratings criteria, including changes to award points if a company with a classified board has passed a proposal to de-classify the board, but where all directors are not yet elected annually,[83] and to award points if a company has a combined chairman and CEO, "but where there is a counterbalancing governance structure in place."[84] ISS has deleted options expensing as a ratings criterion because "it has become obsolete as a result of regulation, and is no longer a differentiator of companies within the model."[85]

Finally, another component of ISS' business is its advisory services to companies. The CGQ is provided to institutional investor clients, but it is also available to the subject companies. Subject companies may, in ISS' words, "use CGQ dynamically to evaluate their governance structures, benchmark their governance performance and conduct peer analysis."[86] The "dynamic" use refers to a subject company's ability to, for a fee, use ISSue Blueprint, a corporate governance analytic tool that allows companies to compare governance standards to peers and against "best practices."[87] Through the web interface, a client company may input various governance changes to test how the change would impact the company's CGQ. Essentially, the client clicks a box indicating that its directors receive annual education and training on their responsibilities, for example, and the CGQ score increases. Combine the roles of chairman and CEO and the CGQ decreases.

ISS also offers a separate tool for compensation plans—ISSue Compass—which similarly uses a web interface to allow a company the opportunity to test a provision with ISS before submitting it to shareholders for approval in the proxy statement. A client

77. *Id.* at 4.
78. *Id.*
79. CGQ UPDATE, *supra* note 72, at 1.
80. *Id.*
81. *Id.*
82. *Id.*
83. *Id.* at 2.
84. CGQ UPDATE, *supra* note 72, at 2.
85. *Id.*
86. *See* CGQ METHODOLOGY, *supra* note 72.
87. *Id.*

company can thus know whether or not ISS will support the compensation plan when ISS is asked for its recommendation.

2. GovernanceMetrics International

GovernanceMetrics International (GMI) provides corporate governance ratings and reports on nearly 4000 companies in the United States and abroad.[88] It does not offer proxy advisory services. GMI uses almost 500 data points in assessing a company's corporate governance. The result of the GMI analysis is a GMI rating report, which includes a summary of the company's overall governance score, as well as a discussion and individual score for each of six governance broad categories: board accountability, corporate social responsibility, executive compensation, financial disclosure and internal controls, takeover controls and ownership base, and shareholder rights.

GMI has developed its ratings by examining SEC regulations, exchange listing requirements, and many of the sources of corporate governance guidelines discussed above, including the OECD, the ICGN, and the Business Roundtable. Like ISS, GMI has produced a set of variables that are structured so that they can only produce "yes," "no," or "not disclosed" answers, which GMI believes eliminates "a large degree of subjectivity."[89] GMI obtains its information primarily through public documents and filings. After the initial report is completed, it is sent on to the company for a final accuracy check. GMI uses a proprietary scoring algorithm, which uses asymmetric, geometric scoring that results in the magnification of "outliers," so that companies with the best practices are rewarded even more, while those with the worst practices are subject to additional penalties.

3. The Corporate Library

Another major corporate governance analysis firm, the Corporate Library, was founded by former ISS executives Nell Minow and Robert Monks. Generally speaking, the Corporate Library's analysis is less quantitative and more qualitative than ISS' or GMI's analyses.[90] While the Corporate Library does produce some numeric ratings based on the adherence of a company to a set of enumerated "best practices" (which are based primarily on the OECD's model),[91] the company also notes in its analysis that the "one-size-fits-all aspects of the best practices compliance approach [is] limited at best."[92] As a result, the Corporate Library does not use the best practices benchmark as a component of its analysis of the board's effectiveness; indeed, the Corporate Library notes that it has "assigned very low Board Effectiveness Ratings to a number of boards that rate quite well on best practices compliance. Such was the case with the disastrous Enron board, for

88. *See* GovernanceMetrics Int'l, Overview, http://www.gmiratings.com/(hgwaa055h0jyiu55scbird45)/About.aspx#top (last visited Apr. 3, 2007).

89. GovernanceMetrics Int'l, Research Methodology, http://www.gmiratings.com/(hgwaa055h0jyiu55scbird45)/About.aspx#methodology (last visited Apr. 3, 2007).

90. For an example of a Corporate Library analysis, see its analysis of OMX, CORP. LIBRARY, OFFICEMAX INCORPORATED CORPORATE GOVERNANCE PROFILE (2006), http://www.thecorporatelibrary.com/special/misc/OfficeMax.pdf.

91. *Id.* at 8 (evaluating OMX with respect to a list of "best practices").

92. *Id.*

example, the clearest possible confirmation of the notion that best practice compliance alone is simply not enough."[93]

4. Glass, Lewis & Co.

Glass, Lewis & Co. (Glass Lewis) provides research and advisory services to institutional investors through a number of products. Glass Lewis does not provide consulting services to rated companies "except in the rare circumstance that a money manager is a public company or a division of a public company."[94] Glass Lewis will provide copies of its previously published research to rated companies, sometimes for a fee.[95]

Like ISS, Glass Lewis provides proxy advisory services to institutional investors. It also provides governance research, although its analyses are generally subjective and do not result in numerical governance ratings.[96] One exception is the Glass Lewis product "Board Accountability Index" (BAI). The BAI includes all companies in the S&P 500 and indexes all S&P 500 companies through a modified market-cap weighting algorithm that adjusts a company's weight based on the presence or absence of five "critical corporate governance features."[97] The BAI is based on research conducted by Professors Lucian Bebchuk, Alma Cohen, and Allen Ferrell and focuses on five entrenchment factors that, according to their research, indicate a "statistically significant and strong correlation, over a long period of time" with stock performance.[98]

5. Proxy Governance, Inc.

One relatively new corporate governance industry firm, Proxy Governance, Inc., a proxy adviser, has determined to differentiate itself from ISS by offering a more subjective analysis—an "issue-by-company" approach, rather than an "issue-by-issue" approach:

> Instead of reviewing proxies and recommending votes on an issue-by-issue basis, PROXY Governance conducts its analysis and provides recommendations on an "issue-by-company" basis. It views proxy issues in the context of company-specific metrics, taking into account a variety of relevant factors, such as an individual company's financial performance relative to its industry, its business environment, the strength of its management and corporate strategy, and the quality of its corporate governance, among others.[99]

93. *Id*.

94. *See* Glass, Lewis & Co. (Glass Lewis), Conflicts of Interest Disclosure, http://www.glasslewis.com/company/disclosure.php (last visited Apr. 3, 2007).

95. *Id*.

96. For a sample Glass Lewis research report, see Glass, Lewis & Co., In-Depth Analysis of Unrecognized Risks, http://glasslewis.com/downloads/overviews/yellowcard.pdf (last visited Apr. 10, 2007).

97. Glass, Lewis, & Co., Board Accountability Index, http://www.glasslewis.com/solutions/bai.php (last visited Apr. 3, 2007).

98. *Id.* These factors include: staggered boards, limits on shareholder bylaw amendments, poison pills, golden parachutes, and supermajority requirements for mergers. *Id.*

99. Proxy Governance, Inc., Recommendations on an Issue-By-Company Basis, http://www.proxygovernance.com/content/pgi/content/issue_by_issue.shtml (last visited Apr. 3, 2007)

Proxy Governance also states that "[m]uch proxy analysis today is based on methodology that assumes a specific set of corporate governance initiatives is or is not inherently beneficial to shareholders, and that a specific conclusion regarding a particular issue should be applied 'across-the-board' to the voting of all corporations' proxies."[100]

The company notes that a "'one-size-fits-all' approach may result in poor decisions on issues that genuinely impact long-term shareholder value."[101] As I will discuss below, this method has significant advantages over a "one-size-fits-all" approach, although such an approach is undoubtedly more time-consuming and costlier.

6. Morningstar, Egan-Jones and other Credit Ratings Agencies

Morningstar, the mutual fund ratings firm,[102] has also produced a new "Stewardship Grade" for stocks.[103] The grade is derived from three broad criteria: "transparency" (accounting practices and overall financial disclosure); "shareholder friendliness" (such as the presence of insider-controlled share classes, takeover defenses, combined CEO/chairman role, and related-party transactions); and "incentives, ownership, and overall stewardship" (compensation and whether the subject firms have "consistently treated shareholders with respect, and which we think will continue to do so.")[104] The Stewardship Grades are absolute, rather than relative with respect to an industry peer group.

Credit ratings firms Egan Jones and Standard & Poor's (S&P) have also entered the corporate governance business. Egan-Jones has a stand-alone proxy advisory business, Egan-Jones Proxy Services, which, like Proxy Governance, does not adhere to a "one-size-fits-all" policy. While stating that "[v]oting recommendations generally follow along prescribed voting guidelines", the firm also notes that "each proxy proposal is unique and is given individual attention by our research staff. We do not vote according to a book of voting principles enumerating a canned predetermined response to every possible situation without respect to the specifics at hand." [105]

S&P produces a "Corporate Governance Score" for S&P 500 companies, which covers approximately 100 criteria in four main categories: ownership structure, shareholder rights and stakeholder relations, disclosure and audit issues, and board structure and effectiveness.[106] S&P also provides tailored research as requested by its clients. S&P's share of the corporate governance market is rather low. Two other major credit ratings agencies, Moody's Investors Service, Inc. and Fitch Ratings Ltd., also

(emphasis omitted).

100. *Id.*

101. *Id.*

102. Morningstar has also produced governance ratings for mutual funds. *See* Kristen French, *Morningstar Does Its Part for Corporate Governance Reform*, FINANCIAL-PLANNING.COM, May 24, 2004, http://www.financial-planning.com/pubs/fpi/20040527104.html.

103. Pat Dorsey, *Introducing Stewardship Grade for Stocks: Find Shareholder-Friendly Firms with Our New Grading System*, MORNINGSTAR.COM, Feb. 7, 2005, http://news.morningstar.com/article/article.asp?id=126900&_QSBPA=Y.

104. *Id.*

105. EGAN JONES PROXY SERVICES, ABOUT OUR SERVICES, (2007) http://www.ejproxy.com/services.aspx..

106. STANDARD & POOR'S, CORPORATE GOVERNANCE SCORES - CRITERIA, METHODOLOGY AND DEFINITIONS (2002), http://www2.standardandpoors.com/portal/site/sp/en/us/page.article/2,1,1,0,1021558139012.html.

analyze corporate governance as part of their overall credit rating services but do not currently offer stand-alone governance ratings services.

III. CONCERNS WITH THE CORPORATE GOVERNANCE INDUSTRY

There are three broad areas of concern with business practices in the corporate governance industry (though not all firms in the industry exhibit each of these problems). First, a number of commentators have expressed concern over the potential for conflicts if governance analysts also serve as governance consultants. Second, ISS and some of its competitors impose on companies (through proxy recommendations or through ratings pressure) a number of governance standards for which there is limited or no evidentiary support and in some cases may be inversely correlated with improved firm performance.[107]

A third and related concern is that, to the extent that the particular best practices amount to a "one-size-fits-all" model, the board and management are effectively denied the ability to experiment with various governance structures in accordance with their corporate governance roles. In this sense, the corporate governance industry may, by discouraging tailored or innovative governance structures, reduce some of the competitive benefits made possible by a flexible and enabling regulatory structure. I discuss each of these concerns below.

A. Conflicts of Interest

A few governance advisers, and ISS in particular, have also been criticized because of perceived conflicts of interest.[108] The concern stems from ISS' advisory work for both the subject company and the company's shareholders.[109] This concern has two roots. First, ISS is providing both governance ratings and advice on how to improve the governance score—the governance adviser administering the test will also provide the answer key to those willing to purchase it. Observers have wondered whether this allows companies to effectively "game" the governance ratings, so long as they are willing to pay the price of the service.[110]

Second, in the case of ISS, the governance adviser also serves as a proxy adviser, which creates a concern that ISS' recommendation in a proxy matter may be affected by whether or not the subject company purchases other services from ISS, such as governance advice. Both of these potential conflicts of interest bear some similarities to the role (now reduced, but not wholly eliminated, by Sarbanes-Oxley) played by accounting firms as both auditors and advisers. In the case of auditors and governance advisers, an outside firm retained to provide an independent analysis of the subject company has built into its business model the provision of other services to the subject

107. *See, e.g.*, *infra* note 128 and accompanying text. It does not seem unreasonable to assume that ISS or one of its competitors could make such an error because, among other possible reasons, it relied on inadequate research or because, for whatever reason, it promoted a social responsibility issue as a governance issue.

108. *See, e.g.*, Starkman, *supra* note 7.

109. As discussed in Part II.B.1, *supra*, ISS has created separate business units for its corporate and investor advisory businesses in an effort to reduce potential conflicts.

110. *See* Troy Wolverton, *A Warning About eBay's Options 'Giveaway*,' THESTREET.COM, June 16, 2003, http://www.thestreet.com/stocks/troywolverton/10093761.html.

company. Certainly, the nature and regulation of public company audits is much different from governance rating. For example, public company auditors are retained by the company (under the direction of the audit committee and with approval of the shareholders), whereas governance ratings are initiated by governance ratings companies and paid for by interested shareholders. However, even if corporate governance firms are not retained by the subject company to provide governance ratings, the fact that the subject companies may retain the governance ratings agency for other services (such as compensation plan advice) creates a potential conflict of interest. By using objective measures, however, a governance rating agency may more plausibly claim that its governance analysis is not affected by the provision of other services. The persistence of objective measures, despite their dubious reliability as a measure of adequate corporate governance, thus may be explained as a defensive structure against such a conflict of interest, or at least as a defense against claims of such a conflict.

The potential for conflicts where a company serves as both adviser and rater has not been missed by the largest consumers of corporate governance advice: large, institutional investors, including pension funds, have raised concerns and, in some cases, switched advisers over conflicts issues. For example, Missouri's $8 billion pension fund ended its relationship with ISS because it decided it would rather do business with "an organization that at least has the appearance of undivided loyalty to . . . clients."[111] Likewise, Ohio's $69 billion and Colorado's $34 billion public employees' retirement systems chose ISS rival Glass Lewis over ISS in part because Glass Lewis appeared to be "free from any appearance of conflict,"[112] while ISS may have been compromised by "actual or perceived conflicts due to corporate consulting."[113]

B. Governance Ratings Methodologies

This section focuses on the ratings methodologies used by ISS, GMI, and other governance advisers and reviews recent literature that considers whether the evidence matches up with the advice provided by the corporate governance industry. Many of the concerns raised here will also be applicable to proxy advisory work, given that a firm providing both proxy advice and governance ratings will align both on a common set of governance policies (although, as noted above, ISS clients may opt for customized proxy advice).[114] ISS may decline to vote in favor of a director, for example, because the board did not adopt a shareholder resolution that received a majority vote of the shareholders, or because the director nominee serves on more than six public company boards.[115] Note,

111. Starkman, *supra* note 7 (citing Letter from Gary Findlay, Executive Dir., Miss. State Employees' Ret. Sys., to Inst. S'holder Servs. (2004)).

112. *Id*. (referencing statement issued by Colorado Public Employees' Ret. Ass'n).

113. *Id*. (citing Cynthia Richson, Corporate Governance Officer, Ohio Pub. Employees' Ret. Sys.).

114. *See, e.g.*, *supra* note 75 and accompanying text.

115. INST. S'HOLDER SERVS., ISS 2007 U.S. PROXY VOTING GUIDELINES CONCISE SUMMARY 1 (2006), http://www.issproxy.com/pdf/2007%20USConciseSummaryGuidelines.pdf. ISS will also consider firm performance in proxy voting, even when the company has strong CGQ scores. ISS recently received criticism for its advice to reject Fifth Third Bank's CEO, George A. Schaefer Jr., for reelection to the board:

> On Mar. 16, Richard X. Bove of investment bank Punk Ziegel & Co. fired off a research note calling ISS' advice "totally inappropriate" and pointing out that Fifth Third's assets have increased tenfold since Schaefer took over in 1990. Nell Minow, a former president of ISS who

however, that proxy advice is not necessarily based on a corporate governance rating, but common policies (unless otherwise specified by a client) will be applied to proxy advice and governance ratings.

As the corporate governance industry has studied and advised various "best practices," academics have been analyzing the relation between "best practices" advice and firm performance. The question of whether corporate governance matters is often rhetorically posed—I suspect that virtually all scholars, investors, managers, and directors would agree that it matters at least with respect to endogenously selected practices and structures (although intuitively it seems likely that very poor corporate governance practices might correlate more reliably with substandard financial performance than compliance with best practices would correlate with superior performance). Professors Lucian Bebchuk, Alma Cohen, and Allen Ferrell, among others, have instead asked the following questions: What matters in corporate governance?[116] What are the appropriate structures and mechanisms of corporate governance for a given company?[117] How should these structures and mechanisms be evaluated?[118] Which structures and mechanisms are reliable indicators of good governance and superior firm performance (if any truly are), and which are not?[119] While academic research on corporate governance is in relatively early stages, the research has produced helpful, if somewhat contradictory, results.

Some corporate governance advisers are more susceptible to criticisms of their governance advice and ratings methodology because they rely primarily on quantitative methodologies (a kind of "check-the-box," "one-size-fits-all" approach) to analyze subject companies. Such advisers are tied to a set of metrics, which, because they produce a binary and in some cases a trinary output ("yes," "no," or "not disclosed"), may not capture relevant nuances in corporate governance policies and behaviors. Further, to the extent that such metrics are held to apply to a wide range of companies, which may have an equally wide range of appropriate corporate governance structures and mechanisms, the metrics provide a limited and crude analytical tool. Corporate governance providers who rely on qualitative analyses, or a combination of quantitative and qualitative methodologies, on the other hand, may argue that while metrics provide a baseline, further qualitative evaluation allows the adviser to refine its analysis of a company's corporate governance. Whether such qualitative analysis is indeed superior to a quantitative approach will likely become more clear as ratings provided by each type of adviser are compared to actual results attributable to corporate governance actions and policies. Clearly, advisers who engage in qualitative analysis already believe that their

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> now runs governance researcher The Corporate Library LLC, warns that ISS may create "incentive for earnings manipulation that may not be in the shareholders' long-term interest" -- precisely the sort of activity good governance is supposed to prevent.

Analysis & Commentary, *ISS Looks Like It's Channeling Icahn: The Proxy Advisory Firm Says Fifth Third's CEO Should Go Despite Stellar Governance*, BUS. WEEK ONLINE, Apr. 3, 2006, http://www.businessweek.com/magazine/content/06_14/b3978031.htm?campaign_id=rss_magzn.

116. Lucian Arye Bebchuk et al., *What Matters in Corporate Governance?* (Harvard Law Sch., John M. Olin Ctr., Discussion Paper No. 491, 2004), *available at* http://ssrn.com/abstract=593423.

117. *Id.*

118. *Id.*

119. *Id.*

approach yields more accurate results (as evidenced, for example, by the Corporate Library's mention of its low rating for Enron, despite Enron's high rating based on purely quantitative factors).

On the other hand, a review of recent finance literature suggests that a number of the governance metrics selected by ISS and GMI do not reliably predict firm performance. As used in this Article, the term "firm performance" is construed quite broadly, so that good firm performance may include not just superior returns on equity or assets, but whether the company is able to avoid problems that may be attributable to corporate governance failures, such as accounting restatements and lawsuits.[120]

While the use of a set of one-size-fits-all governance criteria is obviously a concern with governance ratings, the problem is also apparent in the rather rigid review of various proxy proposals. For instance, ISS operates under the presumption that certain proposals should or should not be recommended—for example, there is a very strong presumption in favor of a proposal to alter company articles and bylaws to allow for annual election of directors.[121] In order to rebut this presumption, management will spend a great deal of time and effort to make its case to ISS and institutional shareholders.[122] While the annual election of directors arguably encourages director accountability, it also may jeopardize the interests of ISS' core client base—large institutional investors. For instance, much of the activism by hedge funds appears to be event-driven rather than performance-driven,[123] and hedge funds may be hoping to effect a change of control (or at least sufficiently tip the balance) so as to cause an event that will inure to the benefit of the hedge funds, but that may be detrimental to many of the institutional investors. Annual election of directors will generally make it easier for a hedge fund or "pack" of hedge funds to gain the seats it needs to instigate the event. And, as Thomas Briggs has noted, "in contested board elections and other corporate disputes, ISS has become increasingly willing to support dissident candidates and positions,"[124] and ISS support generally correlates with success of the dissident effort.[125]

120. Lynn Stout has argued that increasing share price is not the only (and not even the best) predictor of good firm performance. Lynn A. Stout, *Share Price as a Poor Criterion for Good Corporate Law* (Univ. of Cal., Los Angeles, Sch. of Law, Law-Econ Research Paper No. 05-7, 2005), *available at* http://ssrn.com/abstract=660622.

121. *See* INST. S'HOLDER SERVS., ISS 2006 U.S. PROXY VOTING GUIDELINES SUMMARY (2005), http://www.issproxy.com/pdf/US2006SummaryGuidelines.pdf (describing the procedure and substance ISS considers when voting).

122. *See, e.g.*, Starkman, *supra* note 7 (describing management's resistance to ISS).

123. *See* Audio file: Comments of Scott J. Davis at the 26th Annual Ray Garrett Jr. Corporate and Securities Law Institute, held by Northwestern University School of Law (May 4, 2006) (on file with author).

124. Briggs, *supra* note 11, at 14.

125. *Id.* Similar results were found in a study by members of the SEC's staff in a 2006 study. The authors, which included the Chief Economist and Director of the SEC's Office of Economic Analysis, concluded that "empirical evidence shows that the [proxy advisor] recommendations are good predictors of [proxy] contest outcomes; for example, a recommendation that supports the dissident is a good predictor that the dissident will prevail. The findings are associated with both 'influence' and 'prediction' hypotheses on the role of the advisor-that the recommendation either influences or helps investors to predict the outcome, or both." Chester S. Spatt, Chief Economist and Director, Office of Economic Analysis, U.S. Sec. & Exch. Comm'n, Speech at Rutgers University Conference on "Improving Corporate Governance: Markets vs. Regulation:" Shareholder Voting and Corporate Governance: Economic Perspectives (April 20, 2007), *available at* http://www.sec.gov/news/speech/2007/spch042007css.htm (citing C. R. Alexander, M. Chen, D. Seppi and C.

Board independence, long a major focus of the corporate governance industry, is now required of larger public companies through NYSE and Nasdaq listing standards. Although the corporate governance industry and regulators have spoken definitively on the issue, board independence may not be a cure for governance failures. Indeed, recent research suggests that board independence may be negatively correlated with operating performance.[126] Likewise, corporate governance industry firms have encouraged the separation of the CEO and chairman roles. While separating the roles does not guarantee avoiding poor governance (for example, Enron and WorldCom had separated these roles), it is also true that no study clearly indicates a correlation between firm performance and the duality of the CEO and the chairman.[127]

Governance ratings firms and proxy advisory firms will naturally rely on certain rules of thumb to help evaluate corporate governance. My concern is not with rules of thumb, but rather, in the case of proxy advisory work, with what seem to be strong presumptions based on insufficient evidence, which must be vigorously rebutted by the company. In the case of governance ratings, however, often there is not merely a presumption but also a hard metric by which every company is judged. Professor Jeffrey Sonnenfeld has argued that the metrics used in the ratings analyses are based heavily on "Wall Street superstitions" and "clichés and myths, rather than on genuine research."[128] The argument against ISS' and GMI's analysis is not that all or even most of the variables are inappropriate. Indeed, Sonnenfeld recognizes that some of the quantitative methodology employed by ISS and GMI relies on research-proven measures of effective governance. However, "ISS and GMI [then] blend these dimensions with superstitious ones to create checklists of highly stringent standards, regardless of the genuine research foundation to support them."[129] For example, Sonnenfeld argues that most of the studies that have been cited in support of the proposition that certain board structures correlate with effective governance, in fact, do not examine the impact of board structure but instead focus on other variables. Citing Sunil Wahal and Michael Smith, Sonnenfeld argues that those studies which attempt to isolate the impact of board structure on company performance have not found a strict correlation.[130] Since Sonnenfeld's article, some more recent studies do suggest some relation between board structure and corporate governance.[131] Nonetheless, aside from particular governance requirements mandated by

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Spatt, The Role of Advisory Services in Proxy Voting (2006) (unpublished manuscript)).

126. SANJAI BHAGAT & BRIAN BOLTON, CORPORATE GOVERNANCE AND FIRM PERFORMANCE (2006), http://w4.stern.nyu.edu/emplibrary/Corporate_Governance-Performance.pdf. Recent research by Professor William Sjostrom has also questioned the justifications for annual elections of directors. *See* William Sjostrom, *The Case Against Mandatory Annual Director Elections and Shareholders' Meetings*, 74 TENN. L. REV. (forthcoming 2006), *available at* http://papers.ssrn.com/ abstract=907474.

127. *See, e.g.*, B. Ram Baliga et al., *CEO Duality and Firm Performance: What's the Fuss?*, 17 STRATEGIC MGMT. J. 41 (1996); James A. Brickley et. al., *Corporate Leadership Structure: On the Separation of the Positions of CEO and Chairman of the Board* (Simon Sch. of Bus., Working Paper FR 95-02, 1995), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=6124.

128. Jeffrey Sonnenfeld, *Good Governance and the Misleading Myths of Bad Metrics*, ACAD. MGMT. EXEC., Feb. 2004, at 108, 108.

129. *Id*. at 108-09.

130. *Id*. at 128, at 109 (citing Sunil Wahal, *Pension Fund Activism and Firm Performance*, 31 J. FIN. & QUANT. ANALYSIS 1 (1996) and Michael P. Smith, *Shareholder Activism by Institutional Investors: Evidence from CalPERS*, 51 J. FIN. 227 (1996)).

131. *See* Aggarwal & Williamson, *supra* note 72; David F. Larcker et al., How Important is Corporate

Sarbanes-Oxley, these studies do not investigate the effect of each component that might go into a construct of "board structure." Current research suggests that while there is a correlation between some aspects of board structure and effective governance, it is unclear whether many other aspects of board structure are relevant to firm performance. For example, while the number of board members may be relevant in determining an effective corporate governance structure (e.g., three board members are too few, seventeen generally are too many), the number of board members who are independent, the number of board members who qualify as financial experts, or the number of public boards on which these directors serve may not be relevant.

In a more recent study, Professors Bebchuk, Cohen, and Ferrell analyzed the relationship between corporate governance provisions dealing with entrenchment and shareholder value. Bebchuk notes that much of the research on the effects of various governance structures examines one or more governance provisions in isolation, without controlling for the large universe of other governance provisions.[132] For example, Bebchuk, Cohen, and Ferrell note that a set of studies examining whether the adoption of a poison pill[133] or a golden parachute[134] affected stock prices did not properly take into account that "[w]hen a firm adopts a poison pill or a golden parachute . . . its stock price might be influenced not only by the expected effect of the poison pill or the golden parachute but also by inferences that investors make as to management's private information about the likelihood of a bid."[135] Bebchuk, Cohen, and Ferrell also note that "these studies did not control for whatever governance provisions the firms adopting the poison pill or golden parachute had."[136]

While Bebchuk, Cohen, and Ferrell argue that governance structure matters, they also note that

> [A] "kitchen sink" approach of shareholder advisory firms might not be best. Among a large set of governance provisions, the provisions of real significance are likely to constitute only a limited and possibly small subset. Pressuring firms to improve their index could be counter-productive when the index gives weight to many innocuous or even beneficial provisions and correspondingly under-weights provisions that are in fact quite harmful to shareholders. And governance quality could well be measured more accurately by using a smaller index based on the provisions that do matter than by using a broader index that counts many provisions that do not in fact matter and only serve to introduce noise. Thus, investment decisions and governance improvements could be better served by an approach that seeks to identify and focus on key harmful

Governance? (May 2005) (unpublished manuscript), *available at* http://ssrn.com/abstract=595821.

132. Bebchuk et al., *supra* note 116, at 13 (citing Jonathan M. Karpoff & Paul H. Malatesta, *The Wealth Effects of Second-Generation State Takeover Legislation*, 25 J. FIN. ECON. 291 (1989), and Mick Swartz, *The Massachusetts Classified Board Law*, 22 J. L. ECON. & ORG. 29 (1998)).

133. *Id.* at 14 (citing Michael Ryngaert, *The Effect of Poison Pill Securities on Shareholder Wealth*, 20 J. FIN. ECON. 377 (1988)).

134. *Id.* (citing Richard A. Lambert & David F. Larcker, *Golden Parachutes, Executive Decision-Making, and Shareholder Wealth*, 7 J. ACCT. & ECON. 179 (1985)).

135. *Id.* (citing John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271 (2000)).

136. *Id.*

provisions rather than attempt to count all the trees in the governance forest.[137]

To restate this conclusion a bit more bluntly, good governance analysis may not be so much a matter of examining whether a company adheres to a list of "best practices," but might more profitably entail an examination of whether a firm is engaged in bad or "worst" practices. It is also worth noting that if Bebchuk, Cohen, and Ferrell are right that fewer provisions matter, the value added by the corporate governance industry is reduced. If the information which most accurately reflects governance risk is less expensive to assemble and analyze, there should be a correspondingly decreased interest in outsourcing such research.

Other recent research also calls into question much of the advice offered by corporate governance industry. A 2005 study by Professors Larcker, Richardson, and Tuna[138] analyzed the effect on firm performance of a number of corporate governance indicators falling into "seven general categories: characteristics of the board of directors,[139] stock ownership by executives and board members,[140] stock ownership by institutions,[141] stock ownership by activist holders,[142] debt and preferred stock holdings,[143] compensation mix variables,[144] and anti-takeover devices."[145]

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137. Bebchuk et al., *supra* note 116, at 5.

138. Larcker et al., *supra* note 131.

139. *Id*. (manuscript at 6). Under each of these categories, respectively, Larcker et al. reviewed

> the number of meetings for the audit committee, compensation committee, and the total board . . . , number of directors serving on the compensation committee, audit committee, and the total board . . . , fraction of board comprised of insider (executive) directors . . . , fraction of the compensation committee and audit committee that is comprised of affiliated directors . . . , indicator variables equal to one if the chairperson of the compensation committee and audit committee is affiliated and zero otherwise . . . , the fraction of outside directors and affiliated directors that serve on four or more boards . . . , [and the fraction of inside directors that serve on two or more boards,] fraction of outside, affiliated, and inside directors that are older than 70 . . . , an indicator variable equal to one if there is a lead director (an outside director that can call meetings of all outside directors in executive session) on the board and zero otherwise . . . , an indicator variable equal to one if an internal executive holds the position of chairperson of the board and zero otherwise, and the fraction of affiliated and outside directors that were appointed by existing insiders . . . .

Id. (manuscript at 6-7).

140. *Id.* (manuscript at 6).

> [Larcker et al.'s] board and executive ownership variables are the fraction of outstanding shares held by the average outside director . . . , fraction of outstanding shares held by the top executive . . . , fraction of outstanding shares held by the average executive director after excluding the holdings of the top executive . . . , and fraction of outstanding shares held by the average affiliated director . . . .

Id. (manuscript at 8).

141. "Institutional ownership" is measured as the fraction of outstanding shares owned by block-holders, number of block-holders, and shareholding of the largest institutional owner. Larcker et al., *supra* note 131 (manuscript at 8).

142. The "activist" variables are measured using the number of activist institutions holding shares and the fraction of outstanding shares held by activist institutions. *Id.* (manuscript at 9).

143. The role of debt as a governance mechanism is measured using the ratio of book value of debt (Compustat data item 9 plus data item 34) to the market value of equity (Compustat data item 199 multiplied by data item 25) and ratio of book value of preferred equity (Compustat data item 130) to the market value of equity (Compustat data item 199 multiplied by data item 25). *Id.* (collecting data from Standard & Poor's, Data

In the study, Larcker, Richardson, and Tuna tried to combine the factors in different ways in order to test the significance of various governance structures. The authors of the study start with the proposition that governance matters; indeed Tuna states that: "[w]e set the study up to err on the side of, 'The relationship [between governance measures and good performance] is there.'"[146] However, Tuna notes:

> [W]e can't even find it when we do that. We biased the analysis in favor of finding something . . . [but t]he structural indicators just don't seem to have that much ability to explain whether companies have to do accounting restatements, whether they're selling at a higher multiple, whether they're manipulating earnings and things like that.[147]

Discussing the study, Larcker observes that "[l]ots of people are coming up with governance scorecards. . . . They're coming up with best practices and selling this stuff. As far as we can tell, there's no evidence that those scorecards map into better corporate performance or better behavior by managers."[148] Generally speaking, good governance may affect firm performance, but it is not clear that the variables selected by governance ratings agencies are the appropriate metrics to test and promote good firm performance.

The confusion over the appropriate variables is also underlined by Brown and Caylor in a 2005 study[149] commissioned by ISS.[150] Brown and Caylor created a measure of corporate governance, Gov-Score, based on an ISS dataset that covers 51 provisions or attributes falling into eight general categories:[151] audit, board of directors, charter/bylaws, director education, executive and director compensation, ownership, progressive practices, and state of incorporation.[152] Brown and Caylor then tested the Gov-Score attributes' correlation with two measures of operating performance: return on equity and return on assets.[153] Although their research indicates that that better governed firms are relatively more profitable, they also found that only ten governance provisions were significantly and positively related to operating performance,[154] a finding that

Services Compustat, http://www.standardandpoors.com (last visited Apr. 3, 2007)).

144. "Compensation mix variable" is the fraction of total annual CEO compensation that is earned by exceeding accounting targets in performance plans and annual bonus. *Id.* (manuscript at 9-10).

145. The "anti-takeover" variables are measured using indicator variables regarding whether a firm has a staggered (or classified) board of directors, requires a supermajority vote for a business combination, is incorporated in a state with relatively greater protections to incumbent management (e.g., PA, OH, MA, or WI), has unequal voting rights across shareholders or dual classes of stock, and has a poison pill or where stock purchases can be made at substantial discounts by existing shareholders if a hostile takeover attempt is made on the firm.

146. Wharton Sch., Univ. of Pa., *Corporate Governance by the Numbers: It Just Doesn't Work*, Sept. 22, 2004, KNOWLEDGE@WHARTON, http://knowledge.wharton.upenn.edu/index.cfm?fa=viewArticle&id=1041.

147. *Id*.

148. *Id*.

149. Lawrence D. Brown & Marcus L. Caylor, Corporate Governance and Firm Performance 3 (Dec. 7, 2004) (unpublished manuscript), *available at* http://ssrn.com/abstract=586423.

150. *See* Jay W. Eisenhofer & Gregg S. Levin, *Does Corporate Governance Matter to Investment Returns?*, *in* CORP. ACCOUNTABILITY REPORT (Bureau of National Affairs, Inc., No. 57, 2005), *available at* http://www.issproxy.com/pdf/CorporateAccountabilityReport.pdf.

151. Brown & Caylor, *supra* note 149, at (manuscript 3).

152. *Id.* (manuscript at 1).

153. *Id.* (manuscript at 13).

154. *Id*. These attributes are the following: nominating committee comprised solely of independent outside

supports the "noise" theory described by Bebchuk, Cohen, and Ferrell.[155] Brown and Caylor's research also supports Sonnenfeld's contention that while some governance attributes are demonstrably relevant to firm performance, many others are perhaps inserted in governance indices because of Wall Street "myths" that such attributes are relevant.

Sanjai Bhagat and Brian Bolton's research on the relation of various measures of governance to firm performance indicates that "better governance as measured by Brown and Caylor, and the Corporate Library is not significantly correlated with better contemporaneous or subsequent operating performance."[156] They also find that board independence is negatively correlated with contemporaneous and subsequent operating performance; as they state, "This is especially relevant in light of the prominence that board independence has received in the recent NYSE and NASDAQ corporate governance listing requirements."[157] Perhaps most interestingly, Bhagat and Bolton find that director stock ownership is positively related to both future operating performance and to the probability of disciplinary management turnover in poorly performing firms. Bhagat and Bolton suggest that perhaps "a single board characteristic [might] be as effective a measure of corporate governance as indices that consider multiple measures of corporate charter provisions, management compensation structure, and board characteristics."[158] The fact that the Corporate Library's measures, like the Brown and Caylor measures (which were based on ISS variables), were not a better predictor of firm performance suggests that even a more detailed, issuer-specific analysis of corporate governance still must rely on governance heuristics and, like ISS' approach, may not systematically reveal marketable information with respect to firm performance.

Finally, a study by N. K. Chidambaran, Darius Palia, and Yudan Zheng challenges the causal link on which much of the corporate governance industry is based: the connection between corporate governance *changes* and corporate performance.[159] The authors note that a number of studies have found good governance measures to be positively correlated with firm performance, which has led to the assumption that the adoption of "good governance" measures will cause a firm's performance to increase.[160] In constructing their study to analyze this assumption, Chidambaran, Palia, and Zheng

directors; compensation committee comprised solely of independent outside directors; company not authorized to issue blank check preferred stock; non-employees do not participate in company pension plans; at least one board member has participated in an ISS accredited director education program; average options granted in the past three years as a percent of basic shares outstanding did not exceed three percent; auditors ratified at the most recent annual meeting; company expenses stock options; directors required to submit their resignations upon a change in job status; and no former chief executive officer serves on board. *Id.*

155. Bebchuk, *supra* note 116, at 5 (stating that "governance quality could well be measured more accurately by using a smaller index based on the provisions that do matter than by using a broader index that counts many provisions that do not in fact matter and only serve to introduce noise").

156. BHAGAT & BOLTON, *supra* note 126, at 5.

157. *Id.* Note however that board independence is proposed as a disciplinary device, and not necessarily as a performance enhancement device. However, disciplinary and agency cost-reducing measures are at base designed to keep managers from shirking or siphoning funds away from the corporation, and at least in this basic sense are tied to firm performance.

158. *Id.* at 28.

159. N. K. Chidambaran et al., Does Better Corporate Governance 'Cause' Better Firm Performance? 2 (March, 2006) (unpublished manuscript), *available at* http://papers.ssrn.com/abstract=891556.

160. *Id.* (manuscript at 8).

"'stack the deck' in support for the hypothesis that better governance leads to better firm performance."[161] Using a number of governance changes, including three measures based on the board of directors, five measures of pay-performance sensitivity, two measures of shareholder rights, institutional ownership, and CEO turnover, they find that measures thought to create better governance do not lead to better performance.[162] The authors note that "[w]e do not interpret our findings that good governance does not lead to better performance to imply that governance is irrelevant but rather that firms are endogenously optimizing their governance structure in response to observable and unobservable firm characteristics," noting, as Roberta Romano did in her critique of Sarbanes-Oxley, that "a blanket policy prescription that mandates specific governance provisions in all firms is not optimal."[163]

More specific research is justified by these results, and undoubtedly many academics are attempting to provide a clearer picture of the importance of corporate governance to firm performance. More research is needed on the particular variables used by ISS, GMI, and other governance ratings agencies, as well as the interrelationship and weighting of these variables in the creation of the final governance score.[164] One very positive aspect of the corporate governance industry, however, is that because each adviser employs a different methodology to arrive at proxy and investment advice, scholars will also be able to continue to construct testable hypotheses on what might matter in corporate governance, and whether an "issue-by-company" approach such as that taken by Proxy Governance yields better returns than ISS' advice, and if so, whether it overcomes any cost differences between the services.

Another methodology concern, which is perhaps not limited to checklist governance raters, is a practice this Article will refer to as "methodology churn." Corporate governance ratings firms continually update and retool their services, in part to remain competitive and be at the cutting edge of governance knowledge, but perhaps also because it is simply good business. Every time a new governance fashion appears, a governance ratings agency can retool and advertise the need for companies and shareholders to respond to the change. Methodology churn will ultimately sell more services, whether through additional governance advice, software access, or the purchase of reports. But why not wait until the knowledge of a particular governance structure becomes more certain before advocating say, majority voting for director elections? The answer may be simply that it does not make good business sense to wait for evidence to support governance claims when money can be made advocating them right now. Methodology churn and unproven governance metrics raise even more concerns when a firm, like ISS, is granted voting power by many clients. Perhaps a third or more of a company's outstanding shares may be automatically voted in favor of fashionable or intuitively appealing yet unproven governance constructs in the form of a shareholder resolution. If another 20% of the shareholders agree with ISS' assessment, the proposal has a majority. The board is not obligated to go along with the shareholders, but if the

161. *Id.* (manuscript at 43).
162. *Id*. (manuscript at 44).
163. *Id.*
164. Much of this latter research is dependent on the release of proprietary scoring models to researchers, which is probably too much to reasonably expect. I believe that it is reasonable, however, to expect the in-house analysts at governance ratings agencies to conduct such research.

board does not, ISS may not support the directors in the following year's election, based on their refusal to adopt a shareholder resolution approved by a majority of the shareholders.

Despite the lack of strong evidence linking corporate governance to superior performance, the corporate governance industry continues to enjoy tremendous influence.[165] What explains this? A large part of the explanation is that, as noted above, federal rules require pension funds and mutual funds to vote proxies in the best interests of their investors, and as fiduciaries these funds are compelled to perform due diligence with respect to proxy voting.[166] This perhaps best explains the fact that ISS was purchased five years ago for $40 million and sold in November 2006 for $550 million.[167] Granted, funds may use the ratings services merely as one part of their overall governance analysis—they buy the report as part of a diligence process, but do not necessarily follow the advice.[168] While that may be true for most institutions, however, that is not the case for the 15%-20% of ISS clients that have outsourced not only their governance analysis to a ratings firm, but also their proxy voting responsibilities. If up to a third of U.S. equities are indeed voted in accordance with ISS advice, we see another explanation for the corporate governance industry's influence in the comments of Richard Koppes, former general counsel for the California Public Employees' Retirement System (CalPERS): "an institution voting against the ISS recommendation better have a pretty good reason."[169] Following the advice of governance experts may provide "criticism insurance"[170]—a fund following ISS advice has no burden of proof with respect to a particular proxy vote. Further, it seems unlikely that a fund following the expert advice of ISS or another proxy adviser would be found to have breached its fiduciary duties.

The uncertain relationship between governance metrics and firm performance may suggest that the project of reducing good governance to metrics is misguided. Indeed, it is telling that although the corporate governance industry has argued that good governance is related to superior firm performance, governance analysis is often outsourced. Perhaps many institutional investors outsource governance analysis and proxy analysis because they do not believe that significant gains could be realized by focusing on governance issues. Good governance, as measured through objective (and perhaps even subjective) analysis is bound to result in Type I errors (false positives) like Enron—companies with strong governance practices, according to the wisdom of corporate governance metrics, that still experience major governance breakdowns. On the other hand, governance analysis will certainly also result in Type II errors (false negatives), as companies with diligent and effective governance practices that do not meet the corporate governance industry's recommendations are penalized for maintaining those practices.

165. *See supra* notes 9-15 and accompanying text.

166. *See supra* notes 56-57 and accompanying text.

167. *See supra* notes 12-13 and accompanying text.

168. Hilzenrath, *supra* note 12 and accompanying text.

169. Eleanor Laise, *Is This the Most Influential Man on Wall Street?*, SMARTMONEY, Oct. 16, 2002, *available at* http://www.smartmoney.com/mag/index.cfm?story=oct02-influential.

170. Larry Ribstein, Mildred Van Voorhis Jones Chair, Univ. of Ill. Coll. of Law, Comment at Conglomerate Junior Scholars Workshop (Aug. 22, 2005).

C. The Homogenization of Corporate Governance

As argued above, much of the rise of the governance industry is explained in part by tremendous inflow of investor dollars to institutional investors (e.g., through pensions and 401Ks). Although it is generally true that institutional investors and other governance services clients have more time and resources to evaluate companies than the individual investor (and, of course, are paid specifically for their expertise in such evaluation), institutional investors do not have an unlimited ability to conduct research, and so they outsource some of this research work to corporate governance advisers. This is not to say that institutional investors rely solely on the governance research provided by corporate governance advisers. However, it is probable that institutional investors are more likely to rely on corporate governance advisers when confronted by an unusual governance structure simply because they are less likely to possess, or willing to acquire, specialized knowledge needed to evaluate the structure. To the extent that fund managers defer some of the governance analysis to governance rating agencies (for example, if a fund manager decides that it will avoid companies with governance rating below a certain CGQ), a one-size-fits-all approach will punish companies that adopt innovative governance structures. A one-size-fits-all model essentially standardizes corporate governance and discourages company-specific (or even industry-specific) governance policies and novel governance structures and standards.[171] On the other hand, we can see how a case-by-case analysis might promote innovation (or at least not restrict it) by allowing governance raters like Proxy Governance to evaluate innovations and report on their value as governance devices. Again, however, although the "objective," one-size-fits-all model may not provide a good analysis of a company's corporate governance, the persistence of the model may lie in the fact that the use of objective criteria may help eliminate, or at least lessen, the appearance of potential conflicts of interest where these firms serve both investors and the company.

While rigid governance metrics may result in an inaccurate assessment of a firm's governance, the influence of the corporate governance industry generates a more general, market-wide concern: the imposition of governance metrics serves to standardize governance structures and compels a rigid set of acceptable practices in a context where flexibility should be a goal. Such a concern has been made with respect to the federalization of corporate law through the encroachment of Sarbanes-Oxley, but it is also relevant here. As former Delaware Chief Justice Norm Veasey has argued, Sarbanes-Oxley

> does not account for the complexities of the corporate environment. Rather than setting broad standards and allowing public companies some leeway in determining how best to comply with those standards, Sarbanes-Oxley "prescribe[s] the precise means by which directors and officers are to pursue certain ends." Delaware fiduciary law, by contrast, promotes good governance practices while "recogniz[ing] that what generally works for most boards may not be the best method for some others." Delaware's approach, which relies on

171. "Innovative" may thus be another way of saying "different"; a company may not be attempting a new kind of governance model, but may be retaining an older practice that has worked well for the company in the past.

> the courts to define what is required of officers and directors on a case-by-case basis, ensures that firms can select the appropriate governance regime for their situation. This flexibility, so vital to maintaining a sensible, effective regulatory regime for corporate governance, is largely absent from Sarbanes-Oxley.[172]

The same may be said for the mandates of many firms in the corporate governance industry. An inflexible, standardized governance checklist used to determine whether a company is appropriately governed or whether shareholders should approve a particular proposal will invariably fail to adequately analyze the governance structure or proposal, and will also serve to stifle potentially beneficial governance innovations. The overwhelming market power of ISS underscores this concern. Because corporate governance ratings firms play a significant role in directing corporate governance discourse, both through ratings and through proxy advisory work, it is worth considering whether public company management is effectively being deprived of some essential latitude in how it may manage the company. The result of a strict set of governance guidelines, upon which a company's rating depends, is that the company may be less likely to consider innovative governance structures (unless, of course, the governance structure is the structure du jour advocated by the governance industry). It is also worth noting Delaware Vice Chancellor Leo Strine's concern that "unlike the individual investors whose capital they use to wield influence, institutional investors and their [proxy] advisers bear far less of the residual risk of poor voting decisions, as their compensation turns more on short-term factors than long-run growth."[173]

Recent empirical evidence also suggests that one-size-fits-all governance will generally produce lower returns than a flexible approach that allows corporations to deviate from "best practices." Sridhar Arcot and Valentina Bruno of the London School of Economics analyzed the effect of corporate governance on performance in the context of the United Kingdom's disclose-or-explain corporate governance structure (under this approach, compliance with a code of best practices is voluntary, but companies must disclose whether they are complying with the code, and if not, explain why).[174] The authors found that "companies departing from best practice for valid reasons perform exceptionally well and out-perform the fully-compliant ones. In contrast, mere compliance with the provisions of the Code does not necessarily result in better performance."[175] The authors also noted:

> An index which identifies better governed companies by analyzing adherence to governance provision(s) discards relevant information and imposes a *one-*

172. E. Norman Veasey et al., *Federalism vs. Federalization: Preserving the Division of Responsibility in Corporation Law* (Yale Law & Econ., Research Paper No. 324, 2005) (citing William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 960 (2003)), *available at* http://ssrn.com/abstract=878246.

173. Leo E. Strine, Jr., *Towards a True Corporate Republic: A Traditionalist Response to Lucian's Solution for Improving Corporate America* (Harvard Law & Econ., Discussion Paper No. 541, 2006), *available at* http://ssrn.com/abstract=883720.

174. The Combined Code on Corporate Governance, pmbl. para. 4 (2003), *available at* http://www.fsa.gov.uk/pubs/ukla/lr_comcode2003.pdf.

175. Sridhar R. Arcot & Valentina G. Bruno, One Size Does Not Fit After All: Evidence from Corporate Governance 3 (May 16, 2006) (unpublished manuscript), *available at* http://ssrn.com/abstract=887947.

> *size-fits-all* [approach] framework on what is expected from companies. . . . Not recognizing the . . . heterogeneity among firms by . . . imposing *one-size-fits-all* approaches would raise efficiency issues. Indeed, there are many arguments for and against each regulatory proposal, recommendation or governance criteria.[176]

Arcot and Bruno's research suggests that the mandatory provisions of Sarbanes-Oxley and related SEC rulemaking (such as the implementation of internal controls under section 404) may create inefficiencies by eliminating heterogeneity among firms' governance structures. However, these same concerns run to the check-the-box governance criteria of ISS and GMI to the extent that their criteria operate like mandatory regulations. While it is certain that ISS' governance criteria are not enforceable by SEC or other governmental sanction, the significant voting power under ISS' control and the influence of ISS with institutional investors may nonetheless compel compliance, thereby creating a more homogenous corporate population. International competitors of U.S. companies, by contrast, generally operate under disclose-or-explain governance regimes such as the United Kingdom's, "where companies can make different governance choices reflecting their unique circumstances."[177]

Despite the potential for homogenization, a potentially positive effect from the perspective of management discipline may come from the efforts of the corporate governance industry (among others) against anti-takeover protections: the success of the efforts may invigorate the market for corporate control. Indeed, these efforts may be a significant cause of the recent heavy merger activity in the United States.[178]

IV. REGULATION OF THE CORPORATE GOVERNANCE INDUSTRY: PRELIMINARY CONSIDERATIONS

Ironically, the efforts of the corporate governance industry to fill (and profit from) a regulatory void raise the question of whether the governance industry itself should be regulated, with the SEC the most likely regulator. This Article attempts to outline several problems which might justify regulation.

However, with the possible exception of conflicts of interest (which, for this reason, receives the most attention), I believe that these problems would not be solved, and may even be exacerbated, by SEC regulation. The following sections outline some preliminary thoughts on the regulation of conflicts, methodology concerns, and the homogenization of corporate law.[179]

A. Conflicts

As noted above, various state pension funds have responded to perceived conflicts

176. *Id*. (manuscript at 2-3).

177. *Id*. at (manuscript at 3).

178. 2006 was a record year for M & A, with the value of acquisitions totaling over $4 trillion. *See* Joe Bel Bruno, *Merger Activity Lifts Investors*, BEACON J., Dec. 31, 2006.

179. My belief that the federalization of corporate law will ultimately result in a less flexible, less responsive corporate governance framework obviously limits the scope of my vision. Scholars that are not restrained by such a concern will likely see no difficulties in SEC regulation of the corporate governance industry.

of interest within ISS by migrating to other proxy advisers.[180] Aside from market pressure, existing SEC rules under the Investment Advisers Act of 1940 (the "Advisers Act"), and particularly through proxy voting regulations passed in 2003, also provide some conflicts prevention for governance raters that are also doing proxy advisory work.[181] Under the Advisers Act, proxy advisers have a fiduciary duty of care to vote proxies in the clients' best interests.[182] The 2003 regulations:

> Require . . . investment adviser[s] that exercise . . . voting authority over client proxies to adopt policies and procedures reasonably designed to ensure that the adviser votes proxies in the *best interests* of clients, to disclose to clients information about those policies and procedures, and to disclose to clients how they may obtain information on how the adviser has voted their proxies.[183]

Note, however, that the rules apply specifically to proxy voting and would not be appropriate to governance advisory work generally because of the lack of any statutory duty of care. The potential conflicts of interest created by governance marketers simultaneously providing governance ratings advice to companies and their investors are not covered under any existing or proposed SEC rules.

The SEC does not specify specific policies for advisers to insure that they will vote in the best interests of clients; nor does the SEC provide a list of approved procedures because it believes that "[i]nvestment advisers registered with [the SEC] are so varied that a one-size-fits-all approach is unworkable. By not mandating specific policies and procedures, [the SEC] leaves advisers the flexibility to craft policies and procedures suitable to their businesses and the nature of the conflicts they face."[184] ISS, for example, has put in place a "firewall" similar to the kind of structural protections used by banks to keep separate the research and investment banking units.[185] In a no-action request letter to the Division of Investment Management, ISS describes the firewall, noting, among other things, that the "firewall involves functional, physical, and technological separations."[186] The management and staff of the research departments that analyze proxies and formulate voting recommendations are "completely different from the management and staff of the Corporate Programs division who supply the web-based tools and publications to corporate clients and provide advice in connection therewith."[187] The research staff and corporate programs staff operate out of separate and secure areas at ISS' headquarters, and they maintain separate and secure office equipment and information databases. It appears that the research staff has no way of knowing

180. *See supra* notes 111-14 and accompanying text.

181. *See supra* note 57 and accompanying text.

182. *See* SEC Investment Advisers Act Release No. 2106, 17 C.F.R. § 275 (2003), *available at* http://www.sec.gov/rules/final/ia-2106.htm.

183. *Id*. (emphasis added).

184. *Id*.

185. Sec. & Exch. Comm., The Global Research Analyst Settlement, http://www.sec.gov/spotlight/globalsettlement.htm (last visited Apr. 20, 2007) (stating that most investment banks have followed the lead of WorldCom and started using firewalls).

186. Letter from Mari Anne Pisarri, Attorney, Pickard and Djinis LLP, to Douglas J. Scheidt, Assoc. Dir., Sec. & Exch. Comm'n (Sept. 15, 2004), *available at*, http://www.sec.gov/divisions/investment/noaction/iss091504.htm.

187. *Id*.

whether clients purchase advisory services, since "both the Corporate Programs staff and the sales staff for the corporate products have been trained in the requirement to keep the identities of the issuer clients confidential, and they communicate with those clients in a secure fashion."[188] ISS has also instituted a "blackout" policy, so that the advisory division may not provide any advisory services to issuers or access to the web-based tools from the time a definitive proxy statement is filed and until the date of the issuer's shareholders' meeting.[189] Since the no-action request, ISS has attempted to further separate its investor and corporate advisory businesses by creating a stand-alone subsidiary called ISS Corporate Services.[190]

ISS also believes that the publication of its Proxy Voting Manual helps protect against conflicts by making clear its position on various issues so that "each individual proxy analysis and voting recommendation is made on an objective basis."[191] Again, however, this raises the concerns created by a one-size-fits-all approach, which is perhaps necessitated by a need to appear objective. Further, these policies will incorporate the same errors as the corporate governance ratings, especially since the proxy advisory arm of ISS generally relies on the same policy constructs as ISS' governance ratings business.

Several points are worth noting in connection with the Division of Investment Management's response to the no-action request letter. First, the Division of Investment Management does not specifically grant no-action relief to ISS, noting that:

> In your letter, you specifically request no-action relief under rule 206(4)-6 under the Advisers Act. That rule addresses the adoption, implementation and disclosure of proxy voting procedures that are reasonably designed to ensure that investment advisers vote client proxies in their clients' best interests. You do not, however, request relief from any requirement of the rule. Consequently, we will not respond to your request for no-action relief under the rule.[192]

Second, like all SEC no-action letters, the SEC makes clear that it does not specifically approve of the ISS firewall, stating that it "take[s] no position . . . regarding whether ISS' conflict procedures . . . effectively ensure that its proxy voting recommendations to investment advisers are impartial."[193] Finally, the Division of Investment Management represents just one potential regulator within the SEC itself. The Division of Corporation Finance, which oversees proxy and shareholder proposal review and generally covers proxy policymaking, has stepped in to provide rules designed to

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188. *Id*. ISS also discloses the existence of its corporate relationships on each proxy analysis:

> This issuer may have purchased self-assessment tools and publications from ISS, or ISS' Corporate Programs Division may have provided advisory or analytical services to the issuer in connection with the proxies described in this report. Neither the issuer nor any Corporate Programs Division employee played a role in the preparation of this report. To inquire about any issuer's use of ISS Corporate Programs products please email disclosure@issproxy.com.

Id.

189. *Id*.

190. *See* Message from John M. Connolly, President and Chief Executive Officer, Inst. S'holder Servs., ISS Creates New Corporate Services Subsidiary, *available at* http://www.issproxy.com/about/ceoarchive/0706ceomessage.jsp (last visited Apr. 20, 2007).

191. *Id*.

192. Letter from Mari Anne Pisarri to Douglas J. Scheidt, *supra* note 186, at n.2.

193. *Id*.

limit auditor and analyst conflicts of interest and could design rules relating to proxy advisers. It is possible that the Division of Corporation Finance would take a different view of ISS' potential conflicts than the Division of Investment Management and, given its history with such rulemaking, it seems less likely that ISS' procedures would merit a no-action letter from the Division of Corporation Finance. In sum, the Division of Corporation Finance is under no obligation to refrain from regulating the corporate governance industry nor from referring a conflicts matter to the SEC's Division of Enforcement if it perceives a problem with the industry's activities.[194]

Other conflicts prevention rules, developed to address analyst conflicts of interest, provide models that may be more applicable to governance rating than the proxy voting rules. Regulation AC, which deals with analyst conflicts, addresses these concerns through a certification procedure. The certification requirement applies to "brokers, dealers, and their associated persons that are 'covered persons' that publish, circulate, or provide research reports."[195] The regulation requires analysts to certify that "the views expressed in the research report accurately reflect such research analyst's personal views about the subject securities and issuers," and also

> (1) that no part of his or her compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report; or (2) that part or all of his or her compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report. If the analyst's compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report, the statement must include the source, amount, and purpose of such compensation, and further disclose that it may influence the recommendation in the research report.[196]

As a conflicts prevention device, a certification procedure may be appropriate for governance ratings agencies, and would perhaps be welcomed by the corporate governance industry because it would enhance the credibility of internal conflicts prevention controls. Like Regulation AC, such a rule could require a certification that the analyst's compensation is not tied to the specific recommendations or views contained in the research report, and if the analyst's compensation is tied to specific recommendations or views, the certification should disclose the source, amount, and purpose of such compensation. A firm that uses quantitative methodology could argue that no conflict is possible given the objective nature of the analysis (there really are no analysts for governance ratings—just persons who collect data then input them into a model, without any opportunity to benefit from the analysis). However, the SEC considered but did not

194. Although the Division of Corporation Finance almost certainly would consult with the Division of Investment Management (IM) on the issue, the fact that IM did not grant specific no-action relief seems to leave the issue open to the Division of Corporation Finance. However, because ISS falls under IM's purview as a consultant to investment advisers, the Division of Corporation Finance may be deferential to IM's decision, although neither the Division of Corporation Finance nor the Division of Enforcement would be bound by IM's letter.

195. Letter from Mari Anne Pisarri, *supra* note 186, at n.2.

196. Regulation Analyst Certification, Securities Act Release No. 8193, Exchange Act Release No. 47,384, 68 Fed. Reg. 9841 (Apr. 14, 2003), *available at* http://www.sec.gov/rules/final/33-8193.htm.

accept that argument with respect to Regulation AC.[197] The SEC noted in the final rule release that if there is no identified analyst because the report is based on the firm's quantitative or technical model:

> the firm itself may provide the certifications that the views expressed in the research report accurately reflect the firm's quantitative research model, and that no part of the firm's compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views disclosed in the research report.[198]

The SEC also noted the possibility that a model could be skewed to favor certain companies:

> tying an analyst's [or a firm's] compensation to the performance of a quantitative or technical model would indicate that the report is the product of the analyst's subjective views (reflected by the design of the model employed). In that case, that analyst must certify the report containing the model's results in accordance with . . . Regulation AC.[199]

In the case of a governance ratings agency that also provides governance advisory services, the agency would likely create a "firewall" (as ISS has apparently done) in order to eliminate the possibility of a violation. The principal benefits of this form of regulation are that it allows the ratings firm to craft its own policies while encouraging sound conflicts prevention policies, and it provides the SEC a direct means to enforce governance ratings firms' conflicts. Also, if this Article's hypothesis that the perception of a conflict of interest may exacerbate methodology problems (firms worried about conflicts will use a more objective but less accurate "one-size-fits-all" methodology) is correct, a rule that certifies that there are no conflicts may relieve some of the pressure on these firms to stick with such a methodology, encouraging them to opt instead for a more flexible, case-by-case analysis.

Despite these benefits, however, it is worth considering whether governance ratings firms, in response to market pressures, will effectively self-regulate with respect to conflicts. For example, because of rules requiring proxy voting firms to vote in a client's best interest, some firms, such as ISS, have put in place sophisticated conflicts prevention procedures that should also prevent conflicts between governance ratings and governance advisory work. Other firms will also have basic competitive incentives to avoid conflicts—most importantly, their credibility as ratings firms may be jeopardized by the appearance of conflicts. A number of pension funds have migrated away from ISS, despite its conflicts prevention rules, because ISS suffers from the perception (although perhaps not the reality) of conflicts of interest.[200] If ISS continues to lose business, it may be pressured to strengthen the wall between its consulting business and its proxy advisory/governance ratings businesses. However, it is not clear how ISS could do this since, as noted above, ISS has created a stand-alone subsidiary for corporate advisory services and has separated the physical and technological operations of the potentially

197. *Id.*
198. *Id.*
199. *Id.*
200. *See* Starkman, *supra* note 7.

conflicting business units. But in any case, what may be at the root of the pension funds' concern is not the potential for conflicts per se, but the fact that ISS gives advice to companies at all, even if ISS only has the benign intention of enabling companies to improve their governance. Would ISS accept an unassailable conflicts prevention device—the sale of its corporate consulting businesses? The selling point of ISS' consulting service is that it can tell issuers exactly what they need to do in order to receive a good governance rating or approval for a compensation plan, so it is unlikely that ISS' consulting business could be as successful as a completely independent enterprise.

Another justification for allowing corporate governance raters to self-regulate is that SEC regulation of the industry may actually increase the market power of the few major corporate governance players. As Jonathan Macey has argued in the context of derivatives regulation (a much more competitive industry than governance ratings, at least in terms of the number of significant market participants), the fixed costs associated with regulation would serve as barriers to entry of new competitors in the market.[201] This would be an especially unfortunate side-effect in a market that is already dominated by a single firm which competes with only a handful of others.

B. Methodology Concerns

While there are good reasons why SEC regulation of conflicts of interest within corporate governance firms may not be ideal, the case for SEC regulation of methodology problems is even more tenuous. In the context of proxy advice, the Investment Advisers Act rule requiring advisers to vote in the shareholders' best interest may provide some general protection against outrageous methodological flaws. However, the more fundamental methodology concerns outlined above, which are perhaps more significant in governance ratings work than proxy advisory work, would be extremely difficult for the SEC to regulate.[202] This is especially so given that the basic premise of methodology regulation seems functionally equivalent to merit regulation, which is not part of the SEC's regulation program (the only area of SEC regulation that has come close is the SEC review of shareholder proposals that companies wish to exclude under Rule 14a-8).[203] Without a direct mandate from Congress, the SEC could only regulate methodology through disclosure and related antifraud rules. It is unlikely that the precise methodology would be disclosed, however. In order to protect trade secrets, the SEC does

201. Jonathan Macey, *Wall Street Versus Main Street: How Ignorance, Hyperbole, and Fear Lead to Regulation*, 65 U. CHI. L. REV. 1487 (1998). Macey notes that "[l]ong ago George Stigler recognized that regulation, including regulation of the securities markets, provided significant benefits to competitors by cartelizing the industry." *Id.* at 1506 (citing George Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117 (1964)). Note that this concern is somewhat mitigated by the fact that SEC regulation akin to Regulation AC would favor the creation of governance firms that are either investor-focused or issuer-focused, but not both, due to the cost of conflicts prevention.

202. Proxy advice, at least as performed by ISS, is not quite as black-and-white as its governance ratings—there is at least a basic review of the proposal, rather than a simple data entry function as takes place with governance ratings.

203. *See* Alan R. Palmiter, *The Shareholder Proposal Rule: A Failed Experiment in Merit Regulation*, 45 ALA. L. REV. 879, 886-89 (1994) (arguing that the responsibility for regulatory reform under Rule 14a-8 lies with the SEC).

not require such disclosure under its new rules for credit rating agencies (CRAs),[204] and it is unlikely that such disclosure would be required from governance raters. Instead of requiring methodology disclosure, however, perhaps the SEC could require a certification from the governance ratings firm that the rating represents the governance raters "true belief," as with research analyst certification.[205] Similar to the rules now applicable to credit ratings agencies, the SEC could also mandate that the governance ratings firms use systematic procedures "designed to ensure credible and reliable ratings, manage potential conflicts of interest, and prevent the misuse of nonpublic information, and [have] sufficient financial resources to ensure compliance with those procedures."[206] To protect trade secrets, merely requiring a basic description of the methodology, without requiring discussion of the weighting methodology, might be appropriate. However, the ratings firms already do this to some degree (at least those that rely on a one-size-fits-all approach), so the market is able to analyze whether such a method would work.

For these reasons, the best protection against methodology concerns may be simply heightened scrutiny by researchers, which will hopefully increase institutional investors' awareness of the flaws in proxy vote recommendations and governance ratings methodology. As discussed above, some governance metrics correspond to measurable improvements in firm performance while some do not, even though they have generally been thought to correlate with good firm performance.[207] Further, if ratings accuracy is to be a serious consideration, the complexity of the variables involved may ultimately preclude broadly applicable objectives measures. One might imagine that while certain governance criteria matter, they may only be important if other governance structures are present, or if a company is of a certain size, has a certain shareholder composition, or is at a certain stage of its life-cycle. Figuring out what matters, and what does not, all within a regulatory environment that is perpetually unstable (whether under Delaware decisions, new SEC rules, or exchange listing standard changes), will no doubt be an elusive goal.

C. The Homogenization of Corporate Law

The homogenization of corporate law is directly related to issues of methodology. I readily acknowledge that it is reasonable to restrict management activities in situations where we know such activities would damage a company. Professor Bebchuk and his colleagues, for example, have spent a great deal of effort arguing that certain anti-takeover structures damage companies, and he has produced evidence to demonstrate how that is so.[208] Accepting their research, we might agree that a company that institutes such poison pill structures (especially in combination with other structures such as a classified board) should receive a lower governance rating. Even in this scenario, however, we should be careful about applying general prohibitions—in some cases, such a structure might be consistent with shareholder interests if, as some argue, pills are used to increase an acquisition price. On the other hand, even where there is no such evidence

204. *See* Definition of Nationally Recognized Statistical Rating Organization, Exchange Act Release No. 33-8570, 85 SEC Docket 607 (Apr. 19, 2005), *available at* http://www.sec.gov/rules/proposed/33-8570.pdf.

205. *Id*.

206. 17 C.F.R. § 240.3b–10 (2006).

207. *See supra* Part II.B and accompanying text.

208. Bebchuk et al., *supra* note 116.

that a particular structure is undesirable, the fact that a governance ratings agency believes it to be may impede management from adopting it.

Again, I believe this concern is best addressed through the force of continued research. If research suggests that a particular "bad" governance structure does not negatively affect firm value (or perhaps is even shown to positively affect firm value), governance ratings agencies should cease penalizing it. If they do not, hopefully investors will discipline the ratings agency by moving to a competitor, or, in the case of proxy advice, will simply not follow the recommendation. However, this depends on the ability of the investors to recognize when ratings agencies are not in step with the research. It is not certain that institutional investors will see significant value in exploiting such inefficiencies.

One area in which the SEC could act is in clarifying fiduciary responsibilities with respect to proxy voting. The SEC's proxy voting rules have played a major role in the recent growth of the corporate governance industry. If the goal of the new proxy voting rules was to produce more dedicated oversight by fund managers, the regulation has the opposite effect: rather than more oversight, firms now outsource. The SEC could clarify its rules, however, to make clear that merely following the advice of a corporate governance adviser will not establish due care with respect to proxy voting.

V. CONCLUSION

The goal of this Article is to encourage academic interest in the corporate governance industry and its methodology, and to encourage debate on whether and how it should be monitored or regulated. The corporate governance industry in general plays a very significant role in capital allocation by collecting governance information and identifying poor performers. ISS and its competitors are also helping shareholders gain power[209] by providing a more unified voice, and may be (perhaps inadvertently) invigorating the market for corporate control. However, this Article offers several reasons why investors should be skeptical of the reliability of some of their recommendations. Although the SEC may help in this respect by more closely monitoring potential conflicts of interest within the corporate governance industry, SEC regulation of methodology concerns does not fall within the SEC's traditional scope of regulation and is outside the SEC's expertise.

Even if we accept that further SEC regulation of corporate governance is unlikely to help, the problems reducing the effectiveness of the corporate governance industry are not insurmountable. Increased competition in the industry may help discipline some of the problematic activity, especially if the competition comes from governance ratings agencies and proxy advisers that do not rely on unproven governance metrics and do not adopt a "one-size-fits-all" methodology. Further, there is already some evidence that investors will punish companies whose practices seem to be in actual or potential conflict with the investors' interests. Finally, continued academic interest by finance scholars and increased interest by legal scholars will also help clients of the corporate governance industry by testing whether the rules and standards proposed by the industry are

209. Whether or not this is a good thing is another debate. For an excellent recent discussion, see Iman Anabtawi, *Some Skepticism about Increasing Shareholder Power* (Univ. of Cal., Los Angeles, Sch. of Law, Law-Econ Research Paper No. 05-16, 2005), *available at* http://ssrn.com/abstract=783044.

appropriate and supported by reliable evidence.