GREAT EXPECTATIONS:
THE PERIL OF AN EXPECTATIONS GAP IN PROXY
ADVISORY FIRM REGULATION

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ABSTRACT

Large, institutional investors have come to wield great power over
shareholder votes in publicly held companies. These investors, with their
everous ownership shares, can dramatically influence issues that are
put to a shareholder vote. And when deciding how to cast their ballots,
institutional investors look to proxy advisory firms. These are entities
that advise investors on which actions to take in shareholder votes.
Because institutional investors prefer to focus on building portfolios,
rather than on researching shareholder votes, they often outsource these
duties to proxy advisory firms. As a result, financial industry and
government leaders have voiced concern that proxy advisory firms exert
too much power over corporate governance to operate unregulated. The
Securities and Exchange Commission as well as the U.S. Congress have
investigated and debated the merits of proxy advisory regulation. The
U.S. House of Representatives held a hearing on the matter in June of
2013, and the SEC followed this hearing with a roundtable discussion in
December of 2013. On June 30, 2014, the Investment Management and
Corporate Finance Divisions of the SEC issued a bulletin outlining the
responsibilities of proxy advisors and institutional investors when
casting proxy votes. As of yet, no binding regulation has been
promulgated, despite repeated calls for it. Rather than commenting on
that debate, this Article urges policymakers to consider the potential for
an "Expectations Gap" if proxy advisory regulation is adopted. An
Expectations Gap arises when the parties interested in regulation, in this
case particularly the mass media, academics, politicians and the general
public, inaccurately estimate the efficacy of a regulatory regime. They
typically overestimate a regulation's effectiveness, which in the proxy
advisory context could actually lead to a responsibility deficit. Both
proxy advisory firms and institutional investors could shift blame away
from themselves in the event of a corporate governance failure stemming

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from poorly-cast shareholder votes or a lack of oversight. This deficit would severely hamper the effect of any future regulation, and steps must be taken to reduce the possibility of that occurrence. This Article is the first to examine this potentially serious negative consequence of proxy advisory regulation. It is also the first comprehensive scholarly writing to propose solutions for minimizing an Expectations Gap arising from new regulation. This Article applies the Expectations Gap theory to the current proxy advisor debate taking place and uses the theory to develop mechanisms for making potential regulation more effective. Additionally, these suggestions are applicable to any new regulation that is susceptible to an Expectations Gap. Taken together or individually, these suggestions could improve information symmetry in the financial market and help prevent serious corporate governance failures.

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I. INTRODUCTION

Every law has a dual identity; two separate versions of the law in coexistence. One version is the law as it is enforced in the real world. This is the actual application of the written rules upon the actors governed by them. The other version of a law is the way that the law is perceived to work. This is composed of the collective beliefs of those affected by the law regarding how well the law is being enforced and how well it is achieving its intended goals. In a world of perfect information and rational, unbiased predictions, these two identities associated with each law would be exactly the same. The reality is often quite different, though, and the gap between these two versions of a law can produce significant negative consequences. This Article examines the phenomenon just described, which is termed an "Expectations Gap," in the context of proposed regulation in the field of public shareholder proxy advising. This potential regulation carries a significant risk that it will create an Expectations Gap for reasons described later in this Article. Fortunately, several steps can be taken to mitigate this risk and promote effective regulation.

Over the past few years, Congress and the Securities and Exchange Commission ("SEC") have come under increasing pressure to regulate proxy advisory firms operating in the United States and global proxy voting system. These firms, which help institutional investors
"determine how to vote their clients' shares on literally thousands of proxy questions companies pose each and every year, have been accused of having too much influence on institutional investors. Proxy advisory firms have indeed grown to play an increasingly influential role in corporate governance. Critics allege that institutional investors rely exclusively on the recommendations of proxy advisory firms without conducting sufficient analysis of their own. Many are also concerned that proxy advisory firms create conflicts of interest for themselves. Other criticisms leveled at proxy advisory firms include lack of transparency concerning the way they formulate their recommendations, reliance on a "one-size fits all" methodology, lack of competition in the advisory market, and the practice of providing

or may opt to grant the proxy discretion to make the voting decision. Id. at § 2. The proxy card may be submitted to the company via the mail or online. Proxy rules are covered by SEC Regulation 14A. See 17 C.F.R. §§ 240.14a-1 to -14b-2 (2014).

The Organisation for Economic Co-operation and Development ("OECD") defines institutional investors as "financial institutions that accept funds from third parties for investment in their own name but on such parties' behalf." See OECD, THE ROLE OF INSTITUTIONAL INVESTORS IN PROMOTING GOOD CORPORATE GOVERNANCE 9 (2011)

The Organisation for Economic Co-operation and Development ("OECD") defines institutional investors as "financial institutions that accept funds from third parties for investment in their own name but on such parties' behalf." See OECD, THE ROLE OF INSTITUTIONAL INVESTORS IN PROMOTING GOOD CORPORATE GOVERNANCE 9 (2011), archived at http://perma.cc/UV6L-ZTF4. Institutional investors include insurance companies; private pension funds; corporate, state, municipal and labor union pension funds; commercial banks; educational and other endowment funds; trust funds; collective investment funds; hedge funds; SEC-registered investment advisers; private equity funds; state-registered investment advisers; venture capital funds; and mutual funds. Most proxy votes are cast by or on behalf of institutional investors given the level of stocks they manage as compared to other types of investors. See id.


Speaking to the Practising Law Institute in 2009, then-SEC Chairman Mary Schapiro said of shareholder access, "Corporate governance, after all, is about maintaining an appropriate level of accountability—accountability to shareholders by directors whom shareholders elect, and by managers whom directors select." Mary Schapiro, Chairman, Sec. & Exch. Comm., Address to the Practising Law Institute's 41st Annual Institute on Securities Regulation (Nov. 4, 2009) archived at http://perma.cc/5Z5J-9S3X.

See Letter from Edwards S. Knight, Exec. V.P., Gen. Counsel & Chief Reg. Officer, NASDAQ OMX, to Elizabeth M. Murphy, Sec. & Exch. Comm'n 5 (Oct. 8, 2013) [hereinafter NASDAQ Petition], archived at https://perma.cc/7WH2-KWVU (noting inability of companies to review or correct the reports of their proxy advisory firms).

According to this concern, voting recommendations of proxy advisors "can lack individualized industry and company analysis" and "are often made on the basis of generic models, without considering the specific circumstances of a company or the array of reasonable choices among compensation policies and practices." Id. at 6. In other words, the one-size fits all approach describes a situation in which advisors apply generic, formulaic approaches without taking into account company-specific or industry-specific circumstances in making voting recommendations.

See NASDAQ Petition, supra note 10, at 2 (noting that two proxy advisory firms control virtually 97% of the market for proxy advisory services).
only an extremely limited opportunity—if any at all—for companies to review a draft copy of their reports.\textsuperscript{15}

The wave of criticism has caused Congress and SEC to seriously consider regulating proxy advisory firms.\textsuperscript{16} It prompted the SEC's concept release published in July of 2010.\textsuperscript{17} The release generated enormous interest and resulted in the SEC receiving 307 comment letters.\textsuperscript{18} The momentum generated by the debate recently culminated in a hearing before the U.S. House of Representatives held in June of 2013\textsuperscript{19} and a roundtable conducted by the SEC in December 2013.\textsuperscript{20} Since then, interest in the issue has not abated.\textsuperscript{21} The significant number of commenters submitting input regarding the SEC's concept release, as well as the rich variety of participants who took an active part in the discussions conducted afterwards, have drawn the attention of Congress and the SEC to the many merits of proxy advisory firm regulation.\textsuperscript{22} However, the potential costs involved in such regulation have garnered little attention, if any at all. This Article seeks to help fill that void in the proxy firm regulation debate. It will take a critical look at the proposed regulatory intervention in proxy advisor operations.\textsuperscript{23} In particular, this Article will explore why an "Expectations Gap" regarding proxy advisor regulation is likely to form and what its potential effects would be.\textsuperscript{24} The Article will conclude by suggesting methods for reducing Expectations Gaps generally,\textsuperscript{25} and it will apply these suggestions to show how an Expectations Gap could be managed in the proxy advisory context.\textsuperscript{26}

The most recent development occurred, on June 30, 2014, when the Investment Management and Corporate Finance Divisions of the SEC, issued Staff Legal Bulletin Number 20 that provided guidance to investment advisors and institutional investors on their proxy voting

\textsuperscript{15} See supra note 3, at 2-7 (arguing for and against proxy advisory firm regulation).


\textsuperscript{18} See supra note 3.

\textsuperscript{19} Transcript of Proxy Advisory Firms Roundtable, Sec. & Exch. Comm'n (Dec. 5, 2013) [hereinafter SEC Roundtable], archived at http://perma.cc/Z57U-QNGW.

\textsuperscript{20} See, e.g., SEC Comments, supra note 18.

\textsuperscript{21} See supra Part III.

\textsuperscript{22} See infra Part IV.

\textsuperscript{23} See infra Part VI.

\textsuperscript{24} See infra Part VII.
responsibilities and the use of proxy advisors. However, as stated in the bulletin "this bulletin is not a rule, regulation or statement of the Commission. Further, the Commission has neither approved nor disapproved its content." Moreover, as noted in many forums, the guidance is far from satisfying for those who have urged the SEC and Congress to regulate proxy advisory firms and who were hoping the SEC would adopt a more comprehensive and robust plan. So, it may be just a matter of time before the SEC acts more vigorously, at the Commission-level rather than the Staff-level. This Article addresses the

27 SEC Staff Legal Bulletin No. 20 (IM/CF), 2014 WL 2965312 (June 30, 2014), archived at http://perma.cc/L7KN-MD8R (consisting of a set of questions and answers summarizing investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms, as well as the availability and requirements of two exemptions to the federal proxy rules that are often relied upon by proxy advisory firms).

28 Id.

29 See SEC Staff Provides Limited Guidance in Connection with Ongoing Debate over Proxy Advisory Firms' Influence on Corporate Governance Matters, JUST THE BASICS (July 3, 2014) [hereinafter JUST THE BASICS], http://kdcramer.wordpress.com/tag/proxy-advisory-firm ("For companies, business groups and their allies looking for bolder action by the SEC to increase the regulation of proxy advisory firms, the limited nature of this week's guidance will be a major disappointment."); Andrew Ackerman, SEC Presses Proxy Firms on Conflicts in Long-Awaited Guidance, WALL ST. J. (June 30, 2014), available at http://online.wsj.com/articles/sec-presses-proxy-firms-on-conflicts-in-long-awaited-guidance-1404179125:

Critics of proxy firms didn't get all they sought, such as a requirement the firms register with the SEC and that they give public companies more time to review their recommendations before publication.

"The SEC has taken this important first step towards bringing the appropriate checks and balances to the proxy advisory industry," said Tom Quaadman, vice president of the Chamber's Center for Capital Markets Competitiveness, in a statement. "Of course, more remains to be done."

See also Jim Kroll & Brian Myers, SEC Staff Issues Guidance on Proxy Voting Responsibilities and Proxy Advisors, TOWERS WATSON (July 3, 2014), archived at http://perma.cc/9FWM-C4CX ("The bulletin... may disappoint companies concerned about proxy advisor influence on executive compensation that had hoped the SEC would take stronger action."); Hilary Johnson, SEC Fails To Curb Proxy Advisory Firms, FIERCECFO (July 7, 2014), archived at http://perma.cc/YLL6-NFYM (quoting David Katz, Trevor Norwitz, and Sebastian Niles, partners and counsel, respectively, at Wachtell, Lipton, Rosen & Katz):

This SEC Staff-level guidance is a step in the right direction towards addressing the outsized role of proxy advisory firms in corporate governance and economic matters, . . . However, we believe that further Staff, Commission-level or legislative action will be necessary to increase the overall accountability of proxy advisory firms, resolve conflicts of interests and address the lack of transparency into their methodologies and analyses.
strong possibility that the SEC will follow this bulletin with actual regulation and warns against an Expectations Gap that may arise should this occur.

The term "Expectations Gap" appears to have been coined in 1974 by Carl D. Liggio. John E. McEnroe and Stanley C. Martens wrote that the phrase "Expectation Gap" stood for the "difference between (1) what the public and financial statement users perceive auditors' responsibilities to be and (2) what auditors believe their responsibilities entail." Over the years, this definition has been widely extended, and it has gained impressive attention in the academic literature across many disciplines. To illustrate this point, as of October of 2014, Google Scholar recorded about 5,880 articles that used "Expectations Gap" as an exact phrase—407 of which cited the phrase in the title of the article. Accounting was the discipline producing the most articles referring to Expectations Gaps. Most importantly for this Article, though, is that the Expectations Gap theory is applicable to the rift that can develop when a law or regulation is perceived to be more effective or enforced more than it really is. As discussed in this Article, an Expectations Gap is the difference between a regulation's perceived and actual efficacy. The gap is the result of both a lack of accurate information about a regulation's efficacy and cognitive biases that adversely influence the manner in which people make predictions. The Expectations Gap can lead to negative consequences that countermand the regulation's goal, and once created, these gaps can be very difficult to close.

So far, the concept of the Expectations Gap has not played a significant role in regulation and policy design. In fact, in this area, it

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30See infra Part II.A.
31See infra Part II.B.
32Liggio, supra note 2, at 27.
35http://scholar.google.com (enter "expectations gap" in quotation marks into search box; then click on search button); see also http://scholar.google.com (enter allintitle: into search box; then enter "expectations gap" in quotation marks into search box; then click on search button).
36http://scholar.google.com (enter accounting into search box; then enter "expectations gap" in quotation marks into search box; then click on search button).
37See infra Part II.C.
38See infra Part II.C.
39See infra Part II.C.
40See infra Part II.C.
41See infra Part VI.
has been almost completely ignored in both governmental and academic circles. However, there have been three important studies. First, Cass Sunstein wrote an article that discussed the division between experts and ordinary people regarding the way such people perceive risks and the implications thereof for law and policy. Second is Donald C. Langevoort's essay, which highlights the Expectations Gap stemming from the difference between the way in which investors perceive the degree of protection afforded by securities regulation as opposed to the actual level of protection that they receive. Third and finally, Amitai Aviram's studies make some progress in exploring the way politicians—and private parties such as insurers and the media—who identify a risk that is either overestimated or underestimated by a segment of their constituency then reap a "private profit from an action that mitigates the discrepancy between the actual and the perceived risk." This Article continues this line of research and breaks entirely new ground in the application of the Expectations Gap model in the regulatory setting. It does so by examining the consequences of an Expectations Gap for both the regulators and those being regulated and by proposing ways to minimize or eliminate a regulatory Expectations Gap that are applicable to any form of new regulation. All of this is done in the specific context of proposed proxy advisor regulation, which carries with it a very high risk of an Expectations Gap.

To understand the problems caused by an Expectations Gap, one must understand the gap itself. This Article explains the divergence between the real quality of a regulation and the regulation's quality as it perceived by those who are not subject to it and who are the recipients of

42See infra Part VI.
43See Sunstein, supra note 1, at 1120-22 (focusing largely on PAUL SLOVIC, THE PERCEPTION OF RISK (2000)).
45Amitai Aviram, Bias Arbitrage, 64 WASH. & LEE L. REV. 789, 792 (2007); see also Amitai Aviram, The Placebo Effect of Law: Law's Role in Manipulating Perceptions, 75 GEO. WASH. L. REV. 54, 78 (2006) ("[C]ognitive biases invariably cause misperceptions of risks among some segments of a politician's constituency."). Politicians who can identify risks that are overestimated and manipulate "biases in the presentation of enacted laws so that a law is perceived as reducing the risk to a greater extent than it actually does" are able to "capture credit for mitigating the perceived risk . . . ." Id.
46See infra Part III.A.
47See infra Part IV.
48See infra Part VI.
49See infra Part III.A.
the regulatory signal ("signalees").50 These are the individuals or groups that receive an implicit message from a regulatory scheme.51 Many of the signalees have an interest in the regulation, and will somehow modify their behavior based on what they believe the regulation's effect will be.52 This Article focuses on situations in which signalees hold overly optimistic expectations of a regulation's efficacy and overall positive impact.53 It goes beyond the common cognitive explanations used by the previously mentioned studies and explains in-depth how an Expectations Gap may be created by a new regulation, how the regulation's characteristics will influence the size of the Gap, and why the Gap may persist long after the regulation takes effect if signalees lack incentives or capabilities to reduce the gap.54

This Article then illuminates that the Expectations Gap problem is likely to arise if proxy advisory firms are regulated in the manner currently suggested by academics, practitioners, and policy-makers.55 It focuses on a wide range of signalees, including institutional investors, public companies, the media, the broad public, and even the SEC and the U.S. Congress, to determine the probable effects of proxy advisory regulation.56 The very potential for an Expectations Gap, let alone the risks it poses in the context of proxy advisory regulation, has been an utterly ignored issue. While most current discourse regarding proxy advisory regulation has been largely in favor of regulation, few have urged caution or highlighted potential shortcomings of such action. This is the first contribution to what will hopefully become a significant dialogue about the dangers of an Expectations Gap.

As this Article will demonstrate in detail, regulation of proxy advisors is likely to raise high expectations among signalees.57 Put simply, the signalees are likely to believe that the research and recommendations of proxy advisors are closely monitored by the SEC,
and therefore can be relied upon. In reality, the many different types of regulation that have been suggested by market practitioners, and are now being contemplated by the SEC and Congress, are not capable of ensuring effective oversight of proxy advisory services. This Article shows that an Expectations Gap may be created because signalees do not hold all the information required to accurately assess a regulation's effectiveness—a situation of asymmetric information—and are susceptible to cognitive biases that may cause them to misjudge the effectiveness. Further, it demonstrates how the Expectations Gap may persist because signalees lack sufficient incentives or capabilities to reduce the gap.

Taken together, the creation of an Expectations Gap and the low probability that signalees will close it can lead to two major unintended consequences. These consequences will allow proxy advisors and institutional investors to gain private benefits at the expense of proxy voting efficiency, shareholder value, and good corporate governance.

First, regulation may cause increased confidence in proxy advisory firms while actually decreasing the quality of services provided by such firms. Due to the Expectations Gap, signalees, who would perceive it to be an efficient tool for supervising proxy advisors, may overestimate

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58 See Rebecca M. Bratspies, Regulatory Trust, 51 ARIZ. L. REV. 575, 584-85 (2009) (explaining that trust in a regulating entity may generate confidence in the regulatee's conduct).
59 See JUST THE BASICS, supra note 29 (discussing the "limited nature" of the SEC's recent regulatory guidance directed at proxy advisory firms).
60 See infra Part III.B.
61 See infra Part II.B.
62 See infra Part II.B (describing the persistence of the Expectation Gap among the seven types of signalees).
63 See infra Part IV.A-B (discussing the consequences faced by both proxy advisory firms and institutional investors).
64 See Aviram, Bias Arbitrage, supra note 45, at 792 (expounding upon the concept of bias arbitrage). To clarify, while Aviram is focused on regulators' benefit from the Gap (and potential benefit for other private arbitrageurs, such as insurance providers and the media), id. at 792-93, this Article explores the benefits for regulates (in this case, the proxy advisory firms) and those related to them (in this case, the institutional investor clients of the advisory firm). See infra Part IV.A-B. This is the first scholarly article to address the manner in which regulates may benefit from an Expectation Gap. Further, while Aviram concentrates on cognitive biases as the main reason for "Bias Arbitrage," Aviram, Bias Arbitrage, supra note 45, at 795, this Article expands the reasons for the "Gap" to include lack of signalees' capabilities and/or incentives for conducting research needed to close the Gap. See infra Part III.B.
65 But see Holly J. Gregory, SEC Guidance May Lessen Investment Advisor Demand for Proxy Advisory Services, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 29, 2014, 9:10 AM), archived at http://perma.cc/UP76-7UZ3 (suggesting that regulation may improve proxy advisory firm's quality of services).
the regulation's effectiveness. Consequently, confidence in proxy advisors would increase. Regulation may also release advisors from some degree of the "undesirable" attention and pressure currently exerted by signalees in the absence of regulatory intervention. Such pressure now flows through the media and is exerted by the public companies currently opposing advisors' unrestrained operations. Furthermore, regulatory intervention in proxy advisors' operation may provide advisors with quasi-insurance, allowing them to deflect reprobation and responsibility towards the SEC in cases where their suboptimal analysis and recommendations fail to prevent corporate wrongdoing. All of the above-mentioned factors could lead to a responsibility deficit and may unintentionally cause proxy advisors to invest less in research and recommendation processes. At the end of the day, the quality of proxy advisors' services could suffer.

66See Bratspies, supra note 58, at 584-85 (demonstrating the overestimated effectiveness of regulators that are perceived to be trustworthy, such as the Food and Drug Administration).

67See id.


69See Andrew Ackerman et al., ISS. Other Proxy Advisers Pressed to Disclose Conflicts: SEC Readies New Guidelines for Firms That Advise Shareholders, WALL ST. J. (June 3, 2014), http://online.wsj.com/articles/sec-to-pressure-proxy-advisers-on-disclosures-1401798780:

The U.S. Chamber of Commerce, the Center on Executive Compensation and the Society of Corporate Secretaries and Governance Professionals have all urged the SEC to act, arguing proxy advisors aren't responsive enough to companies' concerns and have too much sway over corporate governance issues, including who sits on corporate boards and how directors oversee their companies and pay top executives. See also Steven Davidoff Solomon, Proxy Firms Need More Rules, Companies Say, N.Y. TIMES DEALBOOK (Nov. 30, 2010), archived at http://perma.cc/4NBV-74Z6 (providing examples of public companies' comments arguing for regulation of proxy advisory firms); infra Part V.B (referencing some of the major events regarding public companies' push for the power of proxy advisory firms to be restricted).

70See Letter from Timothy J. Bartl, Senior V.P. and Gen. Counsel of the Ctr. On Exec. Comp., to Elizabeth M. Murphy, Sec'y of the Sec. & Exch. Comm'n, (Oct. 25, 2010), archived at http://perma.cc/4NBV-74Z6 (explaining that an SEC interpretation permits institutional investors to consider their fiduciary duties discharged so long as the investors have followed the recommendations of proxy advisory firms).

71But see Gregory, supra note 65 ("As a result of the greater oversight exercised by all of their investment adviser clients, the proxy advisory firms will presumably respond by enhancing their policies, processes and procedures, as well as the transparency of these policies, processes and procedures. In turn, the corporate community may indirectly benefit to some degree.").
Second, regulation may drive the institutional investors to become even more dependent on proxy advisors. 72 Such regulation is likely to cause the advisors to serve as de facto gatekeepers. 73 From the institutional investors' perspective, regulation of proxy advisors may allow them to share with the advisors any criticism they receive regarding the manner in which they cast proxy votes and fulfill corporate governance responsibilities. 74 This would create a blame game, allowing institutional investors to shift the blame on to the advisors and even onto the SEC in a case of a governance failure or scandal. 75 As this Article will explain, the danger posed by the Expectations Gap and its perverse effects are particularly relevant in cases such as proxy advisors regulation, where it is difficult to measure whether the regulated party has actually done a good job. 76

It is perhaps worth noting at the outset that this Article does not suggest that regulation of proxy advisory firms is ill advised. Instead, it suggests incorporating the Expectations Gap theory into the regulatory process by four means. 77 First, regulatory agencies should integrate an appraisal of potential Expectations Gaps into the Regulatory Impact Analysis, which is conducted by regulatory agencies when contemplating new regulatory and policy issues. 78 As a second solution, this Article suggests that promulgations of regulations, at least significant ones, should include "disclaimers," in order to shape and limit expectations arising from the regulation by pointing to potential incongruities between the regulation's purpose and performance. 79 Third, this Article proposes that an agency publishing a notice of final rulemaking in the Federal Register should include a section detailing how the agency will

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72 But see id. (indicating that the SEC guidance may cause institutional investors to become less dependent upon proxy advisory firms).

73 See John C. Coffee, Jr., Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms, 84 B.U. L. REV. 301, 308-11 (2004) (describing an elaborate definition of the term "gatekeeper" and its fundamental concepts, including the two core underlying elements). First, the gatekeeper has "significant reputational capital, acquired over many years and many clients, which it pledges to assure the accuracy of statements or representations that it either makes or verifies." Id. at 308. Second, the gatekeeper "receives a far smaller benefit or payoff for its role . . . ." Id. See also Stephen Choi, Market Lessons for Gatekeepers, 92 Nw. U. L. REV. 916, 918 (1998) ("[Certification] intermediaries screen for product quality and certify value to purchasers in the market . . . .").

74 See David A. Lagnado et al., Causal Responsibility and Counterfactuals, 37 COGNITIVE SCI. 1036, 1046-53 (2014) (assessing the allocation of blame in situations where there are multiple parties involved).

75 See id. at 1046 (presenting a hypothetical to demonstrate the varying degrees of responsibility and blame).

76 See infra Part III.B.

77 See infra Part VI.

78 See infra Part VI.

79 See infra Part VI.
implement the rule and test its effectiveness over time. Fourth and finally, this Article suggests that the content of informational communications released by agencies regarding new, significant regulation should be monitored by a disinterested third party, perhaps the Office of Information and Regulatory Affairs. Taken together or individually, all of these measures could help prevent significant regulatory Expectations Gaps from forming and in turn prevent the negative consequences caused by the Gaps.

This Article is organized as follows: Part I provides a short historical background, from the growth of institutional investors, through proxy advisors' evolution, and culminating in the emergence of calls for regulatory intervention in proxy advisors' operation. Part II develops the Expectations Gap model and describes the way such gaps are created and why they tend to persist. Part III applies the model to the proxy advisory firm context. Part IV demonstrates negative consequences of an Expectations Gap within the context of proxy advisory firm regulation. Part V briefly presents other perverse effects likely to result from proxy advisor regulation and explains why concerns currently raised regarding advisors are likely exaggerated. Part VI outlines four potential solutions for managing Expectations Gaps in general and with regard to proxy advisory regulation in particular. Part VII provides responses to possible arguments in favor of an Expectations Gap.

II. BACKGROUND

This Part lays the groundwork for the subsequent discussion of the Expectations Gap theory and its relevance in the proxy advisory context. It does so by providing a short overview of the way advisors have acquired their market power and influence over corporate governance voting, and the reasons that the scope and use of this power has provoked criticism and a strong call for regulatory intervention. The evolution of

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80 See infra Part VI.
81 See infra Part VI.
82 See infra Part I.
83 See infra Part II.
84 See infra Part III.
85 See infra Part IV.
86 See infra Part V.
87 See infra Part VI.
88 See infra Part VII.
89 See Tamara C. Belinfanti, The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control, 14 STAN. J.L. BUS. & FIN. 384, 385 (2009) (discussing proxy advisors' increasing influence in corporate governance voting); see also CTR. ON EXEC. COMP., A CALL FOR CHANGE IN THE PROXY ADVISORY INDUSTRY STATUS
the proxy advisory industry is closely connected to the evolution of institutional investors throughout the past few decades and their symbiotic relationship has, in part, given rise to both the calls for proxy advisory firm regulation and the problems likely to develop from an Expectations Gap.

Over the last thirty to forty years, institutional investors have played an increasingly prominent role in corporate governance. This rise is commonly attributed to the steady growth in their proportional ownership of U.S. public companies. Institutional investors now account for over 70% of share ownership in the 1,000 largest U.S. corporations. SEC regulations have significantly expanded the type of issues now subject to shareholder votes, and this expansion has increased the number of shareholder proposals subject to votes at annual shareholder meetings. These increased shareholder proposals have also helped create the current relationship between the institutional investors and proxy advisory firms, because investors are being called upon much more frequently to cast votes in these proposals.

The relationship between investors and advisors has been further cemented by two seminal initiatives that have reinforced fiduciary duties.
of institutional investors related to proxy voting.95 The first initiative is an opinion letter published by the U.S. Department of Labor—commonly known as the "Avon Letter"—stating that shareholder voting rights are considered valuable pension plan assets under the Employee Retirement Income Security Act ("ERISA"), and therefore the fiduciary duties of loyalty and prudence applied to proxy voting.96 Thus, pension plan fiduciaries—such as union, corporate, and other officials who control or manage a plan’s assets—must vote the plan’s shares on the basis of active analysis, regardless of whether or not the fiduciary was certain that expending time and effort to analyze how to vote would create value for a fund.97 Casting their proxy votes wisely is no longer merely a question of generating value for the fund, but also of insulating the institutional investor from claims for breaches of fiduciary duties.98

The second important initiative is the SEC’s new rule and amendments under the Investment Company Act of 1940.99 These rules govern mutual funds and registered investment advisers,100 and were designed to encourage the funds and investment advisors to vote their proxies in the best interests of their clients.101 The new rule requires an investment adviser who exercises 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,102 to disclose to

97CTR. ON EXEC. COMP., supra note 89, at 17 (referring to the Department of Labor's "Avon Letter" of 1988 that declared shareholder voting rights were valuable assets under ERISA and thus subject to fiduciary duties).
98Id.
100"Investment advisor" is defined as:
[A]ny person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities .... § 202(a)(11), 15 U.S.C. § 80b-2(a)(11).
clients information about their policies and procedures, and to disclose to clients how they may obtain information on how the adviser has voted their proxies. The rule amendments also require advisers to maintain certain records relating to proxy voting.

Taken together, these market developments and regulatory initiatives have forced institutional investors to execute votes in accordance with strict fiduciary obligations and disclosure requirements for thousands of public companies on an annual basis. To illustrate this, from May 1, 2009, through April 30, 2010, nearly one trillion shares were voted at more than 13,800 shareholder meetings of U.S. companies. This is an enormous and costly burden, and institutional investors have been understandably less than enthusiastic at the prospect of shouldering it all themselves.

As a separate but related point, institutional investors have traditionally been accused of acting with conflicts of interests, especially regarding highly visible decisions. The core conflict stems from fund managers' unwillingness to hold accountable the boards and managers of companies in which the fund invests because they fear losing corporate business. This situation has been ameliorated by two regulatory actions. First, is the SEC's 2003 proxy voting regulation, by which the SEC indicated that an investment adviser could demonstrate that its vote of its clients' proxies was not a product of a conflict of interest if the adviser voted the proxies in accordance with a pre-determined policy based on the recommendations of an independent third party. So if the

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103 Id. at § 275.206(4)-6(c).
104 Id. at § 275.206(4)-6(b).
105 Id. at § 275.204-2(b)(5)(c)(2)(i).
109 See Bernard S. Black, Agents Watching Agents: The Promise of Institutional Investor Voice, 39 UCLA L. REV. 811, 826-27 (1992); JAMES K. GLASSMAN & J.W. VERRET, MERCATUS CTR., HOW TO FIX OUR BROKEN PROXY ADVISORY SYSTEM 8 (2013) ("Proxy advisors also have shown a tendency toward ideological bias in their recommendations, especially in areas that involve labor union power, executive compensation, and the environment.")
111 See infra notes 112-16 and accompanying text.
adviser's voting decision was made based on third party advice, there would be no conflict of interest. Second is the No-Action letter issued in May 2004, to the small proxy advisory firm Egan-Jones, in which the SEC stated "the recommendations of a third party that is in fact independent of an investment adviser may cleanse the vote of the adviser's conflict." The letter added that the "[SEC] believe[s] that the mere fact that the proxy voting firm provides advice on corporate governance issues and receives compensation from the Issuer for these services generally would not affect the firm's independence from an investment adviser." Later that year, the SEC's staff issued a similar No-Action Letter to the Institutional Shareholder Services Inc. ("ISS") which described some of the reasonable steps that investment advisers should take to ensure that, among other things, the [proxy advisory] firm can make recommendations for voting proxies in an impartial manner and in the best interests of the adviser's clients. The key takeaway here is that the SEC has clearly indicated that reliance on third party advisory opinions removes conflict of interest concerns when institutional investors cast proxy votes.

In conclusion, the ever increasing burden on institutional investors—which frequently complained that they lack the time, information, and energy to serve effectively on each meeting—coupled with the opportunity to eliminate potential conflicts of interests, has led institutional investors to outsource "key proxy voting functions and corporate governance decisions" to proxy advisors. Over the past

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113 Id.
115 Id. (explaining the purposes of making voting recommendations concerning the issuer's proxies for the investment adviser's clients).
117 See id.
118 See, for example, SEC Roundtable, supra note 20, at 45, in which Michelle Edkins, Managing Director and Global Head of Corporate Governance and Responsible Investment at BlackRock, Inc., remarked, "[W]e are all under time pressure, huge time pressure. There are days when we are voting 25, 30 meetings across our team." Edkins continued: "[S]o in the U.S. we vote at about 3,700 company meetings a year. Now, globally we vote at about 15,000." Id. at 48. Jeffrey Brown, from the Legislative and Regulatory Affairs department of Charles Schwab, also commented: "You know, at Schwab in 2012 for the investment adviser we had 27,000 ballots and about 270,000 separate votes. Those would take an enormous amount of time for an index shop to manage if you didn't outsource that process." Id. at 78.
119 Belinfanti, supra note 89, at 384; see also SEC Roundtable, supra note 20, at 21 (Norm Champ, Director of the Division of Investment Management of the SEC, noted that the adoption of Rule 206(4)-6, together with the staff interpretive guidance that followed has "paralleled" proxy advisory firm expansion); Lynn A. Stout, Why Should ISS be the New Master of the Corporate Governance Universe?, CORP. GOVERNANCE (Dow Jones & Co.,
decade proxy advisory firms—especially ISS which controls roughly 61% of the U.S. market for proxy advisory firm services and Glass, Lewis & Co., LLC which has a market share of roughly 36%—play an increasingly crucial role in corporate ballot issues. These firms provide analysis and voting recommendations on matters appearing on the proxy, and other services, such as executing votes in accordance with investor instructions, engaging in recordkeeping and other administrative tasks associated with voting, conducting corporate governance research, and helping to mitigate conflict of interest concerns that their clients may have.

The increasing use of proxy advisors has produced a wave of criticism, based on concerns related to the operation of the advisors themselves. These concerns are focused on five specific issues. First, the conflict of interest for proxy advisors which occurs when firms providing proxy advisory services also have interests in either the companies holding the shareholder meetings or in policy concerns underlying the issues put to a shareholder vote. For example, ISS provides "both proxy voting recommendations to investment advisers and other institutional investors and consulting services to corporations seeking assistance with proposals to be presented to shareholders or with improving their corporate governance ratings." Glass Lewis does not offer corporate governance advice to public companies, but the Ontario Teachers' Pension Plan Board, which manages a fund with more than $100 billion in assets, owns it and is an activist investor engaged in


120 GLASSMAN & VERRET, supra note 109, at 8.
121 See id. at 9.
122 See Belinfanti, supra note 89, at 390-402 (discussing the various services offered by proxy advisory firms).
123 See SEC Concept Release, supra note 17, at 43,011.
124 See id.
125 See id. at 43,011-12; see also Belinfanti, supra note 89, at 402-03 (explaining that despite criticism for ISS's many conflicting interests to the point of being "blatantly opportunistic," ISS is still the top choice for mutual funds and is the largest player in the industry); Sagiv Edelman, Proxy Advisory Firms: A Guide for Regulatory Reform, 62 EMORY L.J. 1369, 1383-84 (2013) (expressing concern that the integrity of voting recommendations issued by the proxy advisory firm could be tainted by business considerations); Belinfanti, supra note 89, at 397 n.71 (explaining the second potential conflict exists only for ISS, because the other proxy advisors do not provide consulting services).
126 See Belinfanti, supra note 89, at 397; see also Hearing Before the House of Rep., supra note 3, at 403 (statement of Katherine H. Rabin, Chief Exec. Officer, Glass Lewis & Co.) (expressly stating that Glass-Lewis does not provide consulting services).
both public and private equity. Concern has been raised that Glass Lewis may recommend a favorable vote on activist measures undertaken by its owner. Second, there is a lack of accuracy and transparency in how advisors formulate their voting recommendations. Third, there is the limited opportunity—typically 24 to 48 hours—given to public companies to review a draft copy of advisors' reports. Fourth, there is the lack of competition in the proxy advisory industry. Fifth and finally, there is limited accountability of proxy advisors which do not have a financial stake in the companies about which they provide voting advice: the proxy advisors owe no fiduciary duties to the shareholders of these companies and are not subject to any meaningful regulation. These concerns are exacerbated by the extreme influence that proxy advisors may wield over their clients—mainly institutional investors—who, as many suggest, blindly follow advisors' recommendations and may be subject to the significant sway the advisors have over corporate vote outcomes.

127 See Belinfanti, supra note 89, at 396-97.
129 See SEC Concept Release, supra note 17, at 43,012 (expressing concern that proxy advisory firms' recommendations may be based upon inaccurate or incomplete data).
130 Moreover, some sources indicate that ISS provides drafts only to S&P 500 companies, while Glass-Lewis does not provide reports drafts to any public companies except those that pay for a subscription. See, e.g., Hearing Before the House of Rep., supra note 3, at 159-60 (containing written statement of Niels Holch, Exec. Director of Shareholder Communications Coalition).
131 See Hearing Before the House of Rep., supra note 3, at 70 (providing a short discussion of the background to centralization of the proxy advisory market).
133 See U.S. GOVT ACCOUNTABILITY OFFICE, GAO-07-765, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING 8-9 (2007) [hereinafter GAO 2007], archived at http://perma.cc/56AL-NAYN (observing that ISS and Proxy Governance, Inc. (PGI) are registered with the SEC as investment advisors while Glass Lewis and Egan-Jones are not registered as such).
135 See Leo E. Strine, Jr., The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face, 30 DEL. J. CORP. L. 673, 688 (2005) (explaining how even the most powerful CEOs will beg advisors to listen to their pleas for specific action, recognizing that many institutional investors will simply accept the advisor's decision without judging its merits); see also Edelman, supra note 125, at 1385-86; SEC Roundtable, supra note 20:

During my first tour at the Commission, I first became aware of the role played by proxy voting advice from a research project conducted by four Commission economists, including one of our distinguished panelists, Mark Chen, who returns to the Commission today from Georgia State.
Although the above-mentioned concerns have arguably been exaggerated and overstated in literature and debate, they have led Congress and the SEC to seriously consider establishing checks on proxy advisors' operations. After meeting with a variety of participants in the U.S. proxy advisory industry, in July of 2010, the SEC published a concept release to solicit comments on various aspects of the proxy system. In particular, the SEC outlined some of the concerns that have been raised regarding the accuracy, reliability, transparency, accountability, and integrity of the proxy advisory system. Subsequent serious consideration of proxy advisory regulation was pushed aside because of the Dodd-Frank Act's passage later that month. Interest in proxy regulation was revived in 2013 when consultations and discussions regarding proxy advisors' activity culminated in a hearing before the U.S. House of Representatives in June and a roundtable conducted by the SEC was held in December.

At the same time proxy advising was garnering attention in the United States, the European Securities and Markets Authority ("ESMA") of the European Union ("EU") were also taking notice. On February 19, 2013, the ESMA published its final report on the proxy advisory industry. The ESMA's report contains an analysis of the responses received to its March 2012 consultation on possible policy options.
regarding proxy advisors operations, and it sets out the next steps for the ESMA and the industry. The ESMA is currently recommending that the proxy advising industry develop an EU Code of Conduct that focuses on identifying, disclosing and managing conflicts of interest, and on fostering transparency to ensure the accuracy and reliability of the advice. The ESMA announced it will review the development of the code by February 2015, and may then propose more formal measures if no substantial progress has been made.

While considerations of proxy advisors' regulation—steered by American and European policy makers in collaboration with many market participants—are focused on the virtue and necessity of proxy advisors' regulation, a serious discussion of such regulation's potential costs, however, is missing. The remainder of this Article will highlight one special type of potential intangible cost, rarely taken into account when considering regulatory interference in general, and as of yet totally unconsidered with regard to proxy advisory regulation. This potential cost would derive from the gap between perceived and actual effectiveness of proxy advisors' regulation: the Expectations Gap. The remainder of the Article will elaborate the Expectations Gap notion, apply it to potential proxy advisory regulation, analyze its potential consequences, and propose solutions for mitigating its negative impact.

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146 Id.

147 See ESMA Press Release, supra note 143, at 1.

148 See id. at 3.

149 Thus, it has been argued that an appropriate level of oversight, transparency and accountability of proxy advisory firms will improve the quality and reliability of the analysis and advice provided by these firms, and in turn will promote good corporate governance and enhance public confidence in the market. See Hearing Before the House of Rep., supra note 3, at 176-77, 191, 201; see also ESMA Discussion Paper, supra note 145, at 22, 24.


151 The Expectations Gap has traditionally been analyzed in the context of the auditing profession. See, e.g., Janne Chung, Auditors’ Confidence and the Audit Expectation Gap, AUSTL. ACCT., June 1995, at 26 (“The audit expectation gap represents the difference between the public's perception of the auditors' responsibilities and the auditor's actual performance.”).

152 See infra Part II.
III. THE EXPECTATIONS GAP THEORY

Regulation frequently creates expectations among those who are neither the regulator nor the regulated parties. This Article refers to those parties as signalees. Regulation invites signalees to trust in the way that the regulatee is operating within the regulatory framework. The regulation fosters a sense of security among signalees and it may cause them to become lulled into thinking that the regulator effectively monitors the regulated party. This faith diminishes the possibility of effective monitoring of regulatees by signalees. Regulation can thus replace, or at least supplement, the regulatee's reputation in the minds of signalees. Sometimes expectations of regulation and a regulatee alike are founded and justified. However, in other instances the expectations may be exaggerated, creating an Expectations Gap. The remainder of this section will elaborate on the latter possibility by focusing on three separate but related phases of an Expectations Gap. First, this Article will discuss the moment in which a regulation is adopted and a positive signal is transmitted into the marketplace. Second, this Article will describe the phase in which signalees misperceive the signal, because they hold incomplete—symmetric—information and due to the phenomenon of bounded rationality an Expectations Gap is created. Third and finally, this Article will cover the manner by which the Expectations Gap persists because of signalees' lack of either incentive or capability to close or at least reduce it.

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154 Cf. Teck Heang Lee et al., Towards an Understanding of the Audit Expectation Gap, 6 ICFAI U. J. AUDIT PRAC. 7, 16-17 (quoting a comment from the AICPA secretary in 1939 in the aftermath of the McKesson Robbins scandal):
We find that the public believed that the Certified Public Accountant (CPA) was an infallible superman; that the signature of a CPA invariably meant that everything was perfect; that it was unnecessary to read the accountant's certificate or the financial statements to which it was appended as long as the three major letters were in evidence. . . .
155 Id. (explaining that unreasonable expectations by the public undermine the value of the profession).
156 See infra Part II.A.
157 In this Article, a "positive" signal refers to a signal that the regulation will be beneficial and effective.
158 See infra Part II.B.
159 See infra Part II.C.
A. The Regulatory Signal

In 1999, Frank Partnoy published his seminal work describing how the SEC and other regulatory bodies have given credit rating agencies significant market power. The regulators promulgated rules requiring regulatees to meet standards set forth by credit rating agencies. Because of this, Partnoy argues, rating agencies have gained a "regulatory license" that has given them a substantial degree of market power. In turn, the market has become "less vigilant" about rating agencies' work and the agencies need not worry about their own reputations.

Recently, Jonathan R. Macey used a similar theory to describe the negative consequences of taking market mechanisms that have been generated in the private financial sector and incorporating them into the regulatory process as mandatory mechanisms. Macey termed this phenomenon "regulation by assimilation" and focused on four market mechanisms that were co-opted by government regulators: credit ratings generated by credit rating agencies—which were designated by regulators as Nationally Recognized Statistical Rating Organizations or NRSROs—the Value at Risk ("VaR") models that measure the risk of financial institutions' portfolios, the advisory and fairness opinions issued by investment banks in the context of significant corporate transactions,

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161 Id. at 690:
[S]ince 1973 credit ratings have been incorporated into hundreds of rules, releases, and regulations, in various substantive areas, including securities, pension, banking, real estate, and insurance regulation. The cascade of regulation began in 1973 when . . . the SEC adopted Rule 15c3-1, the first securities rule formally incorporating credit ratings and thereby approving the use of certain credit rating agencies as Nationally Recognized Statistical Ratings Organizations (NRSROs).

165 Id. at 593 (explaining that the use of these market mechanisms by private sector actors became driven by regulation instead of market forces).
and the audits of corporations' financial results by independent outside auditors.\textsuperscript{166}

While the above-mentioned studies dealt with situations in which regulators empowered private entities by delegating authority to them, the relationship between reputation and regulation is relevant under other conditions too.\textsuperscript{167} Regulation can empower regulatees without forcing others to rely on the regulatee, to hire its services, or to obey the standards it sets.\textsuperscript{168} The mere fact that a regulatee is subject to regulation may provide it with a certain degree of market power.\textsuperscript{169} The regulatee can derive power from the mere signal of supervision that the regulation sends to the market.\textsuperscript{170} As long as the regulation is not negligible, the regulatee can "rent" the reputation of the regulator and gain approval.\textsuperscript{171} Put differently, the regulator may act as a "reputational intermediary"\textsuperscript{172} by lowering the costs for regulatees of attaining the benefits of a good reputation.

For anecdotal evidence of the above-mentioned effect, look to the frequent public relations efforts of high-profile regulatees.\textsuperscript{173} Regulatees that are the subjects of mass media investigative reports frequently boast that they are subject to ongoing regulatory supervision.\textsuperscript{174} Thus, for instance, in response to Columbia Broadcasting System's ("CBS") \textit{60 Minutes} segments or \textit{New York Times} pieces, respondents often defend themselves by asserting that their operation is subject to "strong regulations," "supervised by licensed authorities," and subject to ongoing inspection by regulatory agencies.\textsuperscript{175}

Regulation may grant varying levels of market power to regulatee.\textsuperscript{176} The better a regulatory system is perceived to be in monitoring the function of the regulatee, the more the regulatee is

\textsuperscript{166}Id.


\textsuperscript{168}Id.

\textsuperscript{169}Id.

\textsuperscript{170}Id.

\textsuperscript{171}MACEY, supra note 167, at 126 ("Hiring a well-known auditor with a good reputation effectively allows these sorts of unknown, low-reputation companies to 'rent' the reputation of big accounting firms.").

\textsuperscript{172}The term "reputational intermediaries" is commonly used to describe an individual or entity that has significant reputational capital, which it pledges to assure the quality of the product or service that it either makes or verifies. \textit{See id.} at 124; \textit{see also} Coffee, supra note 73, at 309.


\textsuperscript{174}Id.

\textsuperscript{175}Id.

\textsuperscript{176}See MACEY, supra note 167, at 127.
perceived to be efficient and reliable.\textsuperscript{177} This correlation has already been analyzed in scholarly literature with regard to stock market listings.\textsuperscript{178} In the case of stock markets, some distinguished scholars have argued that publicly traded companies increase signal quality by listing on strictly regulated markets and subjecting themselves to tighter standards.\textsuperscript{179} However, these scholars have presented the regulatory signal as a \textit{fait accompli}, without conditioning the existence the signal and analyzing the possibility for a gap between subjective—perceived—and objective effect of regulation.\textsuperscript{180}

This Article will now fill that void. To start with, a regulatory signal—its nature and its volume—are most likely determined by the way a regulation is designed and the identity of those who set and enforce it. The design of a regulation can be best explained by the "rules versus standards" dialectic.\textsuperscript{181} It is common knowledge that rules tend to be clearly defined and highly administrable and that they usually draw a bright line between forbidden and permissible conduct and limit the discretion of regulatees.\textsuperscript{182} In contrast, standards—or principles—are less clear \textit{ex ante}, considered much more flexible than rules and usually allow the actor to make individualized interpretation and judgment about the lawfulness of its contemplated conduct.\textsuperscript{183} Thus, one might argue that as long as regulation is based on rules rather than standards, it is likely to be perceived by signalees as strong regulation—and vice versa.\textsuperscript{184} On the other hand, it should be noted that rules—unlike standards—may allow regulatees to "exploit loopholes" to their advantage.\textsuperscript{185} If a rules-based regulation is perceived to contain

\textsuperscript{177}See \textit{id.}
\textsuperscript{178}See, e.g., Marco Pagano et al., \textit{The Geography of Equity Listing: Why Do Companies List Abroad?}, 57 J. FIN. 2651, 2656-57 (2002).
\textsuperscript{179}See \textit{id.}; see also MACEY, supra note 167, at 255.
\textsuperscript{180}See MACEY, supra note 167, at 254-55.
\textsuperscript{182}Id.
\textsuperscript{183}See Duncan Kennedy, \textit{Form and Substance in Private Law Adjudication}, 89 HARV. L. REV. 1685, 1685 (1976) (discussing distinctions between rules and standards); see also Kaplow, supra note 181, at 559-60.
\textsuperscript{184}See Langevoort, \textit{Managing the "Expectations Gap" in Investor Protection}, supra note 44, at 1154 ("[D]isclosure requirements that are too vague or open-ended invite, as noted earlier, 'violation by rationalization'—seeing if a possible argument can be devised to justify noncompliance, which quickly can lead down a slippery slope.").
\textsuperscript{185}See Donald C. Langevoort, \textit{Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation}, 97 NW. U. L. REV. 135, 167 (2002) [hereinafter \textit{Taming the Animal Spirits of the Stock Markets}] ("[H]ighly salient forms of legal risk will produce excessive issuer caution [due to fear of violating regulations], especially when there is a high level of ambiguity regarding the meaning of the prohibition in question.").
numerous loopholes the signal associated with it may actually be relatively weak.

So far, theoretical and experimental literature has focused on the varying effects of rules and standards—or, in other words, on specificity versus ambiguity—on different aspects of actors' behavior—such as compliance and performance—while paying no attention to the ways different audiences may perceive these effects. This Article does not seek to make any significant contribution to that debate. Without making a sweeping theoretical prediction, it would seem that although both arguments make sense, a stronger signal is likely to be associated with rules rather than standards, mainly because the first argument is simpler, instinctive, and intuitive, whereas the latter requires greater expertise and deeper understanding. Because the simpler argument is likely to reflect the intuitive thinking of more signalees, it probably has the more accurate bearing on the relative signals sent by rules-based and standards-based regulation.

It is also necessary to explore through further study how perception of rules or standards is influenced by their internal structure, language, and style. Thus, for instance, whereas one might argue that a high level of detail in the regulation indicates seriousness on the part of the regulator and that the regulation is reliable because it will be vigorously enforced, others might argue that the detailed structure actually points in the opposite direction—that a regulatee is unlikely to comply with a rule that is considered to be overly detailed and onerous. So far, these questions have only been explored with regard to very limited conditions, and further research is needed with regard to legal texts and variety of addressees.

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187 Id.
188 This is certainly a topic worthy of further debate and experimentation.
189 See DANIEL KAHNEMAN, THINKING, FAST AND SLOW 20-21 (2011) (distinguishing between two systems in the mind: System 1 which operates almost automatically and requires very little effort, if any at all, and System 2 that gives attention to the mental activities that require effort).
190 An overly complex regulatory scheme may discourage regulatees from complying with the law because compliance would require significant effort or expense. See Kaplow, supra note 181, at 569.
191 See Daniel M. Oppenheimer, Consequences of Erudite Vernacular Utilized Irrespective of Necessity: Problems with Using Long Words Needlessly, 20 APPLIED COGNITIVE PSYCHOL. 139, 140 (2006) (describing the results of five studies which primarily investigated the use of needless complexity in writing and found that unnecessary complexity causes raters to negatively assess text). However, the author acknowledged that "one cannot conclude from these results that using [complex text and vocabulary] is always problematic." Id. at 152. According to the author the population that was tested is "extremely limited" to
The second determinant of a regulatory signal is the identity of the regulator that creates and enforces the regulation. Regulators can be roughly divided into two groups—each of which is likely to have different informative features that will produce different signals. Put simply, regulation can be accomplished either by governmental "command and control" regulation, or through self-regulation.

Self-regulation is commonly defined as a situation in which "a group of persons or bodies, acting together, performing a regulatory function in respect of themselves and others who accept their authority." Self-regulation includes many arrangements usually classified according to their legal effect, motivation, and degree of external control and governmental intervention—sometimes without clear distinction between them. To simplify the different kinds of self-regulation, at one end of the spectrum is the purest form of self-regulation, according to which a business or industry body may voluntarily adopt and implement policies to ensure self-restraint on its conduct towards consumers. This kind of self-regulation may be implemented to deflect criticism, to persuade legislators, and regulators that they should have no cause for concern or intervention and to

Stanford students who "are both well educated and motivated" and therefore "further research is necessary to determine if these results generalize to the population as a whole." Id. The author added that "another limitation is that these studies exclusively examined written text; it is unclear whether the same effects would apply to oral conversation as well." Id. A regulator is often some kind of governmental entity, but it need not be. See Douglas C. Michael, Federal Agency Use of Audited Self-Regulation as a Regulatory Technique, 47 ADMIN. L. REV. 171, 175 (1995) ("Self-regulation" is delegation of the power to create and enforce rules to an entity outside the federal government. . . . The source of the delegated authority is a federal agency to which Congress has delegated such authority, with permission or command to delegate it further."). Some regulations allow regulated entities to self-regulate. See id. at 203-07 (discussing the history of the SEC's use of and reliance on self-regulation).

The varying signals sent by different regulatory entities are similar to the varying degrees of reputation that can be borrowed from different regulators, and there is often a relationship between a regulator's reputation and the signal it sends. See Macey, supra note 164, at 623-25.


Julia Black, Constitutionalising Self-Regulation, 59 MOD. L. REV. 24, 27 (1996); see also ROBERT BALDWIN ET AL., UNDERSTANDING REGULATION: THEORY, STRATEGY, AND PRACTICE 137 (2d ed. 2012) ("Self-regulation . . . take[s] place when a group of firms or individuals exerts control over its own membership and their behaviour.").

See Anthony Ogus, Rethinking Self-Regulation, 15 OXFORD J. LEGAL STUD. 97, 99-100 (1995) ("There is no clear dichotomy in this respect between 'self-regulation' and 'public regulation', but rather a spectrum containing different degrees of legislative constraints, outsider participation . . . and external control and accountability.").

See id. at 100 ("Thus, at one extreme, rules may be private to a firm, association or organization . . . . [T]hey may be formally binding . . . or purely voluntary.").
promote industry-wide reputation.98 At the other end of the spectrum is
the form of "recognized" codes approved by the government—or the
regulator—after formal or informal negotiation between industry
representatives and the regulator.199

The second group is the traditional "command and control"—top-
down—regulatory model, within which the regulator prescribes,
promulgates, implements and enforces fixed statutes and detailed rules,
as well as, "minimum acceptable levels of behaviour."200 The regulator
does not share with the regulatees the traditional roles of governance.201
Instead, the regulator exerts control over the regulatees, and the
regulatees must comply with the regulator's demands or suffer
sanction.202

Following the rationale of regulatory signal discussed earlier in
this section,203 the signal sent to the signalees is likely to be negatively
correlated with the amount of autonomy given to the regulatee.
Accordingly, signals associated with self-regulation are expected to be
weaker than signals associated with conventional command and control
regulation—and vice versa.204 This rationale also applies to the internal
taxonomy of regulatory modes.205 Thus, with regard to self-regulation

198 Cf. Harvey L. Pitt & Karen L. Shapiro, Securities Regulation by Enforcement: A
Look Ahead at the Next Decade, 7 YALE J. ON REG. 149, 211 (1990) (discussing the SEC's use
of regulatory programs to deflect criticism from the media and legislature and the effect of
such programs on building reputation).
199 See Ogus, supra note 196, at 101-02 (discussing government approved regulatory
codes and negotiations in the context of occupational health and safety regulations in Britain).
200 BALDWIN ET AL., supra note 195, at 134.
201 See, e.g., Orly Lobel, The Renew Deal: The Fall of Regulation and the Rise of
(explaining the difference between the command and control—top-down—model and other
"reflexive," "soft," or "collaborative" models).
202 See Johnson, supra note 194, at 234 ("The command-and-control approach . . .
reposes absolute authority in the government or its delegated agencies. Under [this approach],
government authorities adopt, implement, and enforce regulation through administrative
proceedings."); see also Jodi L. Short, The Paranoid Style in Regulatory Reform, 63 HASTINGS
L.J. 633, 659-60 (2012) (discussing how the various definitions of command-and-control
regulation include the common elements of strict standards backed by punitive enforcement
mechanisms).
203 See supra text accompanying notes 188-94.
204 Compare Pitt & Shapiro, supra note 198, at 211 (discussing the appearance of strict
government regulations sending a positive signal to the media and legislature while building
reputation), with Johnson, supra note 194, at 234-35 (discussing skepticism of free market
regulation and how some self-regulation approaches fall more closely to free market regulation
on the continuum), and Stephen R. Diamond, 12.0 Should the Law Profession be Self-
regulating? (with emphasis on California), JURIDICAL COHERENCE (Sept. 22, 2011), archived
at http://perma.cc/9HZ6-R3XC ("The common misfortune of incompetent attorney
performance is what makes the public distrust self-regulation.").
205 Since there is a spectrum of self-regulation models between command-and-control
and free market regulation, theoretically models that fall on one end will send an opposite
for instance, recognized codes are likely to have a stronger signal than voluntary codes. The big picture here is that regulation may send a promising signal that conveys a message of quality. The strength of the signal will depend on the regulator—which could be a government entity or the private firms themselves in cases of self-regulation—and the structure of the regulation. Such a signal, as long as it justified and well founded, is not a cause for concern. A problem emerges, however, when signalees over-estimate the real impact of regulation because of reasons that are discussed in the next section, and an Expectations Gap is created.

B. Creation of an Expectations Gap

The theory of the Expectations Gap is premised upon the assumption that at the moment in which a new regulation is adopted, signalees—such as the U.S. congress, the SEC, the media and the broad public—are uncertain about the potential impact of regulation on regulatees' behavior. The signalees may attach various possible outcomes to the fact that a regulatee is subject to a new regulation. When the distance between the signalees' expectations and the regulation's actual efficacy is significant, an Expectations Gap is formed. The larger the Expectations Gap is, the greater the danger for negative consequences will be. As this Article will explain, an

signal than those on the other end. See Johnson, supra note 194, at 234-35 (discussing the use of various self-regulation models in comparison to laissez-faire and command-and-control approaches).

See supra text accompanying notes 192-94, 203-05.

See Langevoort, Managing the "Expectations Gap" in Investor Protection, supra note 44, at 1164-65 ("New rules that are not enforced effectively become part of the problem—they exacerbate the gap, rather than help reduce it. . . . The SEC wants to persuade successive generations of retail investors that everything is controllable. . . . [A]nd so we cannot seem to escape the expectations gap.").

See infra Part II.B. Signalees may also underestimate the impact of regulation. However, because this scenario has a relatively low probability, it is not discussed in this Article.

See Alison M. Hashmall, Note, After the Fall: A New Framework to Regulate "Too Big To Fail" Non-Bank Financial Institutions, 85 N.Y.U. L. REV. 829, 844 (2010) (discussing uncertainty and panic that may be created by particular regulatory schemes).

While some signalees may perceive strict government regulations as positive, others may have the total opposite perception. See Johnson, supra note 194, at 234 (discussing the critiques of various regulatory models).

See Langevoort, Managing the "Expectations Gap" in Investor Protection, supra note 44, at 1139-40 (discussing the basic definition of an Expectations Gap and how broadly the concept applies to securities regulation).

Expectations Gap basically depends largely upon asymmetric information between regulatee and signalees concerning the objective effectiveness of the regulation, as well as signalees' bounded rationality that may cause them to overestimate the potential of new regulation.

Information asymmetry can result when signalees lack the capabilities and skills necessary to assess, at the outset, a regulation's potential efficacy. Signalees' lack of these capabilities may be due to their suboptimal position and limited access to the regulatory process and regulatee's work, as well as their lack of professional experience. Furthermore, information asymmetry demonstrates a positive correlation to a regulation's complexity and difficulty. In other words, where a regulation's characteristics are complex and difficult to understand, information asymmetry is likely to increase. Complexity and difficulty will be described further in Section II.C. Part III.A will employ the concept of information asymmetry in an analysis of potential proxy advisory firm regulation.

A separate concept, but one that is related to the notion of information asymmetry, is bounded rationality, which can make it
difficult for signalees to assess regulation. The idea behind bounded rationality is that a person's ability to make accurate predictions about the future is handicapped by various heuristics, biases, and faulty assumptions. People do not always function as truly rational beings. Thus, for instance, Congress and the SEC may be affected by the status quo bias, which causes people to prefer maintaining the prevailing state of conditions. Regulators may judge the impact of a new regulation according to that bias. Other signalees, such as the media and the broad public, can be influenced by a number of biases including: the optimism bias, which is commonly defined as the mistaken belief that the chance of experiencing a negative event are lower than they actually are; the availability heuristic, under which the frequency and probability of an occasion are assessed by the ease with which people rethink its occurrence; and the framing effect, according to which decisions are shaped by the way information is framed. Biases such as these negatively influence the way signalees make predictions about the future and may strongly contribute to an Expectations Gap.

These and other cognitive errors can be influenced and exacerbated by many factors, such as the rhetoric of the relevant policymaker, which often exaggerates its commitment and overstates its ability to supervise regulatees. This sort of rhetoric is often cited by the news media. An excellent example is statements made by President George W. Bush when he signed the Sarbanes-Oxley Act of

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222 See Ripken, supra note 215, at 181-83.
223 See id.
225 See id.
229 See id. at 458.
231 See id.
2002 ("SOX"). Then-President Bush "bluntly threatened, 'No more easy money for corporate criminals, just hard time,'" and he declared that SOX's provisions are "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt." In the same vein, internal optimistic discussions or assessments that take place prior to the approval of certain regulatory initiatives, or votes conducted for the approval of new regulation, can also inflate expectations if these discussions or votes become public. Thus, for instance, it is plausible to assume that because the final votes in favor of SOX were 99-0 in the Senate and 423-3 in the House, and because the voting results were extensively publicized in the media, signalees have received a signal that the need for SOX was clear. In turn, because the need is perceived to have been so clear, the signal indicates that SOX created a substantial benefit to investors and U.S. capital markets.

Further, the reputation of Congress and the relevant regulatory agency, coupled with the point in time at which regulation is promulgated, are extremely relevant in assessing the strength of the regulatory signal. Thus, for instance, soon after the regulator has led a decisive and aggressive reform to deal with one problem, signalees may be more susceptible to optimism bias when assessing new regulation aimed at solving other problems. Finally, it is worth noting that because "individuals vary in their susceptibility to cognitive biases," biases are likely to have heterogeneous effect on different groups of signalees. Once all of these factors, acting in concert, create an Expectations Gap, the momentum is difficult to reduce. The next section will explain why there is good reason to believe that an Expectations Gap, once created, is likely to persist.

236 See Bumiller, supra note 233; see also Gillan, supra note 235.
237 See Gillian, supra note 235.
238 This Author will return to this point with regard to the specific case of proxy advising and the SEC. See infra Part III.
239 See Aviram, Bias Arbitrage, supra note 45, at 802.
C. Persistence of an Expectations Gap

After an Expectations Gap has been created, certain circumstances may cause it to persist.\textsuperscript{241} To begin with, in order to reduce an Expectations Gap, signalees have to invest in research about the new regulation and discern its true effect on regulatees.\textsuperscript{242} Section III.B of this Article demonstrates in-depth that within the context of proxy advisors regulation, signalees may lack incentives or capabilities—or both—to research a new regulation's effect in order to reduce an Expectations Gap once it has been created.\textsuperscript{243} This Section explains, in general terms, how signalees' capabilities—and in some sense their incentives—to reduce a potential regulatory Expectations Gap depend, to a large extent, on the regulation's level of complexity and difficulty, and the possibility that these characteristics will be concealed or manipulated.\textsuperscript{244}

To begin with, the more complex a regulation,\textsuperscript{245} the more difficulty signalees will face in evaluating its effectiveness. Simply put, in most cases, regulation aims to deal with more than a single issue and therefore has many components and goals.\textsuperscript{246} Given that each component has to be learned and its potential effect has to be assessed, when regulation is complex, it requires signalees to have higher incentives and capabilities.\textsuperscript{247} Moreover, when a regulation has many components, signalees may generalize across the components, and the generalization will in turn make it difficult for signalees to distinguish among effects of regulation regarding the different issues it covers.\textsuperscript{248}

\textsuperscript{241}See infra text accompanying notes 244-71.
\textsuperscript{242}Just as regulatees must invest effort or resources in order to become informed about a regulation, signalees must do the same if they wish to truly understand a regulation's effectiveness. See Kaplow, \textit{supra} note 181, at 569.
\textsuperscript{243}See infra Part III.B.
\textsuperscript{244}See infra note 245; see also supra note 45.
\textsuperscript{245}A regulation's complexity usually depends on how many components or levels of components it contains. Simply put, something is said to be complex when it is complicated in structure. See W. Brian Arthur, \textit{Complexity and the Economy}, 284 SCI. 107, 107 (1999) ("Common to all studies on complexity are systems with multiple elements adapting or reacting to the pattern these elements create."); see also id. at 109 n.5 ("[Complex systems] exhibit certain properties that have to do with the multiplicity of potential patterns or with the coherence or propagation of substructures . . . .").
\textsuperscript{248}See \textit{Over-regulated America}, \textbf{ECONOMIST} (Feb. 18, 2012), archived at http://perma.cc/N9HY-JQRK (pointing to the Dodd-Frank Act as an example of regulation
They will be unable to see the whole picture. The Dodd-Frank Act can best illustrate the above-mentioned problem. The Act, which spans 848 pages, covers a huge range of financial regulatory issues. It created the Consumer Financial Protection Bureau, ended the possibility of "Too Big to Fail" bailouts, attempted to improve derivatives rules, dealt with issues of corporate governance, and the list goes on. A thorough understanding of each of these issues requires a high level of expertise and significant effort. Therefore, those who aspire to learn the Dodd-Frank Act are required to have a high level of incentives and capabilities. Another example is the draft version of the "Volcker rule," which aims to curb risky proprietary trading by banks. This draft was circulated by the Federal Deposit Insurance Corporation ("FDIC") to solicit public comments on all aspects of the proposed rule including 383 specific questions that were broken down into 1,420 subquestions. The same is true for any complex regulatory scheme.

For the sake of precision it should be noted that although complexity and difficulty are often used synonymously and treated as one, both factors describe different mental operations. Thus, whereas complexity "describes the thought process that the brain uses to deal with information," difficulty "refers to the amount of effort that the learner must expend within a level of complexity to accomplish a learning..."
In our context, difficulty emerges not only when dealing with a complex structure of regulation, but also whenever regulatory content is unclear and requires someone—in this case, signalees—to invest mental efforts in processing and understanding the regulatory information. Moreover, the difficulty further intensifies where it is hard to measure whether the regulatee performed a good job.

In addition, evaluating the effect of regulation becomes an even harder task when regulatees choose to conceal or manipulate a regulation's real impact and make it difficult—or even impossible—for signalees to observe the real impacts. Alternatively, regulatees can alter signalees' impressions by pulling their attention away from one focal point and drawing their attention toward another. In some cases, the interest to manipulate the regulatory impact can be common to others—except the regulatee—who may simultaneously misuse the regulatory signal to escape from undesirable attention.

Even a regulator may misuse the regulatory signal. Sometimes, regulators may seek to maintain the status quo due to their own status quo bias. In some circumstances, the regulator can even extract private benefits from an inaccurate regulator signal. The regulator may receive publicity for targeting high profile matters, and for
focusing on measurable factors. They may even exploit an Expectations Gap to receive credit for "mitigating" a risk that was grossly exaggerated due to signalees' misperceptions regarding the risk's probability and magnitude.

In summation, according the Expectations Gap theory, regulation can be overly trusted by those who observe it "from outside." Such a perceptual gap may be caused by several factors that were covered above and which will be further discussed in the next Part. These factors relate to the regulation itself and to those who surround it—including regulators, regulatees, the media and the public at large. Policy-designers should be aware of such a potential gap, and should take steps to reduce it in order to minimize its negative consequences.

IV. APPLYING THE EXPECTATIONS GAP MODEL IN THE PROXY ADVISORY CONTEXT

A. The Regulatory Signal and the Creation of an Expectations Gap

This Part of the Article applies the Expectations Gap theory to the proxy advisory context. Because the SEC has not adopted a final regulatory plan yet, the analysis offered in this section is mostly theoretical, though not entirely. The analysis is based on discussions conducted over the years by the SEC and the U.S. Congress, as well as hundreds of comments submitted by market practitioners who took an active part in the brainstorming. Furthermore, the analysis that is offered here takes into account the principles and codes that have been already adopted by the ESMA.

According to the Expectations Gap theory, regulation of proxy advisory firms may send a positive signal. In the absence of a final decision from the SEC about the manner in which advisory firms should be regulated, this Article assumes that regulation of proxy advisory firms would generate a signal with strength dependent on the level of

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271 MACEY, supra note 167, at 253 ("The SEC focuses on measurable factors such as the raw number of cases it brings and the size of the fines it collects, even though this is not the best data with which to evaluate the conduct of the SEC.").
272 Aviam, Bias Arbitrage, supra note 45, at 792.
273 See supra Part II.A; see also infra Part III.A.
274 See supra Part II.B; see infra Part III.A.
275 See Kroll & Mycrs, supra note 29 and accompanying text.
276 See Gregory, supra note 65.
277 See supra notes 141-48 and accompanying text.
278 See supra note 157 and accompanying text.
complexity and difficulty of regulation. Given that signalees may be affected by cognitive biases and heuristics, a few of which were discussed previously,\textsuperscript{279} and may also hold asymmetric information as will be discussed below,\textsuperscript{280} regulation may develop exaggerated expectations among signalees.\textsuperscript{281} These expectations would likely consist of beliefs that proxy advisory firms are being supervised on an ongoing basis, and that their voting recommendations to institutional investors are based on the best possible research and support, and promote the economic interests of investors.\textsuperscript{282} This may be especially true because proxy advisory regulation, if implemented in the near future, would follow on the heels of recent influential SEC reforms, especially SOX and the Dodd-Frank Act.\textsuperscript{283}

\textsuperscript{279}See supra text accompanying notes 222-29.
\textsuperscript{280}See infra Part III.B.
\textsuperscript{281}See supra note 264-71 and accompanying text.
\textsuperscript{282}See supra notes 68-70.
\textsuperscript{283}Trust in regulators is fragile and dynamic, and "negative (trust-destroying) events" are "more visible" and "carry much greater weight" than "positive (trust-building) events." PAUL SLOVIC, THE PERCEPTION OF RISK 319-23 (2000) (calling it "the asymmetry principle"). See ONORA O'NEILL, A QUESTION OF TRUST 6-7 (2002) ("[t]rust ... is constantly observed, is hard earned and easily dissipated"). Therefore, one might argue that SEC's failure to anticipate fraudulent financial reporting in a series of cases such as Enron and Worldcom, its alleged failure to report problems at Lehman Brothers, and its failure to detect the $7 billion fraud perpetrated by Sir Allen Stanford and Bernard Madoff's ponzi scheme, all may damage the SEC's reputation. See MACEY, supra note 167, at 215-227. However, over the last several years the SEC has taken some significant steps to rebuild its reputation. First, the SEC started to fine big-name public companies in order to send "a swift, clear message that corporate wrongdoing will not be tolerated, and penalties for securities violations will be stiff." Joanna Chung & Brooke Masters, SEC Moves to Rebuild its Reputation, FIN. TIMES (Aug. 4, 2009), available at http://www.ft.com/intl/cms/s/0/353d8904-8121-llde-92e7-00144fcabdc0.htmi #axzz36mh6Mxe. Second, the SEC strengthened its enforcement efforts. For instance, during the first six months of 2009, "the SEC issued 224 formal orders of investigation, compared with 93 over the same period" in 2008. Id. Third, "in a novel move" in July 2009, the SEC pursued "some compensation from a former chief executive whose company's profits were found to have been inflated by fraudulent accounting." Id. Fourth, it had taken steps to ensure that its own officers are held accountable for their mistakes. Eight of the SEC's employees—including an enforcement manager, a senior officer in the inspections office and staff attorneys—were disciplined over failures in Madoff fraud. See David S. Hilzenrath, Eight SEC Employees Disciplined Over Failures in Madoff Fraud Case; None Are Fired, WASH. POST (Nov. 11, 2011), archived at http://perma.cc/Z5NJ-JHBB. Fifth, in the wake of the financial crisis, the SEC's leadership has changed twice. In January 2009, Mary L. Schapiro was sworn as the 29\textsuperscript{th} Chairman of the SEC, promising to "move aggressively to reinvigorate enforcement" at the SEC. Jean Eaglesham, SEC Tries to Rebuild Its Reputation, WALL ST. J. (Sept. 11, 2013), http://online.wsj.com/news/articles. "She created teams to target various types of alleged misconduct, including one focused on the complicated mortgage bonds that helped set off a global financial panic." Id. In April of 2013, former federal prosecutor, Mary Jo White "started work as SEC chairman with a simple enforcement motto: 'You have to be tough.' She tossed out the SEC enforcement policy that allowed almost all defendants to settle cases without admitting wrongdoing." Id. As noted elsewhere, White's nomination as chairwoman of the Securities and Exchange Commission "has been hailed as a
Assuming that regulation of proxy advisors is adopted, it will be accompanied by a strong regulatory signal. However, the regulatory measures currently proposed in the proxy advisory context are not capable of strictly controlling the way proxy advisory firms process information and provide recommendations. Solutions that were offered through hundreds of comments submitted to the SEC and Congress were focused mainly on improving transparency about the internal procedures, guidelines, standards, methodologies, and assumptions used in advisors' development of voting recommendations. They also recommend requiring full disclosure of advisors' conflicts of interest, providing public companies with draft reports prior to submitting their reports to institutional investors, and permitting companies to review accuracy of drafts' factual content and suggest corrections—within a reasonable time frame—before a final report is issued.

Indeed, increased transparency and adequate opportunity for companies to make their cases to the advisory firms before recommendations are made could enhance the procedural fairness of advisors' decision-making and make their work more efficient. However, these protective measures do not vest the SEC with much real control over the advisors' operations. Simply put, mere transparency requirements may be extremely vague and leave much discretion in the hands of advisors to decide how much transparency to give. Advisors can also circumvent fair review of their reports simply by insisting on their factual information and adhering to their conclusions. Even when the reports are demonstrated to contain factual errors, advisors may still assert that the recommendations contained within the reports have

signal that a tough regulator will be patrolling Wall Street." See Peter J. Henning, How Mary Jo White's Connections Could Complicate Her S.E.C. Job, N.Y. TIMES DEALBOOK (Jan. 28, 2013), archived at http://perma.cc/L99X-DYP9. Her motto is "to be everywhere." See Mary Jo White, Chair, Sec. & Exch. Comm'n, Remarks at the Securities Enforcement Forum (Oct. 9 2013), archived at http://perma.cc/L3MU-4B6T. President Obama has warned during a White House appearance with White:

You don't want to mess with Mary Jo... Mary Jo White is a fearless, tough-as-nails prosecutor with the knowledge of industry to keep up with the markets' swift innovation... She will not shy away from enforcing the laws to ensure that markets operate fairly, but her integrity means she will approach all matters without regard to politics.


See JUST THE BASICS, supra note 29.

See Gregory, supra note 65.

See id.

See Katz, supra note 68.

See Gregory, supra note 65.
not been compromised by the errors. Such a tendency of decision-makers to adhere to their original decisions has been comprehensively demonstrated by the academic literature, and it is quite founded when speaking about proxy advisory firms.

Thus, for instance, a survey conducted by the Society of Corporate Secretaries and Governance Professionals in 2010 indicated that:

[F]or the respondents who found inaccurate information in a vote report, the proxy advisory firm did not correct the mistake 57% of the time. Furthermore, in 44% of the instances where issuers found mistakes the proxy advisory firm reviewed its recommendations but was unwilling to change the recommendation or factual assertion. In another 22% of the instances where issuers found mistakes, the proxy advisory firm was unwilling to reconsider the recommendation at all.

Similar results were received by a survey conducted in 2010 by the Human Resource Policy Association, which showed that "of the firms that indicated the use of such an inappropriate peer group [by proxy advisory firm], 96% indicated that the peer group was not adjusted in the final version of the report."

Katherine H. Rabin, CEO of Glass-Lewis, acknowledged this pattern of conduct and attempted to justify it by stating:

[O]ften what a corporation indicates is an error is ultimately a difference in interpretation or opinion regarding a certain issue, and therefore requires no correction. As of May 31, 2013, material errors in Glass Lewis' research (brought to our attention by the company, its advisors or through subsequent disclosure) that resulted in a change to the Glass Lewis recommendation represented one-tenth of 1% of the items up for vote at US companies analyzed by Glass Lewis.

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289 See Eckstein, supra note 268 (providing an overview).

290 Hearing Before the House of Rep., supra note 3, at 234 (containing written testimony of Darla C. Stuckey, Society of Corporate Secretaries and Governance Professionals).

291 Id. at 113 (containing written testimony of the Center on Executive Compensation).

292 Id. at 416 (containing written statement of Katherine H. Rabin, CEO of Glass-Lewis).
Regarding conflicts of interest, assuming that the SEC will not adopt a firmer approach that prohibits ISS from providing services to both institutional investors and public corporations at the same time, procedures which are designed to prevent an exchange of information between the corporate side and investors side cannot function as a hermetic seal to prevent two-way communication between the two groups. This point was demonstrated during the SEC’s Roundtable, which noted that Chinese firewalls that were designed within ISS did not prevent communication between the corporate side and the institutional side.

To summarize this point, the procedural mechanisms that have been offered to control proxy advisory firms may still allow those firms a larger amount of discretion about the way they will obey and respond to these procedures. As Justice Stephen Breyer and his co-authors put it: "'[D]ue process' is not a fixed set of procedures . . . . Rather, the required procedures—the amount of process that is 'due'—vary according to the setting."

Further, drawing on consultancy and professional services literature, the process of consultation and the content of consultation should be distinguished. In the case of proxy advisors, alternatives that were suggested for regulation of advisors may improve the process of proxy advising rather than ensure that advisors will make recommendations that best serve the interests of the shareholders. This Article does not speculate as to the best method for controlling proxy advisors' operation. Rather, it aims to warn against illusory belief that the regulation as currently proposed would ensure sufficient control on their operation.

So in summary, the relatively strong regulatory signal that will be sent by proxy advisory regulation is likely to create expectations among signalees. The regulations, as currently proposed, are unlikely to result in the kind of regulatory control over proxy advisory firms that signalees will expect. As the next Section will show, this Expectations

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293 See SEC Roundtable, supra note 20, at 123-24.
294 See id.
295 See Ackerman, supra note 29.
296 See supra note 59 and accompanying text.
297 See supra note 60 and accompanying text.
298 See infra Part III.B.
299 See infra Part IV.
300 See supra note 59 and accompanying text.
301 See supra note 60 and accompanying text.
Gap is likely to persist once it has been created. Moreover, as Part V.A of this Article will demonstrate, the regulation of advisory firms may paradoxically harm the quality of proxy advisory services.

B. Probable Persistence of the Expectations Gap

This section of the Article presents seven groups of signalees. It will explain why they are likely to have asymmetric information, which will contribute to the creation of an Expectations Gap, and why these groups lack incentives and capabilities to close or reduce the gap. As a general remark, it is worth noting in advance that the task of reducing the Expectations Gap may be particularly difficult in the case of proxy advisor regulation because it is inherently difficult to measure whether advisors have done a good job in processing information and making recommendations. When the quality of a service is difficult to measure, the effect of regulating that service will likewise be difficult to quantify.

The first group of signalees is composed of the institutional investors, the advisory firms' clients. As clients, they are in the best position to assess the true worth of proxy advisory regulation and its effect on advisors' work product. Beyond their privileged position, institutional investors—mainly large investors—have the ability to make their voting decisions without the aid of advisory firms. They can

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302 See infra Part V.A.
303 See infra Part V.A.
304 This list is not exhaustive. It is only meant to examine the signalees who could most affect the overall market if the Expectations Gap is created and persists.
305 For a discussion of when asymmetric information can arise, see supra notes 216-19 and accompanying text. This section discusses limitations specific to each group of signalees. For a general discussion of reasons why asymmetric information can persist, see Part II.C.
306 Cf. CTR. ON EXEC. COMP., supra note 89, at 1 ("[T]he lack of transparency of the advisory firms' analytical models makes it extremely difficult for investors or companies to determine why a proxy advisor has made certain determinations or to correct factual inaccuracies before a vote is held . . . ."). This is unlike the credit rating agencies' context, for instance, where a failure rate is measurable. See Lynn Bai, The Performance Disclosures of Credit Rating Agencies: Are They Effective Reputational Sanctions?, 7 N.Y.U. J.L. & BUS. 47, 59-66 (2010) (detailing the SEC's performance disclosure requirements for credit rating agencies).
308 Id. at 651 (questioning institutional investors' ability to understand proxy advisors' work product).
309 Indeed, institutional investors made voting decisions without the assistance of proxy advisors prior to the mid-1980s when such services became available. See id. at 650.
simply apply their own guidelines and rely on their own in-house research. Furthermore, some of the institutional investors employ more than one proxy advisory firm. Considering the above-mentioned factors, institutional investors seem to be the ideal group for assessing the potential efficacy of regulation and reducing information asymmetry for themselves and for others. Institutional investors are also in a good position to evaluate the efficacy of regulation over time. However, as will be explained in detail Part IV.B, institutional investors can reap huge benefits from taking advantage of a strong regulatory signal, and they therefore cannot be expected to act as whistleblowers or market correctors.

The second group of signalees is composed of the public companies for whose shareholder votes proxy advisors give recommendations. In the case of these public companies, there may be a convergence between incentives to discover the true effect of proxy advisory regulation and the ability to do so. Public companies are in a very good position to accurately evaluate the effectiveness of regulations by dealing with concerns regarding proxy advisors' function.


311 See GAO 2007, supra note 133, at 16 (reporting that of twenty large investors interviewed, fifteen stated that they generally rely more on their own in-house research than on the recommendations of proxy advisory firms).

312 See SEC Roundtable, supra note 20, at 56 (containing statement of Mrs. Karen Barr, General Counsel, Investment Adviser Association).

313 Cf. Aguilar, supra note 93 ("It is clear . . . that professionally-managed institutions can help ensure that our capital markets function as engines for economic growth. Institutional investors are known to improve price discovery, increase allocative efficiency, and promote management accountability.").

314 See infra Part IV.B.

315 Cf. John R. Hamman et al., Self-Interest through Delegation: An Additional Rationale for the Principal-Agent Relationship, 100 AM. ECON. REV. 1826, 1843 (summarizing the benefits that a principal might receive from delegating responsibility to an agent).

316 Cf. Belinfanti, supra note 89, at 390 ("Ultimately, should ISS’ advice prove misguided, the parties who stand to bear the brunt of any losses are the individual investor who has entrusted his/her money to mutual funds and the public companies who are impacted by ISS’ decisions."); see also Gallagher, supra note 108, at 14-15 (noting that one concern of public companies is that proxy advisors sometimes base their recommendations on incorrect information and refuse to review those recommendations once the error comes to light).

317 Public companies are incented to monitor proxy advisors because they are exposed to the negative consequences of proxy advisor conduct. See Belinfanti, supra note 89, at 439
companies enjoy relatively comfortable access to proxy advisors' work and thus are able to assess the regulatory impact.\textsuperscript{318} Also, public companies have strong incentives to shed light on a regulation's shortcomings. Public companies have been the driving force behind the contemplated regulation of proxy advisors.\textsuperscript{319} They have established a coalition, filed petitions for rulemaking, and lobbied both Congress and the SEC.\textsuperscript{320} Thus, given their combined power and incentives, public companies should reduce the high expectations that will result from proxy advisory regulation. However, a critical problem may reduce their effectiveness. Although public companies may face a relatively low "burden of proof," they are likely to incur a high "burden of

\textsuperscript{318}But see Hearing Before the House of Rep., supra note 3, at 417 (containing statement of Katherine H. Rabin, Chief Executive Officer, Glass, Lewis & Co.): In accordance with feedback from clients, Glass Lewis does not believe it is in the best interests of investors to provide previews of PA analysis to the subject companies. This type of "consultation" would open Glass Lewis up to being lobbied by companies, since companies could use this communication opportunity to push for a change in a recommendation against management. Furthermore, from a practical perspective, given the often tight timeframe between the issuance of the proxy statement and the vote deadline, any delay in the distribution of reports to investors would further limit the time available for them to review the analysis, discuss in internal meetings (many clients maintain proxy committees), engage with companies and make fully informed voting decisions.

Still, such access is not completely open. First, as noted supra note 130 and accompanying text, ISS provides drafts only to S&P 500 companies while Glass-Lewis provides its drafts only to public companies that pay to subscribe to its services. See Hearing Before the House of Rep., supra note 3, at 159 (containing statement of Niels Holch, Executive Director, Shareholder Communications Coalition); but see id. at 235 (containing statement of Darla C. Stuckey, Senior Vice President, Society of Corporate Secretaries and Governance Professionals) (noting that in addition to offering a subscription, Glass-Lewis allows companies to buy their reports for a fee). Second, based on discussions conducted so far, there is no intention to require proxy advisory firms to conduct full transparency in their work. See Katz, supra note 68 (noting that SEC Commissioner Daniel M. Gallagher has not recommended comprehensive regulation of proxy advisory firms).

\textsuperscript{319}See Edelman, supra note 125, at 1382: [T]he Shareholder Communications Coalition, whose membership is composed of some of the largest corporate officer groups, proposed a regulatory framework that called for the firms to maintain public records of all voting recommendations—with disclosure of the data, information, and rationales used to come to the recommendations. The proposed framework also suggested requiring that proxy advisory firms provide all public companies with drafts of the proxy advisory firms' reports prior to dissemination to clients. Furthermore, should a public company find an error in the report, proxy advisory firms would have to correct the error.

\textsuperscript{320}See infra Part V.B.
They are likely to be perceived by other signalees as biased and strongly self-interested. This is especially true given the growing antagonism toward the American business sector that "has resurfaced today," and the activism of the populist Occupy Wall Street movement that influenced the American political discourse. Many signalees associate with the "social cry" of "We Are The 99%," and are patently distrustful of public companies. Therefore, these companies may face difficulty in persuading others that regulation is illusory.

The third group of signalees is composed of politicians—in this case, Congress. Politicians generally have good capabilities for assessing regulatory potential. Their fact-finding tools are based mostly on the Office of Information and Regulatory Affairs ("OIRA"), which carries out several important functions, including reviewing initiatives for federal regulations, together with taking testimony and statements made by regulatory stakeholders—mainly institutional investors and public companies—through congressional hearings. These capabilities, however, are often speculative and are relatively limited at the time of a regulation's adoption because politicians—similarly to regulators as discussed below—cannot predict in advance the true effect of a regulation until after its implementation.

321 The term "burden of proof" is commonly used to refer to the obligation to produce sufficient evidence to prove a certain point, whereas the term "burden of persuasion" is used to refer to the obligation to convince as to the validity of the evidence. See generally Fleming James, Jr., Burdens of Proof, 47 VA. L. REV. 51 (1961) (providing a general discussion of these two distinct concepts).


323 Id. "We Are The 99%" is a political slogan used by the Occupy movement. It refers to the concentration of wealth among the top-earning 1% (Wall Street Banks, big corporations, etc.) at the expense of the remaining 99%. The Occupy movement claimed the right of the people "to create a world that works for the 99%." Sarah van Gelder, This Changes Everything: How the 99% Woke Up, YES! MAGAZINE (Nov. 18, 2011), archived at http://perma.cc/3VMS-H5UX; see also THIS CHANGES EVERYTHING: OCCUPY WALL STREET AND THE 99% MOVEMENT 2 (Sarah van Gelder ed., 2011).


326 See, e.g., Michael Greenstone, Toward a Culture of Persistent Regulatory Experimentation and Evaluation, in NEW PERSPECTIVES ON REGULATION 111, 113 (David
Over time, politicians gain more information and can better assess the regulation's impact. The question then becomes: will politicians have incentive to re-evaluate a regulation's efficacy after it has already been implemented? History suggests that, often, they do not. Whether or not one accepts the public choice theory, which models politicians as actors driven by self-interest rather than ideological goals, one thing is quite clear: politicians base their decisions, at least to a large extent, on the public's demand for intervention. As will be explained infra in Part IV.A, once regulation of proxy advisors is adopted, the public's demand—currently at its peak—is likely to fade. In such a scenario, politicians are unlikely to doubt the regulation's effectiveness or re-examine the regulation's efficacy in retrospect, unless a new public outcry emerges. As detailed below in Part IV.A, the chances for that are relatively low.

The fourth group of signalees is composed of non-elected bureaucrats—in this case the SEC—who are responsible for implementing the policies chosen by Congress. These regulators are unable to conclusively assess and predict the effect of regulation in advance, but they would be in a good position to assess ex-post the real impact which regulation would have on proxy advisors' behavior. However, as noted earlier, regulators may have relatively weak incentives to do so, largely due to the status-quo preference and the potential for gaining private benefits when the is regulation perceived as

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328 See DANIEL A. FARBER, Introduction to PUBLIC CHOICE AND PUBLIC LAW ix-x (2007).

329 See Amitai Aviram, Counter-Cyclical Enforcement of Corporate Law, 25 YALE J. ON REG. 1, 18 n.66 (2008) ("Politicians, sensing this demand by their constituents, will respond by adopting policies addressing (or at least purporting to address) the relevant risks.").

330 See infra Part IV.A.

331 See infra Part IV.A.

332 See infra note 336 and accompanying text.

333 See infra Part IV.A.

334 Of course, this view is too simplistic, and in fact, "the boundaries between decision and execution are a grey area and in many cases bureaucrats do much more than executing either de jure or de facto." Alberto Alesina & Guido Tabellini, Bureaucrats or Politicians? Part I: A Single Policy Task, 97 AM. ECON. REV. 169, 169 (2007) (giving an in-depth analysis of the blurred distinction between politicians and bureaucrats).

335 See Thomas O. McGarity, A Cost-Benefit State, 50 ADMIN. L. REV. 7, 55 (1998) ("[Bureaucracies] are generally not able to predict accurately how regulated entities will react to particular requirements or inducements.").
effective. As Donald C. Langevoort put it: "The SEC wants to persuade successive generations of retail investors that everything is controllable (and largely under control), because that is why it gets its funding and power." Therefore, in the absence of a crisis or scandal—which would likely force regulators to retrospectively reassess the regulatory regime—regulators may have a strong incentive to preserve an Expectations Gap, or at least to turn a blind eye to the Gap after it has been created.

The Fifth group of signalees that deserves attention is the media, particularly the business media. Although many expect the media to act as a watchdog and to keep an eye on advisors' operations, the stark reality that has emerged in the wake of the global crisis of 2007-2008 is

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336 See Samuelson & Zeckhauser, supra note 224, at 8; see also Eckstein, supra note 267, at 7.

337 Langevoort, Managing the "Expectations Gap" in Investor Protection, supra note 44, at 1165; see also Langevoort, Taming the Animal Spirits of the Stock Markets, supra note 185, at 175 ("The risk here is that the message of empowerment may contribute not simply to investor confidence, but to overconfidence. . . . [T]he SEC's cheercading for broad public participation in the securities markets implicitly overstates both the safety and promise of equity securities vis-à-vis other forms of savings and investment.").

that the media may fail to "bark" in time to prevent a catastrophe. As Howard Davies explained in detail in his insightful book—in which he surveys the different financial crisis explanations—journalists may be influenced by a number of corrosive forces, including "collective euphoria," informational capture by financial firms that force them to present the stories in a particular manner, and failure to understand the nature of new financial products.

Furthermore, it has long been conventional wisdom that the media organizations are ratings-driven and profit seeking. They constantly seek fresher and more sensational news and they are less concerned with a story's true social value. Martha Stewart's insider trading case provides a great illustration. This case drew the attention of the media for years, in defiance of the relatively small scope of Stewart's crime and its effect. Thus, despite the fact that by selling her stake in biotech company ImClone Stewart avoided losses of only $45,673—a tiny fraction of her net worth, which Forbes had estimated at $700 million just six months before Stewart misused the inside information, and unremarkable gain in terms of securities fraud—Stewart's case drew heavy media scrutiny.

Indeed, following the ratings-driven rationale, one might argue that in the proxy advisory context, the media is likely to provide accurate and meaningful coverage. Because the media is likely to cover contested

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339 Dean Starkman, Power Problem: The Business Press did Everything but Take on the Institutions that Brought Down the Financial System, COLUM. JOURNALISM REV., May-June 2009, at 26 ("[The business press] is the watchdog that didn't bark.").


341 ANDREW CURRAH, CHALLENGES, WHAT'S HAPPENING TO OUR NEWS: AN INVESTIGATION INTO THE LIKELY IMPACT OF THE DIGITAL REVOLUTION ON THE ECONOMICS OF NEWS PUBLISHING IN THE UK 47 (2009) (quoting Lucy Hadfield, Managing Partner, Crucible Partners) ("News organisations are now driven by rating figures and a story's potential to generate revenue through advertising—they now want news about celebrities, starlets, gossip, violence, large brands and snappy sounds bites and statistics . . . News organisations are increasingly driven by the commercial potential of a story."); see also ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 72 (2000) ("The news media are in constant competition to capture the public attention they need to survive.").

342 See infra notes 339-41 and accompanying text.


344 See Joan MacLeod Heminway, Martha Stewart and the Forbidden Fruit: A New Story of Eve, 2009 MICH. ST. L. REV. 1017, 1044 ("[Martha Stewart's] case is marginal in a number of respects and involves a small number of shares and a relatively small loss avoided.").

345 See Susan Fournier, Martha Stewart and the ImClone Crisis 1-4 (Tuck Sch. of Bus. at Dartmouth, Case No. 1-0083, 2005) (providing a summary of Martha Stewart's insider trading case).
shareholder votes—such as in the case of Hewlett Packard—and because a meaningful number of contested votes occur, the argument would posit that the media could deliver meaningful, accurate coverage and reduce the Expectations Gap. However, even regarding contested votes we have reasons to be skeptical that the media would provoke a meaningful discussion on the merit of proxy advisory regulation. As noted elsewhere, the media usually prefers "superficial opinions" to "in-depth analyses," is not singularly dedicated to assisting in good corporate governance, and already suffers from a deficit in public confidence. Therefore, the media cannot be fully trusted to balance expectations when a new regulation is adopted or to track the real contribution of regulation after its adoption.

At this point, one might ask how public companies have attracted so much attention to the topic of proxy advisor regulation, causing Congress and the SEC to conduct serious discussions and consider

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346 Contested votes are typically "the result of a significant event at a company including poor stock performance, large amounts of compensation coupled with poor company performance, a financial debacle of some sort, or a failure of the board and management to adequately explain actions they have taken such as with respect to acquisitions." Hearing Before the House of Rep., supra note 3, at 352-53 (containing testimony of Lynn Turner, Manager Director, LitiNomics, Inc.).

347 In March 2013, ISS and Glass-Lewis advised Hewlett-Packard shareholders to vote against the re-election of two directors—ISS also urged shareholders to oppose the re-election of Chairman Ray Lane—over their roles in the costly 2011 acquisition of software company, Autonomy, which led to a massive write-down for HP. See Serious Fraud Office to Investigate Autonomy, Says HP, BBC NEWS (March 12, 2013), archived at http://perma.cc/95F7-QTV6; see also Martin Lipton, Some Thoughts for Boards of Directors in 2014, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Nov. 29, 2013, 9:55 AM), archived at http://perma.cc/NY79-DUCM.

348 Hearing Before the House of Rep., supra note 3, at 352 (containing testimony of Lynn Turner, Manager Director, LitiNomics, Inc.) ("[T]here are around 100 or fewer proxy voting contests each year that garner the attention of the press and media."); see also Kirsten Grind, Proxy Wars Put Money Managers on the Hot Seat, WALL ST. J. (May 10, 2013, 7:51 PM), http://online.wsj.com/news/articles/SB100014242127887324059704578473003550194468 ("The courtship comes as proxy fights, in which investors seek to oust corporate directors, are on the rise. Institutional Shareholder Services Inc., a proxy advisory firm, counts 22 proxy contests this year, compared with 15 in the comparable stretch last year and nine in 2011.").

349 SHILLER, supra note 341, at 75.

350 A recent survey of financial journalists in the United Kingdom found that there is no consensus among financial and business journalist about whether, and to what extent, business and financial journalists should play a "watchdog" role in relation to markets and corporate behavior. See Damian Tambini, What are Financial Journalists For?, 11 JOURNALISM STUD. 158, 159-60 (2010).

351 JOSEPH N. CAPPELLA & KATHLEEN HALL JAMIESON, SPIRAL OF CYNICISM: THE PRESS AND THE PUBLIC GOOD 210 (1997) ("[T]he decrease in the public's confidence has been especially strong [in the past decade].").
changes in the status quo. The answer for that is quite simple—it took 10 years of concerted effort.

The general public comprises the sixth signalee group. Simply put, the public acquires its knowledge mostly by reading and watching the news and is likely to have very little understanding of the precise quality of advisors' services, with or without regulatory intervention. The general public is often passive and indifferent with regard to financial regulation and market developments, and does not pay attention to warnings that sometimes appear in the press. There is no reason to believe that this trend will not apply in the proxy advisory context. The effectiveness of future proxy advisory firm regulation will likely go largely unnoticed by the general populace.

The public's indifference has real implications on the Expectations Gap analysis. Although the individual members of the public themselves will likely be unaffected by an Expectations Gap, the lack of interest in this issue will make it difficult for other signalees to close the gap. In situations where the public is actively involved in truth seeking and evaluation, politicians and the mass media become much more involved for their own self-interested reasons. Members of the general public also constitute a large share of the stakeholders in both

352 See supra text accompanying notes 22-27.
353 See infra Part V.B (discussing the role of public companies in pushing for regulation of proxy advisory firms).
354 See Coffec, The Political Economy of Dodd-Frank, supra note 338, at 1029 ("Financial regulation is inherently opaque, and the public lacks the same visceral identification with the key values in play . . . Thus, the public's attention span is shorter, and the window of opportunity briefer within which Congress can pass reform legislation."); see also C. Steven Bradford, Crowdfunding and the Federal Securities Laws, 2012 COLUM. BUS. L. REV. 1, 112 ("It is clear that a significant portion of the American public lacks basic financial literacy.").
355 That assumption is especially strong with respect to areas regulated by securities regulators because although they significantly affect the public's general welfare, they are shielded from public view. See PEPPER D. CULPEPPER, QUIET POLITICS AND BUSINESS POWER: CORPORATE CONTROL IN EUROPE AND JAPAN xvi (2011) ("[Although] [h]ostile takeovers have momentous political and economic consequences, . . . the rules governing them seldom command public attention.").
357 Indifference towards the effective enforcement of regulations, whether on the part of the public, media, or legislature, will likely "exacerbate the gap, rather than help reduce it." Langevoort, Managing the "Expectations Gap" in Investor Protection, supra note 44, at 1164.
358 The media's survival depends on the public's attention, so if the public does not care enough about a particular topic, the media may not cover it. See id.
If their stakeholders are indifferent, these power signalees have less incentive to expend efforts to close the gap.

The seventh and the last group of signalees is a residual group composed of professionals and experts. This group would include: professors of Economics, Management and Law; professional services providers such as accountants and lawyers; and prominent members of the financial community—some of whom held senior positions in U.S. federal agencies. These people have the skills and incentives to effectively assess a potential regulation before it comes into force, as well as, its effectiveness in the subsequent months and years. They are also quite vocal and frequently communicate their opinions through testimony before Congress and regulatory bodies and through coverage in the mass media and scholarly publications. Therefore, they are in a good position to develop and convey their own assessments of regulation. However, the reality is that the experts do not always effectively perform this task.

To begin with, experts who grade legislation or regulation frequently provide opposing assessments—which may neutralize each other's effects. A day after the passage of the Dodd-Frank bill and few days before President Barack Obama signed the bill into law, twelve experts graded the bill for the Wall Street Journal, including Henry Paulson (former Treasury Secretary), William Isaac (former Chairman of the FDIC), Harvey Pitt (former SEC Chairman), Eugene A. Ludwig (former U.S. Comptroller of the Currency), and Raghuram Rajan (former Chief Economist at the International Monetary Fund). These and "other prominent members of the financial community gave the overhaul legislation mixed reviews, with some saying it would do nothing to stop another financial crisis from occurring and others saying it was a good first step toward a new financial system." Similarly, consensus cannot be found within the academic literature. For instance, when Roberta

361 See id.
362 See Lee Fang, Scholars for Sale, NATION, Nov. 11, 2013, at 13, 17 (discussing how many scholars have been paid to speak out against regulations).
364 See id.
365 Id.
366 Id.
367 See Di Leo, supra note 363.
Romano, Professor of Law at the Yale Law School, acted as a very vocal critic of the SOX. Donald C. Langevoort, a distinguished Professor at Georgetown Law School, tried to put Romano’s assessment "in perspective." He stated "[t]here is no clear-cut answer to the question of how much SOX benefits investors; both positive and critical positions are plausible."

Moreover, not all regulatory or legislative initiatives and reforms gain extensive interest and response from experts, regardless of whether their response is initiated of their own accord or invited by the media, Congress, or other interested groups. Proposed proxy advisory regulation has garnered some attention from academics, practitioners and few former officials, such as Mr. Harvey Pitt. However, this attention pales in comparison to the frenzy surrounding Dodd-Frank or SOX.

Furthermore, providers of professional services, including former officials who provide consultancy services, are unlikely to diminish an Expectations Gap. Although these people are likely to be better informed of a regulation’s likely efficacy than most signalees, they are likely to support a regulation’s proffered necessity rather than deflating expectations. Increased regulation tends to be a source of income and prestige for these professionals, and challenging the efficacy of new regulation would diminish their own potential for personal returns. In

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368 See Romano, The Sarbanes-Oxley Act and the Making of Quack Corporate Governance, supra note 338, at 1602-03.


370 Id. at 1820.

371 See id. at 1821-28.


373 See Ben Protess & Jessica Silver-Greenberg, Former Regulators Find a Home With a Powerful Firm, N.Y. TIMES DEALBOOK (Apr. 9, 2013), archived at http://perma.cc/75ST-Q64T.


375 See Larry E. Ribstein, Lawyers as Lawmakers: A Theory of Lawyer Licensing, 69 Mo. L. Rev. 299, 347-48 (2004). Thus, it is not surprising that Ernst & Young, one of the "Big Four" accounting firms, has welcomed SOX and ten years after its passage stated that: At Ernst & Young, we believe history has shown, and will continue to show, that the Sarbanes-Oxley Act as a whole has afforded a substantial benefit to investors and US capital markets. We believe that one of the greatest successes of the Sarbanes-Oxley Act was to align the interests of auditors, independent audit committees and audit oversight authorities with those of shareholders. In our view, as the 10th anniversary of the Sarbanes-Oxley Act
the unlikely event that they would nevertheless choose to publicly oppose regulation in order to preserve long-term business ties—in this case with public companies—signalees may perceive these professionals as lacking in credibility. Because these professionals, such as accountants and lawyers, work closely with the public companies, their opinions regarding regulation may be perceived as self-serving. In attempting to deflate expectations, the professionals would bear a high burden of persuasion. Similarly, former officials who move into the private sector are also discredited in the eyes of signalees because they often make substantial amounts of money through the notorious "revolving-doors" phenomenon. Even academics have shown to be biased in favor of public companies that provide them with easy access to the data necessary for their research.

This Article has identified the relevant signalees within the context of the proxy advisory industry and explained the challenges they may face in assessing—ex-ante or ex-post—the efficacy of a new regulation. An additional frustrating factor is that, according to the Expectations Gap theory, those who are expected to benefit from the positive impression received by signalees can manipulate a regulatory signal. In this context, as this Article will demonstrate below, both approaches, the Act continues to provide a solid foundation from which to further this alignment.


See Joseph J. Belonax Jr. et al., The Role of Purchase Importance on Buyer Perceptions of the Trust and Expertise Components of Supplier and Salesperson Credibility in Business-to-Business Relationships, 27 J. Perselling & sales mgmt. 247, 248-49 (2007) (showing that the extensive research literature on credibility—from the early 1950s until the present—demonstrates how credibility of individuals and organizations rests on the two pillars of trust and expertise).


See Luigi Zingales, Preventing Economists' Capture, in Preventing Regulatory Capture: Special Interest Influence and How to Limit It 124, 130-44 (Daniel Carpenter & David A. Moss eds., 2014) (discussing how economists in academia may become captured).

See supra Part III.B.

the proxy advisory firms and institutional investors may benefit from Expectations Gap. Furthermore, even the SEC may prefer the status quo after regulation is implemented, and may gain credit when the regulation's effectiveness is overestimated. These incentives for manipulation are likely to further diminish the chances of reducing a potential Expectations Gap.

V. CONSEQUENCES OF AN EXPECTATIONS GAP IN THE PROXY ADVISORY CONTEXT

A. Releasing Constraints on Proxy Advisors

Relying upon the Expectations Gap notion, the effectiveness of proxy advisory firm regulation may be overestimated by signalees. Proxy advisory firms would then benefit from an increase in their reputations. In that way, regulation may unintendedly exempt advisors from a large amount of undesirable attention from signalees—and at the same time may dissuade ongoing pressure on regulators to play an active role in supervising advisory firms—in normal times, as well as provide advisors with an escape hatch from the fallout of a corporate governance failure. Thus, regulation may unintendedly cause a decline in proxy advisors' incentives to invest in rigorous analysis, which in turn would reduce the quality of their recommendations to institutional investors.

In normal times, an Expectations Gap may cause signalees to become lulled into thinking that advisory firms are effectively supervised by the SEC so there would be less need for them to test the advisors' recommendations. As this Article will show below, in the absence of regulatory intervention in advisors operation, it seems that free market mechanisms themselves—mainly financial media coverage and public companies' own efforts—are currently policing proxy advisors' work—although the precise effectiveness of this policing is debatable. This effect can paradoxically decrease the pressure exerted on regulatees to

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381 See infra Part IV.A-B.
382 See infra Part IV.A-B.
383 See Eckstein, supra note 268, at 7; Samuelson & Zeckhauser, supra note 224, at 8.
384 See Langevoort, Managing the "Expectations Gap" in Investor Protection, supra note 44, at 1165; see also Langevoort, Taming the Animal Spirits of the Stock Markets, supra note 185, at 167.
385 See Choi & Pritchard, supra note 380, at 20-36 (discussing how the potential biases at the SEC may lead regulators to overestimate the effectiveness of regulations).
386 See infra Part V.B.
387 See infra Part V.B.
conform their behavior to expected norms. Regulation—the more it is overestimated—can freeze market mechanisms. In particular, it may shield proxy advisory firms from the scrutiny of signalees and put an end to the ongoing controversy surrounding advisors' operation—as hereinafter explained.

As noted elsewhere, regulation is the result of a "pragmatic negotiation": a political alliance between the regulator on the one hand and the pressure groups—both those who would be subject to regulation and those who would benefit from it—on the other hand. Thus, soon after a regulation is adopted, controversies seem to be largely settled and the status quo is likely to be established while signalees' focus moves to other fields of interest. As long as interested stockholders are satisfied, Congress and the SEC are not likely to track the real impact of regulation on proxy advisors' operation or strive to optimize the regulatory regime.

Indeed, one might argue that as time goes by the real effect of a regulation will become more and more apparent to signalees and the

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388 [See Hearing Before the House of Rep., supra note 3, at 352 (containing testimony of Lynn Turner) ("There are around 100 or fewer proxy voting contests each year that garner the attention of the press and media."). At this point, one might ask why—if we realize that some of the signalees have contributed to improving proxy advisors' operation—we cannot build upon signalees' incentives and capabilities for assessing the effect of future regulation of advisors. It should be noted that evaluation of regulatory impact requires much higher incentives and capabilities than those required for accusing proxy advisors for operating with conflict of interest, lack of transparency, etc. Further, as previously explained, once regulation will be adopted, public corporations are likely to lose their political inertia, Congress and the SEC may adhere to the status-quo, and the media would lose its interest in following proxy advisors' regulation. See supra Part III.B.

390 [See Macey, supra note 164, at 595 ("The original, demand-driven motivation for utilizing a particular market mechanism disappears when the market mechanism is incorporated into a rule.").


393 [See Langevoort, Managing the "Expectations Gap" in Investor Protection, supra note 44, at 1145.

395 [But see At Long Last, SEC Staff Issues Proxy Advisory Firm Guidance: Will it Calm the Controversy?, COOLEY ALERT (Cooley LLP, Palo Alto, Cal.), July 2014, at 3, archived at http://perma.cc/TJ36-N4Y3 (expressing concern that the SEC's recent regulatory guidance is unlikely to eliminate the controversy concerning proxy advisory firms).

397 The adherence of decision makers to the status quo, and the tendency to "satisfice" rather than "optimize," were identified and discussed beginning in the 1950s. Herbert A. Simon, Rational Choice and the Structure of the Environment, 63 PSYCHOL. REV. 129, 129 (1956). Three decades later, this notion was further elaborated upon. See Samuelson & Zeckhauser, supra note 224, at 7-8.
Expectations Gap will shrink. In that respect, it should be noted that it might take time, perhaps a long time, for the true merit of regulation to become clear. Even when emerging data about the regulation and the regulatees would serve to lower research costs, psychological biases, such as the anchoring and adjustment bias, can magnetize signalees to their initial belief in regulatory success and make it harder for them to adjust their perceptions.

Even assuming that signalees will eventually revise expectations and beliefs regarding the regulation, some of them—especially the media—may lose interest in spurring reassessment of regulation. Others—especially public companies and in some cases the media—may be willing to do so, but would not be able to generate enough interest and pressure to destabilize the status quo and persuade regulators to consider revisiting the issue. Companies would have to reload their political clout and the media would have to find a way to spur interest in an old story. Lastly, even when assuming a utopian situation in which signalees have both incentives and capabilities to challenge existing regulatory regime, some costs and damage are likely to occur in the interim between the time of the regulation's adoption and the time it takes signalees to make perceptual adjustments and active efforts to close the Expectations Gap.

In "crisis" times, when corporate scandals are being revealed, an Expectations Gap may have two opposing effects on proxy advisory firms. On the one hand, following the Expectations Gap's rational, if the regulation is perceived to be strict, advisory firms will be expected to be more effective in preventing and detecting corporate wrongdoing. If they fail to live up to expectations they are likely to be sharply criticized and publicly lose face. Thus, an Expectations Gap has the potential to actually deter advisory firms from negligent conduct and

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394 According to the traditional explanation, when asked to estimate something, most individuals begin with the initial value as an anchor or starting point and adjust as they get closer to the desired estimate. As a result of this process, the adjustment is typically insufficient and the estimation usually deviates in the direction of the anchor point. Tversky & Kahneman, Judgment Under Uncertainty, supra note 227, at 1128-30; see also Richard H. Thaler & Cass R. Sunstein, Nudge: Improving Decisions About Wealth, Health, and Happiness 23-24 (2008) (defining and explaining the process of anchoring and adjustment).

395 See Edelman, supra note 125, at 1371 (noting that the SEC's desire to regulate proxy advisory firms is not unreasonable, given recent corporate scandals and crises).

396 See id. at 1381-83 (identifying a selection of "hard regulation proposals," which seek to curb the influence of proxy advisory firms by forcing the firms to disclose the underpinnings of their recommendations).

397 See Troy A. Parcells, On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission, 2006 U. Ill. L. Rev. 975, 1011 (indicating that since the SEC received stinging criticism after the Enron and WorldCom scandals, it has responded with strong regulation and enforcement efforts).
consequently improve their work. However, an Expectations Gap includes inflated expectations regarding the SEC's duty and ability to efficiently control advisors' work. Such expectations may allow regulated advisors to deflect at least some of the frustration of the other signalees—the media, broad public and the public companies—towards the SEC if a proxy adviser makes a colossal mistake. In other words, the negligent proxy advisor will lay the blame on the SEC.

In conclusion, regulation of proxy advisory firms may have a signaling effect upon the signalees' assessment of a good quality of advisor's work. Such an effect may enable advisors to escape scrutiny from signalees and may unintentionally remove some of the constraints on their operation. If this dynamic were created, the quality of research and recommendations produced by the advisors could plummet.

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398 See infra Part VII.
399 See At Long Last, SEC Staff Issues Proxy Advisory Firm Guidance, supra note 392, at 3 (observing that the SEC's recent regulatory guidance is unlikely to eliminate the dispute surrounding proxy advisory firms).
400 In that regard, past experience provides us with examples of how regulatees have tried to shift the blame toward regulators and other regulatees in times of scandals. See, e.g., Story & Morgenson, supra note 390. As discussed by the New York Times: In the whodunit of the financial crisis, Wall Street executives have pointed the blame at all kinds of parties—consumers who lied on their mortgage applications, investors who demanded access to risky mortgage bonds, and policy makers who kept interest rates low and failed to predict a housing market collapse. But a new defense has been mounted by a bank executive: my regulator told me to do it. Id.; see also Marlene Y. Satter, Barclays' Diamond Blames Libor Fixing on Other Banks, Regulators, THINKADVISOR (July 5, 2012), archived at http://perma.cc/UD4Y-DR7M ("Former CEO of embattled Barclays Bob Diamond sought to place the blame for Libor fixing on other banks and on regulators . . . saying that Barclays was consistently at the high end of the reporting range and that he was 'disappointed' regulators failed to act on Barclays' advisements . . . .").
401 See Belinfanti, supra note 89, at 418-19 (stressing the importance of transparency in implementing proxy voting policies).
402 See Paul Rose, Commentary, On the Role and Regulation of Proxy Advisors, 109 MICH. L. REV. FIRST IMPRESSIONS 62, 68 (2011), archived at http://perma.cc/F22D-ZNLH ("[T]he SEC has not adequately encouraged investors to scrutinize not just potential conflicts of interest, but also the content of the advice they receive from corporate governance raters and proxy advisors.").
403 Id. ("Unless the SEC provides better guidance on what such scrutiny should entail and undertakes a sustained enforcement program to detect and discipline fiduciaries who fail to meet their duties, the beneficiaries of the funds these institutional investors manage will suffer.").
B. Releasing Constraints on Institutional Investors

Regulation of proxy advisory firms coupled with a resulting Expectations Gap may also have unintended effects on the operations of institutional investors.\(^{404}\) These effects are more complicated than those previously discussed regarding advisory firms. In fact, effects of regulation on institutional investors would be derivative of regulatory effects on advisory firms. Generally speaking, advisors traditionally play a role of "symbolical guarantors" for quality of decisions made by their clients.\(^{405}\) This role may become more significant if an Expectations Gap is created and persists.

Although the regulation of proxy advisors currently proposed would far from assure the quality of advisors' services,\(^{406}\) due to a potential Expectations Gap the regulation could provide advisors with a seal of approval. Such a seal may help institutional investors share with proxy advisors the "undesirable" attention of signalees during the daily routine of business and the risk of blame in the case of a failure to prevent a corporate governance scandal. Before turning to this notion in detail, and in order to better understand it, this Article will briefly refer to the "blame-shifting model" that was expounded upon by the political scientist Morris P. Fiorina who explored the congressional delegation of power to regulatory agencies.\(^{407}\)

According to Fiorina, delegation can be understood not just as a simple "attempt to shift decision-making costs," but also as a "deliberate attempt to shift political costs."\(^{408}\) These political costs derive from the conflict between "powerful pressure groups on one side or the other that

\(^{404}\) See, e.g., OECD, supra note 7, at 10 ("[P]rudential regulations sometimes excessively limit holdings by institutional investors in individual companies and restrictions on incentive schemes may also change their behaviour in an unintended manner.").

\(^{405}\) THOMAS ARMBRÜSTER, THE ECONOMICS AND SOCIOLOGY OF MANAGEMENT CONSULTING 63 (2006) (discussing the role consultants played in the 1980s and 1990s as "symbolical guarantors of [corporate] management quality," and explaining how the need to legitimate, accredit, and certify the decisions of managers toward principals and the public contributed to the growth of consulting in those two decades). In the proxy advisory context it is useful to refer to the comments of Eric Komitec, General Counsel, Viking Global Investors, LP, during the SEC Roundtable, supra note 20, at 73:

I mean, if we have a conflict of interest potentially with respect to the valuation of a given position, we may go get advice from a third party valuation firm because we believe that the valuation decision we make will be less subject to criticism once we have looked to the expertise of a third party that is, you know, intended to think about these issues.

\(^{406}\) See supra Part III.


\(^{408}\) Id. at 46-47.
are affected by government regulation. According to Fiorina's model, a legislator would prefer that administrative agencies shoulder the burden of enforcing policy changes whenever, in the legislator's estimation, the political costs of the enforcement outweigh the potential reputational benefits of the policy.

Returning to the proxy advisory context, institutional investors incur significant costs derived from fulfilling their corporate governance responsibilities. In normal times—unlike times of scandals, as will be discussed next—these costs involve monitoring the companies in which the institutional investors invest and promoting good corporate governance. Promoting responsible governance and managing the associated interests usually consumes precious time and energy at the expense of the institutional investors' ability to make investment decisions and improve performance of their portfolio. Given that value-maximization is at the core of institutional investors' existence,
it is reasonable to believe that their natural tendency would be to share with proxy advisors the "dirty" work—their corporate governance responsibilities—and the undesirable attention related to it.

At this point, one might ask—what role does an Expectations Gap play in relation to the cost saving tactics discussed above? If future proxy advisory regulation is perceived to be effective in controlling the quality of advisors' products, it enhances advisors' perceived expertise and credibility. In some sense, proxy advisors could be perceived as authorized gatekeepers.\footnote{Regulation could provide advisors with the authority to improve the proxy voting system, and at the same time would—in the minds of signalees at least—subject them to greater responsibility for their research and recommendations as well as for the consequences arising from use of their new authority.} Thus, although regulation does not formally "offload" fiduciary duties of institutional investors to their clients,\footnote{The Expectations Gap is likely to make it} the Expectations Gap is likely to make it

Gootzmann, \textit{Performance Persistence}, 50 J. Fin. 679, 679-80 (1995) (showing that poor performance of mutual funds not only cause the funds to lose investors, but also increases the probability of their disappearance altogether); SEC Roundtable, \textit{supra} note 20, at 47 (containing comments from Michelle Edkins, Managing Director and Global Head, Corporate Governance and Responsible Investment, BlackRock, Inc.):

The underlying principle in all our voting decisions is trying to achieve an outcome, a voting outcome, that we believe best supports and promotes the economic interests of our clients. So it's an economic decision, not a compliance decision, and that's really important, and that is why we work very closely with our portfolio managers particularly on the governance issues that are more closely related to value.

See also Marla Brill, \textit{The Mystery of Mutual Fund Proxy Votes}, \textit{REUTERS}, Nov. 1, 2011, 5:02 PM, archived at \url{http://perma.cc/7KHW-SHEN} ("Most people invest in mutual funds to pay for college or a comfortable retirement, not to influence corporate policy. What they want, first and foremost, is strong investment performance from their funds."); Hearing Before the House of Rep., \textit{supra} note 3, at 21 (confirming, based on testimony by Harvey Pitt, that in a case where a pension plan is subject to ERISA, its management can be subject to litigation based on a break of fiduciary duty because management invested based on what they viewed as good environmental policy or good antiterrorism policy).

\footnote{See Jack W. Murphy \textit{et al.}, \textit{Is the Pendulum Swinging? SEC Commissioner Gallagher Expresses Concerns About Reliance on Proxy Advisors}, \textit{ONPOINT LEGAL UPDATE} (Dechert LLP, New York, N.Y.), July 2013, archived at \url{http://perma.cc/9JD8-HJQ6}.} See \textit{RICHARD L. DAFT, NEW ERA OF MANAGEMENT} 310 (2d ed. 2008). Daft defined authority as "the formal and legitimate right of a manager to make decisions, issue orders, and allocate resources to achieve organizationally desired outcomes." \textit{Id}. He defined responsibility as "the flip side of the authority coin...the duty to perform the task or activity as assigned" and accountability as "the mechanism through which authority and responsibility are brought into alignment." \textit{Id}.

\footnote{SEC Roundtable, \textit{supra} note 20, at 55, 57, 61 (emphasizing the testimony of: Lynn Turner, Manager Director, LitiNomics, Inc.; Karen Barr, General Counsel, Investment Adviser Association; and Katherine Rabin, CEO, Glass Lewis & Co., LLC); see also Hearing Before House of Rep., \textit{supra} note 3, at 19 (containing comments from Harvey Pitt) ("The fiduciary duties still remain with institutional investors. They cannot divest themselves of their fiduciary obligations.").}
easier for those investors to informally deflect responsibility for sub-optimal voting decisions as evidenced by this exchange between Representative Hultgren and Harvey L. Pitt, Founder and Chief Executive Officer, Kalorama Partners, LLC, on behalf of the U.S. Chamber of Commerce:

MR. HULTGREN: You kind of touched on this, but Chairman Pitt, by allowing mutual funds and investment advisors to outsource that fiduciary duty to act in their client's best interest when voting their proxies to proxy advisory firms has the SEC effectively decoupled the voting decision from the fiduciary duty?

MR. PITT: I am sorry. Has the SEC—

MR. HULTGREN: Effectively decoupled the voting decision from the fiduciary duty?

MR. PITT: I think that is a fair statement. 419

Furthermore, institutional investors may be even more interested in delegating their governance responsibilities to advisory firms during times of governance scandals in order to avoid as much responsibility as possible. 420 In times like these, institutional investors will be subjected to heavy criticism for their failure to prevent wrongdoing in corporations that they invest and vote. 421 Such criticism would translate into high economic costs associated with reputational damage. 422 This is because a reputational loss of that magnitude is likely to taint the overall reputation of the entire institutional investment firm, not just that of the firm's

419 Hearing Before the House of Rep., supra note 3, at 29.
420 See Hamman et al., supra note 315, at 1843 (demonstrating how the principal-agent relationship might free the principal from blame or responsibility for unfair actions or outcomes). According to the authors, through the act of delegating, the principal himself may feel less responsible, and may be judged differently by others once the responsibility is being diffused. Id. See also Björn Bartling & Urs Fischbacher, Shifting the Blame: On Delegation and Responsibility, 79 REV. ECON. STUD. 67 (2012) (documenting laboratory experiments which strongly confirmed that the avoidance of blame is a motive for the delegation of a decision right).
422 See Jonathan M. Karpoff & John R. Lott, Jr., The Reputational Penalty Firms Bear from Committing Criminal Fraud, 36 J. L. & ECON. 757, 798 n.2 (1993) ("The reputational losses that firms suffer from committing fraud compose a similar portion of their total monetary penalty as that borne by individuals in the commission of crimes.").
corporate governance team that handles the culpable company. In short, reputational forces play an important role in shaping institutional investors' behavior. Institutional investors build their reputation not only on their performance—value creation and risk optimization for their clients—but also on their obligation to promote sound corporate governance in companies in which they invest. A failure to prevent a corporate scandal may also invite strict regulatory response that can even expand the governance duties imposed on institutional investors.

Following the Expectations Gap theory, if new regulation is perceived to be efficient in controlling proxy advisory firms, it would allow institutional investors to share the blame for corporate governance scandals with advisory firms more comfortably. Due to the high expectations imposed on proxy advisory firms, as a result of the regulation, these firms are likely to become a relevant and significant factor in the potential blame game. This new entrant into the equation will help diminish institutional investors' public culpability due to both psychological reasons, and practical reasons related to difficulties in distributing responsibility. Moreover, given that advisory firms are likely to be perceived as having more expertise than institutional investors in making governance decisions, they may be perceived even

423 See Roger D. Huang & Hang Li, Does the Market Dole Out Collective Punishment? An Empirical Analysis of Industry, Geography, and Arthur Andersen's Reputation, 33 J. BANKING & FIN. 1255, 1255-65 (2009) (discussing the effect of massive reputational loss in the context of Enron and showing that the Enron scandal tainted the overall reputation of its auditor Arthur Andersen, and not simply the reputation of the Houston office that handled the Enron account).


425 See Black, supra note 109, at 834 ("[S]hould structure manager incentives be more congruent with shareholder incentives, discourage actions such as diversification that benefit managers but not shareholders, and step in when a CEO, having been given a fair opportunity to run the business, repeatedly falls on his face.").

426 See Roberta Romano, The Sarbanes-Oxley Act and the Making of Quack Corporate Governance, supra note 338, at 1523 (emphasizing that SOX was enacted as a regulatory response to a scandal).

427 See Lagnado et al., supra note 74, at 1046-53 (engaging in an excellent review of the allocation of blame or credit amongst multiple agents). In particular, this article completes an excellent review of allocation of blame or credit amongst multiple agents and demonstrates that in certain situations "responsibility decreases with the number of players who share it . . . ." Id. at 1051.

428 See DAVIES, supra note 340, at 197-201 (identifying the huge number of "suspects" in the financial crisis that occurred in the summer of 2007, ranging from investment banks to borrowers, central banks, financial regulators, and even the media, and illustrating how difficult it is to allocate responsibility among them); see also Financial Crisis Inquiry Commission Slams Greenspan, Bernanke, Geithner, Paulson, Summers, SEC, Rating Agencies and Big Banks for Causing Crisis, WASHINGTON'S BLOG (Jan. 26, 2011), archived at http://perma.cc/S2EN-EAYK.
more responsible than institutional investors. In the same vein, it is quite clear that if the SEC chooses to intervene in proxy advisors' operations it also becomes part of the blame game, and thus enables further dilution of responsibility.

Lastly, an Expectations Gap may lead to an internal blame game played by different kinds of institutional investors. Because regulation of proxy advisors together with the Expectations Gap may drive the institutional investors to further rely on proxy advisors, and because herding behavior may evolve—where more and more institutional investors rely more heavily on advisors—a negligent institutional investor will be able to argue that other institutional investors have also mistakenly voted and failed to fulfill their fiduciary duties and governance obligations, so should also share in the blame for a larger market failure.

To summarize, the SEC's seal of approval on advisors' operation may allow institutional investors to bear minimal residual risk of poor voting decisions in normal times and failure to prevent a corporate wrongdoing in crisis times—vis-à-vis company shareholders—a classic agency problem of "separation of decision and risk-bearing functions." So far, this section has discussed the potential benefits of an Expectations Gap to institutional investors arising from their ability to shift attention—in normal times—and blame—in the aftermath of governance breakdowns. However, execution of these diversionary tactics may be coupled with costs of their own. To complete the picture following Fiorina's model, these potential costs will now be examined.

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429 See, e.g., Tobias Gerstenberg et al., Blame the Skilled, in PROCEEDINGS OF THE 33RD ANNUAL CONFERENCE OF THE COGNITIVE SCIENCE SOCIETY 720 (Laura Carlson, Thomas F. Shipley & Christoph Hölscher eds., 2011) (investigating how people attribute responsibility between multiple agents based on their underlying skill level and actual performance). The authors demonstrated that skilled agents are blamed more for losses than unskilled agents because they are perceived to have more control over the outcome. Id.; see also Bernard Weiner & Andy Kukla, An Attributional Analysis of Achievement Motivation, 15 J. PERSONALITY & SOCIAL PSYCHOL. 1, 2-19 (1970) (documenting experiments which revealed the connection between level of ability to evaluation of achievement-related).

430 Ample amounts of studies have demonstrated—theoretically and empirically—herding behavior among institutional investors. See Sushil Bikhchandani & Sunil Sharma, Herd Behavior in Financial Markets: A Review 5-20 (Int'l Monetary Fund, Working Paper No. WP/00/48, 2000). So far, herding behavior has been documented in the trading decisions. Id. at 14-18. It is reasonable to assume that herding behavior is also prevalent in relation to policy decisions, such as whether and to what extent to rely on proxy advisors.


432 See infra Part V.B.
It is commonly believed that better corporate governance will generally lead to better portfolio returns. It is commonly believed that better corporate governance will generally lead to better portfolio returns. Institutional investors are expected to actively participate in monitoring the companies in which they invest, in order to enhance the value of their investments. If we accept this assumption, in cases where institutional investors become passive and leave proxy advisors to take responsibility for governance issues, they expose themselves to two risks: first, they risk a decline in the value of their investments if poor governance results from proxy advisor's negligence. Second, they risk losing credit for maximizing value if things go well. These two arguments would suggest that institutional investors should take activist roles in researching and influencing the companies in which they invest.

Regarding these arguments, five remarks merit attention. First, meaasuring the effectiveness of shareholder activism is a difficult task. Studies attempting to do so have produced mixed evidence and conclusions. There is no real guarantee that activism on the part of institutional investors would actually create additional value for their investments. Second, because of a potential free rider problem, corporate governance activism may become less worthwhile to institutional investors, who would bear the costs of activism and share the benefits of activism with passive investors at the same time. When institutional investors themselves—as a group—bear the costs associated with activism, they capture only part of the benefits resulting from improved corporate governance. This is because many individual investors hold shares in companies directly, and not through institutional investors. Thus, activist institutional investors may capture only a

434 See Hearing Before the House of Rep., supra note 3, at 378 (containing statement of Ann Yerger, Executive Director of the Council of Institutional Investors) (“Because of the significance of the issues addressed on corporate ballots, the proxy vote is considered part of the underlying value of a stock.”).
435 See id.
436 See OECD, supra note 7, at 38.
437 See Gillan & Starks, supra note 92, at 60-63 (pointing to two important caveats which deserve mention). First, in many cases activists negotiate behind the scenes and there may be no external sign of the activity. See id. Therefore, “identifying cases of shareholder activism can be problematic.” Id. at 60. Second, it is difficult to establish “a causal link between shareholder activism and subsequent changes in governance, and between such governance changes and changes in corporate performance.” Id. at 63.
438 See Gillan & Starks, supra note 92, at 63-69.
439 See Hannes, supra note 92, at 249-51; Gillan & Starks, supra note 92, at 69; Davis Evans, supra note 92, at 1129.
441 See id.
fraction of the increase in stock value that better investor protection would produce.\textsuperscript{442} Third, potential conflicts of interest may prevent institutional investors from being proactive.\textsuperscript{443} Institutional investors are typically well connected in the business community and may not want to risk professional good-will by meddling too much in the affairs of the companies in which they hold a stake.\textsuperscript{444} Fourth, with the exception of private equity and hedge funds, most institutional investors are not remunerated on the basis of the portfolio companies' performance, but rather based on the volume of assets under their management.\textsuperscript{445} They may thus only "reap a very small proportion of the monitoring gains."\textsuperscript{446} Fifth and last, proxy advisory firms are not perceived as entities that select investments for their clients, but as entities that only provide advice on proxy voting.\textsuperscript{447} So when outsourcing proxy voting to the advisors, institutional investors do not risk losing credit for maximizing value.\textsuperscript{448}

As a second cost of attention or blame shifting, one might argue that activism in corporate governance is not merely a tool for investors to maximize portfolio value, but also a civic duty. In the words of Eric Komitte, General Counsel to Viking Global Investors, L.P., "I think investment advisers generally speaking have a duty of good corporate citizenship in the United States the same way ordinary citizens have a civic duty to vote in elections . . . ."\textsuperscript{449} Accordingly, regardless of whether or not corporate governance activism allows institutional investors to maximize returns for their stakeholders, activism can improve institutional investors' reputation.\textsuperscript{450} In contrast, once the institutional investors completely outsource their governance duties, their

\begin{itemize}
\item \textsuperscript{442}See id; see also Gillan & Starks, supra note 92, at 69 ("But since the active investors incur all the costs associated with such activism (while the benefits accrue to all shareholders), only shareholders with large positions are likely to obtain a large enough return on their investment to justify the costs.").
\item \textsuperscript{444}See id.
\item \textsuperscript{445}See Hannes, supra note 92, at 250-51.
\item \textsuperscript{446}See id. at 251.
\item \textsuperscript{447}Hearing Before the House of Rep., supra note 3, at 23 (containing statement from Niels Holch, Executive Director, Shareholder Communications Coalition) ("Their role is very unique. They are not selecting investments for their clients; they are providing advice on proxy voting.").
\item \textsuperscript{448}See Hannes, supra note 92, at 252 (explaining how institutional investors still play an active role with the assistance of proxy advisors).
\item \textsuperscript{449}SEC Roundtable, supra note 20, at 74 (containing statement of Mr. Eric Komitee, General Counsel, Viking Global Investors, L.P. implying a duty of good governance).
\item \textsuperscript{450}Eun-Hee Kim & Thomas Lyon, When Does Institutional Investor Activism Increase Shareholder Value?: The Carbon Disclosure Project, 11 B.E. J. ECON. ANALYSIS & POL'Y 1, 23 (2011).
\end{itemize}
reputations may be damaged. The investors may be viewed as passive, motivated only by profits, or even lazy. Based on theories provided in psychological literature, however, key officials in institutional investment firms may be risk averse. They may be unwilling to risk blame for management's missteps in exchange for a chance to earn reputational credit for diligent monitoring of the companies in which they invest. They would consider the reputational payoff as asymmetrical and not worth the time, effort, and risk.

In summary, an Expectations Gap regarding regulation of proxy advisory firms may provide institutional investors with a convenient basis to further rely on these advisory firms. Even if advisory firms' services do not become more valuable due to regulation—either they stagnate or even degrade—and institutional investors are aware of this fact, the Expectations Gap may still drive them to rely on proxy advisors even more than they already do.

VI. ADDITIONAL INSIGHTS ON THE REGULATION OF PROXY ADVISORY FIRMS

A. Other Perverse Effects

Beyond the major perverse effects associated with an Expectations Gap discussed above, the release of constraints on both proxy advisory firms and institutional investors, regulations of proxy advisory firms may also have other unintended effects. Because these effects are not

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451See generally Weiner & Kukla, supra note 429, at 1-20 (discussing how evaluation of outcomes related to achievement are positively related to the amount of expended effort).
454See id.
455See id. (providing an excellent analysis and overview of this risk-averse bias—sometimes called the Negativity Bias—with regard to politicians, bureaucrats and the media). Hood explains, that in circumstances in which the chance of credit has to be weighed against the risk of blame, the risk preferences in aggregate tend to be asymmetric in human decision-making and potential blame is commonly weighted more heavily than equivalent credit. Id.
458See supra Part IV.B.
459See infra text accompanying notes 462-76.
directly related to the Expectations Gap theory, which constitutes the heart of this Article, these additional effects will be presented only briefly.  

It should be noted that most of these effects are not unique to the proxy advisory regulation context and are often discussed regarding the regulation of corporate gatekeepers.

To begin with, regulation would impose significant costs on proxy advisors. These costs would arise from ensuring regulatory compliance and could redirect advisors' attention away from their work. Costs of regulation can also be indirect. For instance, regulatory intervention designed to increase advisors' independence and minimize their conflicts of interest may also reduce the advisors' access to public corporations. The advisors would then be less connected to, and informed about, the very companies in whose shareholder votes they are making recommendations. In turn, the cost of gaining information for advisors—regarding the public corporations—is likely to become inflated, prompting advisors to charge more for their services. All else being equal, these additional constraints and costs imposed upon proxy advisors would likely reduce the quality of advisors' work if the advisors resist raising their fees and increasing their workforce.

Still, some of the effects have relevance to the Expectations Gap notion because they may damage the quality of proxy advisors' services and thereby expand the potential Expectations Gap. See supra Part III.A.


See Hearing Before the House of Rep., supra note 3, at 129 ("Many of the regulatory proposals for proxy advisors outlined in this section revolve around increased certification, procedural and public filing requirements that would likely increase costs for proxy advisory firms.").

See id. at 110-16. Without SEC regulation, proxy advisory firms are already under enormous pressure from: disclosure requirements, increasing profitability, short turnaround time for analyses, and fiduciary duties owed to their clients. See id. Proxy advisors concede that their industry is prone to inaccuracies; hence, the move for regulation. However, it seems counterintuitive to require more procedural compliance and scrutiny on an already paper-thin workforce. SEC regulation would only produce what they seek to eliminate.

See SEC Roundtable, supra note 20, at 130-34. The president of ISS, Mr. Retelny, detailed his involvement with 350 corporations and explained that polling all interested parties aids ISS with drafting policy. See id. at 132. Information gleaned from the proxy advisors' access to public corporations is beneficial to all constituencies. See id. at 130-34. When all interested parties have a voice, advisory firms like ISS are more informed to the necessities of their client base. See id.

See SEC Roundtable, supra note 20, at 130-34. (discussing how proxy advisors' access to public corporations has helped them obtain feedback from constituencies which in turn has helped them to formulate policies).

See Hearing Before the House of Rep., supra note 3, at 65 ("Two principal reasons for such inaccuracies appear to be the workload pressures caused by the tremendous growth in the length of proxy disclosures and inadequate quality control, as publicly-held firms, such as ISS, seek to reduce costs by outsourcing proxy analysis to low labor-cost countries like the Philippines.").
Additional external pressures could also impact the quality of proxy advisory services if the industry becomes regulated.\textsuperscript{467} If new regulation requirements increased transparency with regard to the advisors' analysis and recommendations, it may cause the advisors to become overly conservative and risk-averse.\textsuperscript{468} The additional public exposure could also subject the advisors to undue influence from interest groups and political organizations.\textsuperscript{469} It is also well established in the economic and psychological literature that external regulatory intervention can crowd-out intrinsic motivations.\textsuperscript{470} This logic is valid in the proxy advisory context as well. Further, increased competition among proxy advisory firms, an ostensible goal of those who urge advisory firms' regulation, may inevitably lead to "race to the bottom."\textsuperscript{471} Due to the ability of institutional investors to select advisory firms—which may differ from each other in their methodology and agenda—and the desire of advisory firms to attract clients, these firms may be tempted to formulate their recommendations in a way that pleases their clients at the expense of accuracy and quality.\textsuperscript{472} Moreover, as

\textsuperscript{467}See id. at 110 (detailing the multitude of pressures proxy advisory firms are under even before proposed SEC regulation).

\textsuperscript{468}But see THE CRISIS INQUIRY REPORT, supra note 161, at 126 ("[T]he rating agencies were not adequately regulated by the Securities and Exchange Commission or any other regulator to ensure the quality and accuracy of their ratings."). The lack of required transparency with respect to rating agencies resulted in erroneous ratings on mortgage-related securities. Ted Kaufman, Political Will Falters On Fixing Credit Ratings Agencies, FORBES (July 30, 2013), http://www.forbes.com/sites/tedkaufman/2013/07/30/political-will-falters-on-fixing-credit-ratings-agencies/.


\textsuperscript{470}See Bruno S. Frey, A Constitution for Knaves Crowds Out Civic Virtues, 107 ECON. J. 1043, 1046 (1997) ("The crowding out effect may spread to further areas . . . . [T]here may thus be an indirect 'motivational spill-over effect' which has to be added to the direct crowding-out effect."); see also Bruno S. Frey & Reto Jegen, Motivation Crowding Theory, 15 J. ECON. SURV. 589, 589-91 (2001).

\textsuperscript{471}See Choi et al., supra note 307, at 649 ("[T]he four proxy advisory firms [ISS, Glass-Lewis, PROXY Governance, and Egan-Jones] differ substantially from each other in their willingness to issue a withhold recommendation, in the factors that affect their recommendations, and in the relative weight of those factors.").

\textsuperscript{472}See id. at 649, 675.

\textsuperscript{473}In fact, such a possibility was identified and shortly discussed during the Roundtable conducted by the SEC in December 2013. See SEC Roundtable, supra note 20, at 105-13. At the beginning, Ms. Anne Sheehan, Director of Corporate Governance at CalSTRS, noted that proxy advisory firms, as any for-profit business, are trying to improve their models all the time. Id. at 105-06. According to Ms. Sheehan:

"[T]hat's part of the free market process, to entice additional customers to refine their process . . . . I see it as a part of the free market and trying to improve the product that we, the customers, want to buy. Many times it's we, the customers, who are asking them to do these additional services [which
demonstrated elsewhere, "increasing the number of competitors . . . decreases the motivation to compete."474

Lastly, increased costs of compliance can serve as barriers to entry for new competitors in the proxy advisory market475 and could exclude from the market entirely existing small advisory firms that are unable to bear the additional costs. Regulation could stifle competition in an already highly concentrated market, frustrating calls for increased competitiveness. Assuming that competition can improve advisory work,476 regulation of advisors may spur just the opposite.

B. Keeping Things Proportionate

This part of the Article will briefly explain why concerns regarding proxy advisors' current operation are exaggerated and overstated. First, as demonstrated elsewhere, although advisory firms are continuously indicted for wielding dramatic influence over ballot results, current evidence leads to inconclusive results.477 Institutional investors

subject advisors to alleged conflicts of interest] for us because we are the big customers.

Id. Commissioner Gallagher then noted "Anne teed up something interesting . . . which is what are the controls about with intra-advisory side, some advisory clients trying to influence your recommendations to the way they want to see it, which may be to the detriment of the other advisory clients." Id. at 112. Mr. Retelny, the president of ISS, answered by stating that, "[s]o we make sure that we bring everybody into the table with the information, and we bring out the feedback that we do get from a multitude of sources, including our clients." Id. at 113.

476This is the common argument of those who call for more competition among proxy advisory firms. See Hearing Before the House of Rep., supra note 3, at 67; see also SEC Roundtable, supra note 20, at 155.
477See Stephen J. Choi et al., The Power of Proxy Advisors: Myth or Reality, 59 EMORY L. J. 869, 869 (2010) (providing empirical evidence and concluding that the influence of ISS is overstated); Stephen J. Choi et al., Who Calls the Shots? How Mutual Funds Vote on Director Elections, 3 HARV. BUS. L. REV. 35, 35 (2013) (finding evidence that most funds do not appear to follow ISS' recommendations automatically). Other scholars, although providing evidence for a high correlation between ISS recommendations and mutual funds voting, do not prove causality. Put simply, these scholars cannot demonstrate that mutual funds vote in line with ISS recommendations because the recommendations guided the votes. It is also possible that mutual funds and ISS often come to the same voting conclusions on their own, or that ISS tailors its recommendations to track mutual funds' voting preferences. See also James Cotter
often do not mechanically follow advisors' recommendations. This is especially true regarding contested votes as evidenced by Eric Komitte, General Counsel to Viking Global Investors, L.P. Additionally, the high correlation between an advisor's recommendation and the manner in which proxy votes are cast could just as easily demonstrate that proxy advisory firms are providing high-quality recommendations that coincide with their client's needs; the correlation cannot be extrapolated to serve as proof that proxy advisors wield too much power.

Second, those who have been calling for regulation of proxy advisors tend to compare advisors with credit rating agencies, arguing that both make recommendations widely relied upon by investors and others, and that both are subject to actual or potential conflicts of interest. Thus, some argue regulators should learn the lesson from

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See *ISS Recommendations and Mutual Fund Voting on Proxy Proposals*, 55 *Vill. L. Rev.* 1, 2 (2010); ESMA report, *supra* note 144, at 12:

From a general point of view, high correlation exists but is normal, sound and not surprising, considering, among others, the following: normal and well-functioning advisor-client relationship (otherwise proxy advisors would lose business); use of automated voting; common cultural approach, a rising stewardship trend and a similar conception of best governance practices shared by investors and proxy advisors; numerous standardised resolutions and routine, non-contentious items; only three possible alternatives when voting proposals and in practice only a binomial vote (for/against); causality is difficult to establish since investors are not likely to admit blindly relying on proxy advisors. See also Hearing Before the House of Rep., *supra* note 3, at 17-18 (documenting the testimony of Lynn Turner, Managing Director at LitiNomics, who has a rich experience as: a member of corporate boards of public companies which were subject to the recommendations of the proxy voting firms, a member on the boards of two institutional investors who did the proxy voting; a former regulator at the SEC; and a senior executive and head of research at Glass Lewis from 2003 to 2007); GAO 2007, *supra* note 133, at 16 (pointing out that most large institutional investors surveyed by the GAO reported that they vote their proxies based on their own diligence or their own corporate rating policies, rather than those formulated by the proxy advisory agency).

See GAO 2007, *supra* note 133, at 15 ("Of the 20 large institutional investors we interviewed, 19 reported that they use proxy advisory services in one or more ways that may serve to limit the influence that proxy advisory firms have on proxy voting results . . . . ").

See SEC Roundtable, *supra* note 20, at 152 ("But ultimately the more contested the vote is the less likely we are to be swayed in the end one way or another by what the proxy advisor is recommending.").

*But see Strine, supra* note 132, at 1765 ("The influence of ISS and its competitors over institutional investor voting behavior is so considerable that the traditionalist will be concerned that any initiative to increase stockholder power will simply shift more clout to firms of this kind—firms even more unaccountable than their institutional investor clients.").

See Hearing Before the House of Rep., *supra* note 3, at 56 ("[T]he characteristics of the [proxy advisory] industry bear an uncanny resemblance to the credit ratings industry before the financial crisis: advisory firms have considerable conflicts of interest in how they are structured . . . . ").
credit agencies' failure to prevent the last financial crisis\textsuperscript{482} and regulate advisory firms. In response, it is worth noting, that unlike credit rating agencies—and similarly auditors—which are paid by the companies they rate and review,\textsuperscript{483} proxy advisory firms are paid for their services by institutional investors, which are not the subjects of their proxy voting recommendations.\textsuperscript{484} Moreover, as opposed to the case of credit rating, and to some extent audit results, institutional investors can make up their own minds and are not bound by recommendations issued by proxy advisory firms.\textsuperscript{485} The proxy advisory industry, in short, is not subject to the same moral hazards from which the credit industry suffers, and comparing the two is like comparing apples and oranges.\textsuperscript{486}

Third, although proxy advisory firms are frequently criticized for being "black boxes" unwilling to make their models completely transparent, these firms repeatedly interact with the public companies about which they report, and with the institutional investors to which they report.\textsuperscript{487} ISS, for instance, provides both issuers and investors with an opportunity to participate in its survey, through which it seeks "feedback on emerging corporate governance issues as a critical component of its annual policy formulation process."\textsuperscript{488} In the end of this process, ISS reports a large number of responses to the survey and a summary of results.\textsuperscript{489} Similarly, Glass-Lewis reaches out to companies whenever clarifications are required, and hosts "Proxy Talk" conference calls, open to the public, to discuss certain issues in-depth.\textsuperscript{490}

\textsuperscript{482}As a matter of fact, as it has been already determined that "[t]he three credit rating agencies [Moody's, Standard and Poor's (S&P), and Fitch] were key enablers of the financial meltdown." \textit{The Crisis Inquiry Report}, supra note 161, at xxv.

\textsuperscript{483}See Kristofer W. Nelson, Rough Waters for the Ratings Companies: Should the Securities Ratings Companies Be Held Liable for Investor Reliance in the Wake of the Real Estate Meltdown of 2007-2008?, 63 U. MIAMI L. REV. 1177, 1190 (2008) (discussing how investors lack the capability to research and analyze and therefore hire the ratings companies to rate the securities).

\textsuperscript{484}See SEC Roundtable, supra note 20, at 31 (documenting the testimony of Mrs. Neil Minow, Co-founder and Board Member of GMI Ratings).

\textsuperscript{485}See Nelson, supra note 483, at 1193 ("[T]he main purpose of the ratings companies is founded and created by the investors' reliance on those ratings when making their investment decisions.").

\textsuperscript{486}See id. at 1189 (noting that throughout history, ratings companies have successfully avoided class action liability from investors who relied on their ratings).

\textsuperscript{487}SEC Roundtable, supra note 20, at 125.

\textsuperscript{488}INSTITUTIONAL SHAREHOLDER SERVICES, 2013-2014 POLICY SURVEY SUMMARY OF RESULTS 2 (Oct. 2013), archived at http://perma.cc/7T9V-EXFC.

\textsuperscript{489}Id. at 3-8; see also Hearing Before the House of Rep., supra note 3, at 358. The ISS policy development process was criticized for being "skewed and biased towards a narrow agenda," including only the small number of institutions who are involved and take the survey, and lacking transparency with regard to whether or not "issuer voice counts." Id. at 15-16, 40.

\textsuperscript{490}See Hearing Before the House of Rep., supra note 3, at 408.
Fourth and most importantly, as mentioned earlier in this Article, in the absence of regulatory intervention in advisors operation, it seems that market is monitoring the way proxy advisors operate. Since 2004—soon after the SEC regulation unintentionally led to the great demand for advisory firms—informal or so-called market supervision mechanisms have been focusing on advisory firms' operation. Over the last decade, public companies, together with the professional associations which represent them—such as the Business Roundtable ("BRT"), an association of chief executive officers from leading corporations—have been lobbying the SEC and Congress to restrain the power of proxy advisory firms. Here are some of the most prominent landmarks.

The first noticeable step was taken in April of 2004, when the BRT filed a petition for rulemaking concerning proxy system as a whole. The petition called upon the SEC to re-examine the shareholder communications system, and incidentally stated that "[m]any institutional investors outsource the voting process to ISS and IRRC, who provide voting instructions on their behalf . . . ." On June 29, 2007, the U.S. Government Accountability Office ("GAO"), the investigative and auditing arm of the U.S. Congress, published a report on the operation of proxy advisors at the request of three U.S. congressmen. In July 2008, the SEC issued a Compliance Alert highlighting some deficient practices of using proxy-voting services by registered investment advisers and mutual funds. In July 2009, the SEC published an announcement from its Investor Advisory Committee.

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491 See supra notes 386-90 and accompanying text.
492 See supra Part I; see also Hearing Before the House of Rep., supra note 3, at 2.
493 See infra text accompanying notes 494-500.
494 See also Hearing Before the House of Rep., supra note 3, at 49, 157, 161.
495 IRRC stands for The Investor Responsibility Research Center, which was founded in 1972 "by a group of college and university endowments and foundations who wanted impartial research on social and environmental questions raised in proxy proposals. Later, in the early 1980s . . . IRRC expanded its services to include research on corporate governance issues . . . ." CTR. ON EXEC. COMP., supra note 89, at 15. In 2005 ISS merged with IRRC. See Hearing Before the House of Rep., supra note 3, at 70.
496 Request for Rulemaking Concerning Shareholder Communications (Apr. 12, 2004), archived at http://perma.cc/TP6A-ELRY; see also Hearing Before the House of Rep., supra note 3, at 10 (containing statement of Niels Holch, Executive Director, Shareholder Communications Coalition) (comprised of the Business Roundtable, the National Investor Relations Institute, and the Society of Corporate Secretaries); SEC Concept Release, supra note 17.
497 See GAO 2007, supra note 133, at 7-8.
that outlined an array of fields of interest, including the role of proxy advisory firms and the need for stricter supervision on them.\textsuperscript{500}

The course of events described above reached its climax with the SEC's concept release and roundtable, as well as the hearing before the House of Representatives. The concept release, published on July of 2010, attracted 307 comments.\textsuperscript{501} The SEC then conducted a roundtable in December of 2012.\textsuperscript{502} The hearing before the U.S. House of Representatives took place in June of 2013,\textsuperscript{503} and it followed a series of high profile battles between union shareholder activists and large firms over corporate governance issues, as well as, the campaign to strip Jamie Dimon of his role as JP Morgan's chairman—under the proposal he would remain as CEO.\textsuperscript{504} All these events have elicited the interest of academic researchers and the financial media.

Proxy advisory firms have not remained indifferent to the market pressure; they have begun to take some steps of their own.\textsuperscript{505} The 2012 peer group pushback is the best example.\textsuperscript{506} In 2012, "ISS recommended investors to vote against Marriott International's say on pay resolution, [which would state that Marriot's] pay scale should not be compared with the pay of major competitors such as Hyatt Hotels Corporation or Starwood Hotels, even though Marriott requested that these companies be included."\textsuperscript{507} "Instead, ISS chose AutoNation, Penske Automotive Group, Icahn Enterprises and Genuine Parts Co. as 'appropriate' peers."\textsuperscript{508} Marriott questioned ISS's peer group selection in their supplemental filing, and more than 87% of the shareholders approved the Marriott say on pay resolution by the end.\textsuperscript{509} This example, and many others like it, led companies to issue supplemental filings with the SEC discussing peer group issues.\textsuperscript{510} These numerous filings gained the attention of the business press, market practitioners, and the SEC. The resulting scrutiny led ISS and Glass-Lewis to reexamine their methodology of peer group selection and eventually to change it.\textsuperscript{511}

\textsuperscript{500}SEC Concept Release, supra note 17.  
\textsuperscript{501}SEC Comments, supra note 18.  
\textsuperscript{502}SEC Roundtable, supra note 20.  
\textsuperscript{503}Hearing Before the House of Rep., supra note 3, at 2.  
\textsuperscript{504}SEC Roundtable, supra note 20, at 116, 121, 146, 153.  
\textsuperscript{505}See infra notes 506-10 and accompanying text.  
\textsuperscript{506}Id.  
\textsuperscript{507}Id.  
\textsuperscript{508}Id.  
\textsuperscript{509}Id.  
\textsuperscript{511}See SEC Roundtable, supra note 20, at 154. Statement of Anne Sheehan, Director of Corporate Governance, CalSTRS:
More importantly, it led ISS to revise its methodology for determining peer groups. A faulty mechanism used by a proxy advisory firm was corrected without the need for any regulatory action. To be clear, these market forces enhance procedural integrity but still do not ensure that proxy advisors make recommendations in the best interests of the shareholders, and they do not necessarily promise sufficient control on advisors' services. However, as previously explained, regulation is also unlikely to promote substantive accuracy.

VII. POTENTIAL SOLUTIONS FOR A REGULATORY EXPECTATIONS GAP

As noted at the outset of this Article, policy designers and regulatory stakeholders, in spite of its relevance and significance, generally ignore the Expectations Gap theory. This shortcoming is not unique to the proxy advisors context, but rather is common to the regulation of most, if not all, fields of interest. This Part of the Article examines potential solutions to the Expectations Gap problem in general and with regard to the proxy advisory system in particular. Beforehand, it is worth noting that to shrink an Expectations Gap, it can be attacked at either of its two ends. The focus can be on remedying signalees' misperceptions about the effectiveness of a regulation, on trying to improve the regulation's effectiveness, or both. While the former option has been largely ignored, the latter has received some attention.

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I have actually seen [proxy advisory firms] make changes in their recommendations in terms of peer groups on behalf of Glass Lewis when there was a lot of complaints from the issuers about how they did that, but I guess one of the messages I would have to some of the folks here is just come talk to us. It's our vote. We are the ones that are the customers of these. See also Hearing Before the House of Rep., supra note 3, at 49-50 (containing statement of Timothy J. Bartl, President of Center on Executive Compensation); id. at 407-08 (containing statement of Katherine H. Rabin, CEO of Glass-Lewis).


See also Hearing Before the House of Rep., supra note 3, at 48.

See sources cited supra note 29.

See supra Part IV.A-B.

See Langaevort, Managing the "Expectations Gap" in Investor Protection, supra note 44, at 1164.

See id. at 1140.

See infra Part VI.


See id.
For instance, Donald C. Langevoort has noted "[T]he United States has under-funded the hard work of investor protection, holding back from the system the resources it would take to substantially lessen the expectations gap, even if it can never be eliminated." In other words, Langevoort suggested that enhancing regulation—either by writing better rules or by devoting more energy toward enforcement—can in turn improve the impact of regulation and reduce the Expectations Gap.

This Author shares Langevoort's view, but also believes that Expectations Gaps should be attacked from both sides. This means that along with increasing regulatory efficacy, signalees' expectations should also be managed, mainly because an Expectations Gap is not static. To illustrate this point, recall that Expectations Gap has two sides. One side represents the actual effectiveness of regulation, and the other end represents the way that signalees perceive its effectiveness. For the sake of simplicity, the former will be annotated as "A" and the latter annotated as "B." Now suppose that the SEC has gained the resources it needs to ensure a well-functioning, robust capital market. Further, suppose that the SEC uses its resources in the most efficient way. The SEC would then bring "A" closer to the optimal level of effectiveness. The regulation's effectiveness has now moved to the hypothetical point "C." Therefore, one might intuitively argue that the Gap has become shorter and is now the difference between points B and C, as follows:

A → C → B

However, further consideration suggests that this is not necessarily the case. This is because when effectiveness improves—by providing the SEC with higher budgets and greater staffing—expectations are

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521 Id. at 1140.
522 This distinction was first coined and described by Roscoe Pound. See Roscoe Pound, Law in Books and Law in Action, 44 AM. L. REV. 12, 23 (1910).
523 See Langevoort, Managing the “Expectations Gap” in Investor Protection, supra note 44, at 1164 (noting that the level of enforcement of SOX is negatively correlated with Expectations Gap).
524 See id.
525 Cf. id.
526 See Howell E. Jackson & Mark J. Roe, Public and Private Enforcement of Securities Laws: Resource-Based Evidence, 93 J. FIN. ECON. 207, 210 (2009) (“Higher budgets and greater staffing allow the regulator to examine allegations of wrongdoing, to write its rules carefully, to conduct market surveillance and review filings, and to act more often to remedy, prevent, and punish wrongdoing.”).
likely to increase. In the hypothetical, expectations now increase to Point "D." Thus, the Gap is now the difference between D and C, as follows:

A → C → B → D

It is worth noting that the proportions presented above do not represent any real ratio and in some circumstances the new gap—D to C—after improving effectiveness together with increasing expectations—may become even larger. Therefore, as previously stated, the best way to close an Expectations Gap is to manage the way regulation is perceived by the signalees. This Article suggests four potential solutions.

First, this Article suggests requiring regulators to appraise the Expectations Gap and its potential consequences when contemplating new regulation. Although costs associated with such a gap are difficult to quantify, appraisal could be made in an "informal" manner, by highlighting "the presence of costs and benefits and acknowledge that regulation's benefits ought to exceed its costs but do not actually try to measure whether they do." Further, as explained earlier in this Article, regulatory agencies have good reasons to hide the "dark side" of regulation in order to avoid chilling signalees' trust in the new regulation. Regulators' natural inclination is to inflate expectations—even when reality is likely to fall short—in order to bolster confidence. Therefore, an Expectations Gap analysis should not be discretionary, but rather a mandatory part of systematic Regulatory Impact Analysis ("RIA")—a traditional process designed to help think through the reasons for regulator intervention, to weigh various options for achieving an objective, to understand the consequences of the proposed intervention, and to assess and present the likely costs and benefits of proposal that might have an impact on specific stakeholders and the public at large.

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527 See id.
528 See Langevoort, Managing the "Expectations Gap" in Investor Protection, supra note 44, at 1144-45.
529 See infra notes 530-66.
531 Id.
533 See id.
534 See id.
A thorough examination of different handbooks which guide regulatory agencies across the globe in assessing the potential impact of new contemplated regulation demonstrates that regulatory agencies commonly give little attention to behavioral aspects, and no attention at all to behavioral failures to perceive regulation. For example, the German Government Handbook does not consider behavioral aspects at all. The Australian Government Handbook dedicates a single paragraph—out of 68 pages—to tell regulators that markets may behave irrationally, and so they "should not always assume regulation alone will achieve the desired objective," but it does not refer to irrationality of the type discussed in this Article. The British Financial Conduct Authority ("FCA")—although embracing behavioral economics in its task of regulating financial markets—is focused on how consumers may misjudge financial products and services, and not how they may misperceive regulation itself. Following this trend, final versions of the SEC's rules do not reflect any manner of behavioral approach in the SEC's regulatory agenda.

Considering the above-mentioned analysis, it is time to incorporate Expectations Gap's costs into regulation cost-benefit analyses. Consideration of these costs would help regulatory agencies to better decide whether to adopt or avoid new regulation and also to examine how new regulation should be structured and applied. In the case of proxy advisors, the high probability of an Expectations Gap and

535 See, e.g., FEDERAL STATISTICAL OFFICE, GUIDELINES ON THE IDENTIFICATION AND PRESENTATION OF COMPLIANCE COSTS IN LEGISLATIVE PROPOSALS BY THE FEDERAL GOVERNMENT (October 2012), available at http://www.bundesregierung.de/Content/DE/_Anlagen/Buerokratieabbau/2013-01-02-erfuehlungsaufwand.pdf?_blob=publicationFile. It appears that consideration of behavioral aspects began only in 2012. See, e.g., FINANCIAL CONDUCT AUTHORITY, OCCASIONAL PAPER No. 1, APPLYING BEHAVIOURAL ECONOMICS AT THE FINANCIAL CONDUCT AUTHORITY 5 (April 2013), archived at http://perma.cc/TLY3-7R6H. 536 See FEDERAL STATISTICAL OFFICE, supra note 535. 537 AUSTRALIAN GOVERNMENT, THE AUSTRALIAN GOVERNMENT GUIDE TO REGULATION 24 (2014), archived at https://perma.cc/7JNS-ZQ3N ("[P]eople do not always make rational, considered decisions even in an otherwise efficiently functioning market. For example, even in the presence of penalties or other disincentives, people still pay their taxes late (or not at all), drink and drive, waste water or engage in unsafe work habits."). 538 See FINANCIAL CONDUCT AUTHORITY, supra note 535, at 5. The paper explains that:

[C]onsumer choice in retail financial products and services is particularly prone to errors because many products are inherently complex for most people . . . [and] many products involve trade-offs between the present and the future . . . [D]ecisions may require assessing risk and uncertainty . . . [and] can be emotional . . . . [S]ome products permit little learning from past mistakes.

its resulting costs should lead the SEC to consider implementing soft regulation in the form of a code of conduct, similar to the ESMA's code.\footnote{\textit{See ESMA Report, supra} note 144, at 3.} Moreover, as explained earlier in this Article, regulators themselves may be susceptible to biases that can make it harder for them to identify an Expectations Gap.\footnote{\textit{See Rachlinski, supra} note 247, at 227.} Assimilation of the Gap's costs into RIA can help the regulators to diminish their own bias, at least to some extent.

As a second and related solution, at least with respect to significant new regulation, regulators should use "disclaimers" as an effective means to clarify expectations from new regulation by pointing to potential discrepancies between the regulation's purpose and performance. Currently, when promulgating new regulation, regulators usually focus on the illegality and illegitimacy of certain actions.\footnote{\textit{See A Guide to the Rulemaking Process, FED. REG, archived at https://perma.cc/GGN3-WPWC (last visited Nov. 29, 2014) (listing the many factors that regulators consider when proposing a new rule, and stating that when regulators publish a new rule, they focus on the problems the rule addresses; implying that regulators focus on wrongful conduct when creating and publishing rules).} They list forbidden behaviors and contain no suggestion that the rules will not be strictly enforced.\footnote{\textit{See Agency, ENCYCLOPEDIA BRITANNICA ONLINE ACADEMIC EDITION, http://0-academic.cb.com.licat.widener.edu/EBchecked/topic/1887629/agency (last visited June 13, 2015) (explaining that an agency's regulation interprets what is inappropriate; thus, they would list forbidden behavors); see also A Guide to the Rulemaking Process, supra note 543 (explaining what final rules contain; a suggestion that rules will not be strictly enforced is not included).} Put differently, regulators direct the attention of their audience to the law in the books rather than law in action.\footnote{\textit{See Pound, supra} note 522, at 15-17 (explaining the distinction between law on the books and law in action).} Indeed, some regulations are followed by interpretations published by the staff of the regulatory agency—such as Staff Accounting Bulletins, Staff Legal Bulletin, and other interpretative letters—which reflect staff's views regarding the implementation of the rules.\footnote{\textit{See A Guide to the Rulemaking Process, supra} note 543 (stating that guidance materials may be published on a website or in the Federal Register once the final rule is published); see also 12 C.F.R. § 205, App. C (2014) (illustrating a regulation that contains staff interpretations after the regulation).} However, such interpretations are usually published only after a certain period of time after new regulation comes into force; meanwhile, signalees' misperception regarding the potential impact of regulation may become consolidated and entrenched.\footnote{\textit{See A Guide to the Rulemaking Process, supra} note 543 (stating that interpretations are done only after a final rule is published; thus, those who are affected by the rule may have a misperception of how the rule applies to them until the interpretations are published).} More importantly, staff interpretations
provide guidance regarding how compliance with the new regulation can be achieved, regardless of its potential impact.548

Disclaimers should be directed at shedding light on possible limitations of regulation in changing behaviors of regulatees with regard to certain issues and circumstances.549 Even assuming that regulatory stakeholders may decline to read disclaimers or fail to understand them,550 disclaimers are supposed to function as a self-restraint mechanism and make the regulator more committed to genuine analysis of an Expectations Gap's costs.551 Further, when regulators are self-aware and recognize and acknowledge their limitations, they may engender the signalees' trust and counterintuitively increase their own credibility.552 In other words, disclaimers designed to minimize over-optimism, may simultaneously minimize over-pessimism and underestimation of regulatory effect.553

As a third solution, this Article suggests requiring agencies to describe—within the formal version of a new rule—how they will implement and evaluate their chosen regulatory option, as well as, how they will test its effectiveness and ongoing relevance.554 Such a description should be an integral part of the version of a new rule and any subsequent attachments and releases related to the rule. Currently, parameters for evaluating new regulation are embedded within the methodology for conducting the Regulatory Impact Analysis ("RIA").555 Although in most cases RIA becomes a public document, it is plausible to believe that signalees who barely read and understand the final version of a new regulation would invest even less efforts in learning about the way a regulation was formulated.

548 See id. (explaining that published interpretations help those affected by the rule to understand how the rule applies to them or how the rule applies in certain circumstances).

549 To be clear, this statement refers to disclaimers that shed light on a regulation's practical merits, as opposed to disclaimers designed to merely define a regulation's mandate.

550 See OMRI BEN-SHAHAR & CARL E. SCHNEIDER, MORE THAN YOU WANTED TO KNOW: THE FAILURE OF MANDATED DISCLOSURE 7-8 (2014) (discussing that one reason why disclosures fail is because most people fail to read and understand them).

551 See Omri Ben-Shahar & Carl E. Schneider, The Failure of Mandated Disclosure, 159 U. PA. L. REV. 647, 679 (2011) (discussing that successful disclosures rely on the lawmakers going into a more in depth analysis; by going into a more in depth analysis the regulator will be more committed to closing the expectation gap).

552 See Jeff Schmitt, Breaking out of Insular Cultures, BLOOMBERG BUSINESSWEEK (July 8, 2011), archived at http://perma.cc/8BJW-W67A ("Acknowledge limitations and unknowns to boost your credibility.").

553 See supra note 53 (discussing the possibility of over-pessimism).

554 See infra notes 555-57 and accompanying text (explaining that such a description is needed because signalees are less likely to read an Regulatory Impact Analysis).

Currently, a formal version of a new rule—or standard—which is published in the Federal Register includes an executive summary, discussion of the regulatory amendments the agency is adopting, and comments received during consultation period and the response which has been given to them.\footnote{556}{See, e.g., Disqualification of Felons and Other Bad Actors from Rule 506 Offerings, 78 Fed. Reg. 44730, 44730-69 (July 24, 2013) (to be codified at 17 C.F.R. pt. 200, 230, 239) (containing all of the components of a final rule promulgated by the SEC, including the aforementioned components plus considerations that were made to comply with the Paperwork Reduction Act and Regulatory Flexibility Act, a summary of cost-benefit analysis, a consideration of impact of new regulation on the economy, the new regulation's burden on competition and its promotion of efficiency, consideration of competition and capital formation, and the statutory basis and text of the final amendments).} This Article suggests incorporating into the final version an additional section which discusses the implementation challenges the regulatory agency may face and describes how the performance of the new regulatory policy will be evaluated against its objectives, both during and after implementation.\footnote{557}{Sec infra notes 563-66 and accompanying text (explaining that a description of how regulators are going to implement and evaluate their rule, as well as its effectiveness, should be included in the final rule).} Such a description of the parameters which may indicate whether and to what extent the regulator succeeded or failed to achieve its regulatory goals could also be useful in imposing some additional discipline in the way regulators formulate a new regulation. This would be true even if the additional disclosure did not garner a great deal of attention from signalees.

The fourth proposed solution is some degree of supervision over the content of informational outputs provided by regulatory agencies in relation to regulatory initiatives. As previously explained, expectations are created in part by the informational environment in which the regulation is promulgated.\footnote{558}{See supra Part II.B (discussing how the Expectations Gap is created from information asymmetry).} For instance, when the SEC adopts a new rule—or standard—it issues a press release, reported in sources such as the Wall Street Journal.\footnote{559}{Sec Press Releases, Sec. & Exch. Comm'n [hereinafter SEC Press Releases], archived at http://perma.cc/7UDK-F6CX (last visited July 24, 2015) (listing press releases by the SEC after they have adopted a new rule or standard). See also Jessica Holzer, SEC, in Split Vote, Adopts 'Say on Pay' Rule, WALL ST. J. (Jan. 25 2011), http://online.wsj.com/articles/SB10001424052748704698004576104071862597358 (illustrating a press release in the Wall Street Journal after the SEC adopted a new rule).} The "tone" of the publicity is a crucial factor in the creation of expectations among signalees, perhaps even more so than the text of the new rule—or standard—itself.\footnote{560}{E-mail from Donald Langevoort, Prof., Georgetown University Law Center, to the Author (May 29, 2014) (on file with author).} Therefore, in order to manage an Expectations Gap, effort should be made to control non-regulatory agency outputs, such as the releases, which are frequently...
posted by regulatory agencies on their websites, or announcements made by their officials via informal channels, such as conferences and media interviews.

Currently, the OIRA reviews formal rulemaking as a part of the pre-rulemaking clearance. The OIRA even reviews certain Guidance documents. This Article suggests extending the coverage of mandatory review to the informational outputs provided by regulatory agencies and their officials regarding "significant" regulation. In general, this review will ensure that when publishing information regarding a new regulation "off the record," the regulatory agency adheres to its mandate and does not create false hopes. The review can be conducted by the OIRA, or perhaps such as the Consumer Financial Protection Bureau ("CFPB") which did another supervisory body recently establish established by the Dodd-Frank Act. In a situation where the OIRA—or other body—concludes that agency's informational releases and announcements may create an Expectations Gap, it should require the agency to publish appropriate clarifications.

Some may argue that this additional level of review would be cost-prohibitive. Indeed, regulatory agencies usually make substantial number of announcements. Subjecting these numerous announcements to mandatory review by the OIRA may be costly,

561 See generally Crolcy, supra note 325 (describing the process by which the OIRA reviews formal rulemaking).
563 See supra text accompanying notes 529-60. The kind of regulation that would qualify as "significant" deserves further research.
564 See About Us, CONSUMER FIN. PROT. BUREAU, archived at http://perma.cc/6T43-J4XQ (last visited July 25, 2015) (explaining that the bureau was established by the Dodd-Frank Act, and the bureau conducts reviews like the OIRA).
565 See A Guide to the Rulemaking Process, supra note 543 (explaining that the regulatory agencies make numerous announcements regarding the rules, including publishing the proposed rule in the federal register to allow public comment, and announcing and publishing the final rule in the Code of Federal Regulations).
straining the resources of OIRA and regulatory agencies that already lack resources sufficient to undertake high quality analyses of new regulations. However, there are some potential solutions to deal with such a burden. For instance, this review could be limited to announcements that are significant in their nature and are likely to resonate with the audience. Criteria for such an announcement would include the stage or forum in which the announcement is made and the rank of the agency's official who makes the announcement or provide an interview. Thus, when the forum is more official—such as agency's website—and the official is more senior, the OIRA should conduct a strict review.

VIII. RESPONSE TO POSSIBLE ARGUMENTS IN FAVOR OF AN EXPECTATIONS GAP

Finally, before concluding, it is worth highlighting two counter-arguments that may be posed in favor of an Expectations Gap. The entire premise of this Article has been that Expectations Gaps are dangerous and should be avoided. However, some critics may argue that an Expectations Gap could be beneficial if managed properly. These arguments have some facial appeal, but are flawed, as shall be explained.

First, one might argue that an Expectations Gap may be desirable for the sake of deterrence. This argument would point out that so far, we have assumed that only signalees suffer perceptual Expectations Gaps. However, regulatees themselves may suffer a gap, at least to some extent. Such a gap would arise from regulatees' uncertainty about the probability of detection and punishment in a case of misconduct. A higher probability of detection and punishment would lead to higher deterrence of regulatee misconduct. Given that regulatory agencies

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566 See Nicholas Bagley & Richard Revesz, Centralized Oversight of the Regulatory State, 106 COLUM. L. REV. 1260, 1266 (2006) ("OIRA's tiny staff was charged with reviewing thousands of technically complex rules, leading to the complaint that OIRA review would necessarily impose costly and lengthy delays on agency action.").

567 See supra Parts IV-V (discussing the negative effects of the Expectations Gap).

568 See infra notes 570-77 and accompanying text (explaining that the Expectations Gap, if managed properly, could be beneficial for deterrence and to increase investors' trust).

569 See infra text accompanying notes 570-82.

570 See supra Part IV.A.

571 See Gary S. Becker, Crime and Punishment: An Economic Approach, 76 J. POL. ECON. 169, 178 (1968) (providing a classic discussion on the impact that the probability—or certainty—of detection and punishment has on actors' deterrence); see also STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 480-81 (2004) (incorporating offenders' risk preferences into an economic model).
always lack adequate resources to reach the optimal level of deterrence, an Expectations Gap, the argument would posit, is essential as a substitute for actual regulatory enforcement capability. Moreover, as noted earlier, an Expectations Gap is likely to lead to high expectations from signallees. The higher their expectations are, the greater their disappointment will be in a case of a regulatee's failure to meet regulatory standards. This dynamic by itself may lead to deterrence of regulatee misconduct.

As a second counter-argument, one might claim that some degree of Expectations Gap is justified in order to bolster investors' trust in the capital market and in turn ensure its depth and liquidity. If signallees had a complete understanding of a protective regulatory measure’s true efficacy—or lack thereof—they may lose confidence in the market itself. Even more troublesome, if the regulation was instituted in response to a particular catastrophe that has a low chance of reoccurrence, the lack of an Expectations Gap may actually cause signallees to overestimate the level of risk in the marketplace.

These arguments have some commonsense merit. However, they cannot be accepted or built upon, particularly when dealing with financial markets and financial regulation. Regulation, especially financial regulation, relies on the concepts of transparency, disclosure of information, and information symmetry, as constitutive principles. These principles lay in the heart of many statutes and regulations, are the object of ample academic literature, and are the motto of regulatory agencies, such as the Federal Reserve, the SEC, and the Consumer Financial Protection Bureau. Financial regulatory agencies strive to

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572 As Donald C. Langevoort put it, the SEC in particular "has lived nearly all its life in a world of chronically inadequate resources . . . ." Langevoort, Managing the "Expectations Gap" in Investor Protection, supra note 44, at 1141.
573 See supra notes 209-12 and accompanying text.
574 See supra notes 209-12 and accompanying text.
577 For example, research by German Professor Gerd Giglrenzer, showed that directly after the September 11th terrorist attacks, the increase in car travel stemming from the disaster likely led to an increase in traffic fatalities measured in the thousands, and possibly more than the number of actual 9/11 victims. See Morgan Housel, Why We're Awful at Assessing Risk, USA TODAY (Mar. 17, 2014, 3:09 PM), archived at http://perma.cc/9UNL-9MC7.
578 See Benjamin Fung, The Demand and Need for Transparency and Disclosure in Corporate Governance, 2 UNIVERSAL J. MGMT. 72, 73 (2014).
579 See id.
reduce asymmetric information between providers of services and consumers and to improve the availability and quality of market information, goods and services to those who have limited access to them.\textsuperscript{580} Thus, it would hardly be acceptable to intentionally use Expectations Gaps to design a regulatory regime. Moreover, it is quite dangerous to rely on Expectations Gap as a systematic matter of a policy design. Such a tactic may lead to a slippery slope in which regulatory agencies invest in manipulating the way regulatory impact is perceived rather than trying to truly improve the impact of regulation.

Furthermore, with regard to deterrence in cases like the proxy advisory context, the cost of using Expectations Gap for creating uncertainty and deterrence dramatically outweighs the potential benefit. This is because both proxy advisors and institutional investors may have fairly complete information regarding the impact of regulation, while signalees may lack a large amount of information and have little certainty about the extent to which they can trust proxy advisors and institutional investors.\textsuperscript{581} Thus, promotion of an Expectations Gap in the proxy advisory case is likely to merely exacerbate asymmetric information between advisory firms and institutional investors on the one hand and signalees on the other hand, rather than improving a regulation's deterrence effect on former.\textsuperscript{582}

Lastly, with regard to the belief that reducing Expectations Gaps may decrease market depth and liquidity, it should be noted that reducing an Expectations Gap does not require inducing panic in regulatory beneficiaries.\textsuperscript{583} The solutions that have been just offered to combat Expectations Gaps can be designed carefully to avoid such a result.\textsuperscript{584} Disclaimers could be designed to both balance expectations and foster confidence in the regulator's ability to meet its own goals.

**IX. CONCLUSION**

Proxy advisory firms play an increasingly important role in the way public companies function.\textsuperscript{585} Large institutional investors hold significant power over the results of shareholder votes and these investors turn to proxy advisory firms for direction on how to vote their shares.\textsuperscript{586} While the extent of the control that proxy advisors exert over

\textsuperscript{580}See id.
\textsuperscript{581}See supra Part III.B.
\textsuperscript{582}See supra Part IV.B.
\textsuperscript{583}See supra notes 575-77 and accompanying text.
\textsuperscript{584}See supra Part VI.
\textsuperscript{585}See supra notes 6-9 and accompanying text.
\textsuperscript{586}See supra notes 116-20 and accompanying text.
institutional investors' voting decisions is a topic of heated debate, it is beyond doubt that these firms have a real impact on corporate governance.\textsuperscript{587}

Due to SEC regulatory initiatives over the last decade, institutional investors now carry significant fiduciary obligations that they must fulfill when casting proxy ballots.\textsuperscript{588} Additionally, institutional investors have traditionally been accused of operating in an environment that generates conflicts of interest: they must vote shareholder proxies affecting public corporations with which the institutional investors have close business ties.\textsuperscript{589} Proxy advisory firms have stepped in to help the institutional investors carry the burden of making informed voting decisions and cleanse investors' conflicts.\textsuperscript{590} Their recommendations allow the institutional investors to avoid spending money and manpower to research the issues put to a vote.

The power of proxy advisory firms has led many individuals and entities to call upon Congress and the SEC to regulate the operation of proxy advisory firms. These academics, politicians, and industry actors have voiced numerous concerns about the manner in which proxy advisory firms operate.\textsuperscript{591} There are powerful arguments in favor of proxy advisor regulation, but this Article takes no stance on that particular issue. Instead, it seeks to alert regulators and market participants about the dangers of an Expectations Gap.

Expectations Gaps are created in the regulatory context when the expectations created by the regulatory signal do not align with the regulation's true effect.\textsuperscript{592} The signal is the message of confidence underlying a regulation and it is perceived and interpreted by those who have an interest in the regulation, the signalees. An Expectations Gap in the regulatory context is typically the result of information asymmetry and cognitive biases, which usually cause the signalees to believe that the regulation is more effective than it actually is.\textsuperscript{593} Absent from any debate regarding the wisdom of proxy advisory regulation is any consideration of whether an Expectations Gap will result if regulations are implemented and what the effects of such a gap would be.

As this Article demonstrated, an Expectations Gap resulting from proxy advisory firm regulation could have several significant negative consequences. First, it could release existing constraints on the behavior

\textsuperscript{587}See supra notes 121-32 and accompanying text.
\textsuperscript{588}See supra notes 95-98 and accompanying text.
\textsuperscript{589}See supra notes 109-10 and accompanying text.
\textsuperscript{590}See supra notes 111-15 and accompanying text.
\textsuperscript{591}See supra notes 121-32 and accompanying text.
\textsuperscript{592}See supra Part II.B.
\textsuperscript{593}See supra Part II.B.
of proxy advisors. Signalees may believe that the regulation and the regulator are effectively managing the risk of proxy advisor misconduct, so they will be more likely to trust proxy advisor recommendations and less likely to expend efforts to investigate proxy advisors' actions on their own. When corporate scandals or governance failures emerge, proxy advisors may also be able to shift some of the blame to the regulator. Instead of proxy advisors being solely responsible for their recommendations, they may be able to accuse a regulator of inadequately supervising them. Both of these possibilities decrease proxy advisors' responsibility for their own conduct.

Second, an Expectations Gap may also diminish institutional investors' responsibility for the votes they cast based on proxy advisors' recommendations. Regulation would give proxy advisors a governmental seal of approval and institutional investors would feel more comfortable relying on the advisors' recommendations. In the event of corporate governance failure, institutional investors could point a finger at the proxy advisors and the SEC, claiming that their reliance on the advisor's recommendation was justified by the regulatory oversight.

Furthermore, any Expectations Gap created in the proxy advisory market is likely to persist. Most signalees do not have adequate incentive to generate complete information about the regulation's true efficacy after it has been implemented. Those that would have incentives to correct the gap generally do not have the ability to either collect the information or to disseminate it. The effects, positive or negative, of any disjoint between signalees' perception and the regulation's reality are not likely to diminish over time.

Some may argue that an Expectations Gap should be welcomed, not avoided. They could posit that the gap would affect regulatees as well as signalees, causing the regulatees to perceive that the regulator's power to enforce the regulation is greater than it actually is. This would increase the regulation's deterrence effect. Another argument in favor of a gap could be that the artificially high expectations of the signalees would increase confidence in the securities market overall. While these arguments make some sense, the entire purpose of financial market regulation is to increase transparency and decrease information asymmetry. The moment that regulators attempt the foster disinformation, the entire regulatory mandate will be jeopardized.

The danger posed by an Expectations Gap does not mean that regulation would not be effective and beneficial. This Article proposes four viable options for reducing an Expectations Gap. These solutions

594 See supra Part IV.A.
are applicable in any regulatory context. First, serious consideration of a potential Expectations Gap should be incorporated in a regulator's Regulatory Impact Analysis conducted before regulation promulgation. Second, when dealing with significant new regulation, regulators should issue disclaimers attempting to clarify the regulation's goals and enforcement expectations. Third, this Article suggests requiring a regulator to incorporate in its final notice of proposed rulemaking, published in the Federal Register, a description of how the regulator plans to implement and evaluate the regulation, as well as how it will test the regulation for ongoing effectiveness. Fourth, there should be some oversight over the content of agency publications and information outputs providing information about new or forthcoming regulation. The oversight would help ensure that regulators did not create false expectations through rosy predictions of their regulation's effectiveness. Some or all of these recommendations could be implemented; their effectiveness is not interrelated.

Individuals may like to believe that they can accurately predict the effect of new rules or regulations in their professional fields. The empirical evidence shows that sadly, this is not always the case. Rather than try to combat Expectations Gaps after they have already been formed, the safer and more efficient route is to recognize when they may be established and to take steps to reduce them before they are created. Proxy advisory regulation carries with it a high risk of an Expectations Gap. If such regulation is implemented, it must be done in a manner designed to minimize that gap. The consequences of failing to do so could be costly.