December 17, 2018

Mr. Brent J. Fields
Secretary, Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

File Number 4-725

RE: Submission in advance of Staff Roundtable on the Proxy Process (Seeking a Paradigm Shift in the SEC's Approach to Shareholder Voting Recommendations)

Submitted By: Bernard S. Sharfman*

Dear Mr. Fields,

The writing of this submission was inspired by the Securities and Exchange Commission ("SEC" or "Commission") staff roundtable on the proxy process (November 15, 2018). Most significantly, while listening to the webcast of the panel on proxy advisors, I was impressed by the comments of Senator Phil Gramm who aspired to use the roundtable as means to discuss general principles of shareholder voting through the lens of economic principles. Moreover, his objective was to identify ways the SEC can use its regulatory authority to enhance the wealth of investors who use investment advisers to manage their savings. In essence, he was striving for the panel to see the forest for the trees.

I am hopeful that this submission is consistent with the aspirations of Senator Gramm. From a big picture perspective, it is seeking a paradigm shift in the SEC's approach to shareholder voting recommendations. Specifically, it requests the SEC to provide investment advisers with a liability safe harbor under the Advisers Act when using board voting recommendations in voting their proxies as long as their clients do not prohibit their use and no significant business relationship exists between the investment adviser and the company whose shares are being voted.

The implementation of this safe harbor will effectively reverse and correct a long-standing SEC policy where the value of proxy advisor recommendations is recognized but the value of board voting recommendations is not. This policy has existed even though a strong argument can be made that board voting recommendations are more informed and precise than proxy advisor voting recommendations. That argument was made in my comment letter dated October 12, 2018.[1] This submission can be considered a continuation of that letter.

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[1] Letter from Bernard S. Sharfman to Mr. Brent J. Fields, Secretary, Securities and Exchange Commission (October 12, 2018), https://www.sec.gov/comments/4-725/4725-4513625-175932.pdf. Please note that I have also submitted two other comment letters besides this one and the one dated October 12, 2018. The first dealt

The Need for Shareholders to Vote

Shareholder voting is a creation of corporate law. Shareholder approval is required for major corporate actions such as merger agreements,[2] changes to the articles of incorporation,[3] and the election of directors at the annual meeting.[4] Moreover, corporate law requires a minimum level of shareholder participation by having quorum requirements for shareholder meetings. For example, under the default rules of Delaware corporate law, "A majority of the shares *entitled* to vote, present in person or represented by proxy, shall constitute a quorum at a meeting of stockholders."[5] While this percentage can be modified in a corporation's certificate of incorporation or bylaw, it cannot go below 1/3 of the shares entitled to vote.[6] In sum, corporate law requires a certain level of shareholder participation to implement certain actions but does not require any particular shareholder to participate.

However, this does not end the story of shareholder voting, at least for institutional investors. Corporate law voting requirements have been significantly modified by federal regulation over the last 30 years. It began with the infamous 1988 Department of Labor ("DOL") letter that is commonly referred to as the "Avon letter."[7] In that letter, the DOL stated that "In general, the fiduciary act of managing plan assets that are shares of corporate stock includes the management of voting rights appurtenant to those shares of stock."[8] That is, the parties responsible for managing voting stock in pension plans governed by Title I of The Employee Retirement Income Security Act of 1974 ("ERISA") have a fiduciary duty to vote their proxies.[9]

In 2003, with the implementation of the Proxy Voting Rule,[10] the SEC formally recognized the fiduciary duties of registered investment advisers when voting proxies:[11]

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with the agency costs generated by mutual fund advisers and how new required disclosures could help to mitigate those costs. *See* Letter from Bernard S. Sharfman to Mr. Brent J. Fields, Secretary, Securities and Exchange Commission (October 8, 2018), https://www.sec.gov/comments/4-725/4725-4555147-176184.pdf. The second dealt with a specific fact pattern where a proxy advisor may have breached its fiduciary duties. *See* Letter from Bernard S. Sharfman to Mr. Brent J. Fields, Secretary, Securities and Exchange Commission (November 27, 2018), https://www.sec.gov/comments/4-725/4725-4684881-176574.pdf.

[2] DEL. CODE ANN. tit. 8, § 251(c).

[3] *Id.* at § 242.

[4] *Id.* at § 211(b).

[5] *Id.* at § 216.

[6] *Id.* at § 216(1).

[7] Letter from U.S. Dep't of Labor to Helmuth Fandl, Chairman of Retirement Board, Avon Products, Inc. (Feb. 23, 1988).

[8] *Id.*

[9] *See also*, Pension and Welfare Benefits Administration, U.S. Department of Labor, Proxy Project Report at 8 (March 2, 1989) ("Properly designated investment managers may not be passive on the issue of exercising proxy votes, even if plan and trust documents are sent to this effect. For example, investment managers may not, as a general policy, decline to vote proxies, or vote only non-controversial proxies."); The DOL affirmed the Avon Letter in 2008. *See* Department of Labor, *Interpretive Bulletins Relating to the Employee Retirement Income Security Act of 1974*, 73 Fed. Reg. 61,732 (Oct. 17, 2008), https://www.gpo.gov/fdsys/pkg/FR-2008-10-17/pdf/E8-24552.pdf.

[10] 17 C.F.R. § 275.206(4)-6.

[11] Proxy Voting by Investment Advisers, Investment Advisers Act Release No. IA-2106 (2003), https://www.sec.gov/rules/final/ia-2106.htm.

> The duty of care requires an adviser with voting authority to monitor corporate actions and vote client proxies…. We do not suggest that an adviser that fails to vote every proxy would necessarily violate its fiduciary obligations. There may even be times when refraining from voting a proxy is in the client's best interest, such as when the adviser determines that the cost of voting the proxy exceeds the expected benefit to the client. An adviser may not, however, ignore or be negligent in fulfilling the obligation it has assumed to vote client proxies.[12]

Absent an agreement with the client to the contrary,[13] there is a general consensus that in order for an investment adviser to meet their fiduciary obligations, it must vote all its proxies unless they have good reason not to.[14]

The Objective of Shareholder Voting

It is not unreasonable to accept the premise that the objective of shareholder voting is shareholder wealth maximization. This view is consistent with the Delaware Courts understanding of why shareholder voting adds value to corporate governance: "[w]hat legitimizes the stockholder vote as a decision-making mechanism is the premise that stockholders with economic ownership are expressing their collective view as to whether a particular course of action serves the corporate goal of stockholder wealth maximization."[15]

Moreover, if shareholders are going to achieve the objective of shareholder wealth maximization when voting, then it is highly desirable for them to be informed prior to voting. According to Schouten, "shareholders need to have at least some information to ensure that they are more likely to be right than wrong."[16] That is, shareholder voting needs to be more than just a flip of the coin.

So, how do we practically achieve informing shareholders without requiring each institutional investor to read massive amounts of information on the hundreds or thousands of companies they have invested in (SEC required documents, other publicly available information, and privately generated information) for the thousands, tens of thousands, or even hundreds of thousands of votes they are confronted with each year, which is impossible to do, and then come to conclusions that none of them cannot adequately make? The solution is to provide shareholders with voting

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[12] *Id.* at 4.

[13] Division of Investment Management, Securities and Exchange Commission, *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms*, Staff Legal Bulletin No. 20 (IM/CF) (June 30, 2014), https://www.sec.gov/interps/legal/cfslb20.htm. ("An investment adviser and its client may agree that the investment adviser will abstain from voting any proxies at all, regardless of whether the client undertakes to vote the proxies itself.").

[14] Luca Enriques and Alessandro Romano, *Institutional Investor Voting Behavior: A Network Theory Perspective*, ECGI Working Paper N° 393/2018 (July 2018), at 18 (These requirements, while stopping short of mandating voting, are a powerful nudge in that direction for all institutions to which they apply.).

[15] Kurz v. Holbrook, 989 A.2d 140, 178 (Del. Ch. 2010) *aff'd* Crown Emak Partners v. Kurz, 992 A.2d 377 388-89 (Del. 2010) (*quoting* Kurz with approval). For a more detailed discussion of shareholder wealth maximization being the objective of shareholder voting, *see* Letter from Bernard S. Sharfman to Mr. Brent J. Fields, Secretary, Securities and Exchange Commission (October 12, 2018), https://www.sec.gov/comments/4-725/4725-4513625-175932.pdf.

[16] Michael C. Schouten, *The Mechanisms of Voting Efficiency*, 2010 COLUM. BUS. L. REV. 763, 773 (2010).

recommendations that are made on an informed basis and with the expectation that they will lead to shareholder wealth maximization.

Contrary to popular belief, the provision of such informed voting recommendations is not generated by a proxy advisor. As argued in my comment letter dated October 12, 2018, proxy advisors, who must come up with hundreds of thousands of voting recommendations, are hampered in their efforts to make informed recommendations by a lack of resources.[17] Such a lack of resources leads to a lack of precision in their voting recommendations.[18] Instead, as also argued in my October 12, 2018 comment letter, such precise voting recommendations, for *every single vote* requested of the shareholder, are provided by a company's board of directors.[19] These board voting recommendations can easily be found in a public company's proxy statement.

Why the Board Provides Superior Voting Recommendations

Corporate law, by establishing the board of directors as the most important locus of decision-making authority in the corporation,[20] allows it access to information from all corners of the corporation. The reason why corporate law takes such an approach is that channeling information into a centralized, hierarchical authority allows for the efficient management of for-profit corporations. As a company grows in size this becomes even more apparent. According to Kenneth Arrow, efficiency is created in a large organization because "the centralization of decision-making serves to economize on the transmission and handling of information."[21] Thus, the board is the source for the most precise voting recommendations because it has a large informational advantage over all other sources, including proxy advisors.

For example, when it comes to nominating directors, "the board nominating committee has an informational advantage over even the most informed of shareholders because of the inside information it has on how the current board interacts with each other and executive officers, expectations on how a particular nominee will meld with other board members and executive officers, and the needs of the corporation in terms of directors, based on both public and confidential information."[22] Hence, the board is in the best position to nominate a director that can enhance shareholder wealth.

Directors, as well as executive management, are often referred to as "insiders." According to Goshen and Parchomovsky, "insiders have access to inside information due to their proximity to the firm; they also have the knowledge and ability to price and evaluate this information."[23]

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[17] Letter from Bernard S. Sharfman to Mr. Brent J. Fields, Secretary, Securities and Exchange Commission (October 12, 2018), https://www.sec.gov/comments/4-725/4725-4513625-175932.pdf.

[18] *Id.*

[19] *Id.*

[20] DEL. CODE ANN. tit. 8, § 141(a).

[21] Kenneth J. Arrow, The Limits of Organization 68–70 (1974).

[22] Bernard S. Sharfman, *Why Proxy Access is Harmful to Corporate Governance*, 37 J. CORP. L. 387, 402 (2011-12).

[23] Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 722 (2006).

The Informational Disadvantages of a Proxy Advisor

For a proxy advisor to have a fighting chance of matching the precision of a board's voting recommendations, it must be informed to at least the level of what Goshen and Parchomovsky would refer to as an "information trader."[24] Such a trader, even though she lacks access to the information possessed by the board of directors, is identified by her willingness and ability "to devote resources to gathering and analyzing information as a basis for its [her] investment decisions,"[25] including the gathering of private information.[26] Moreover, "information traders have the ability and knowledge to collect, evaluate and price firm-specific and general market information."[27] Furthermore, "[s]earching for, verifying, analyzing, and pricing general market and firm-specific information are costly tasks."[28]

Yet, it is very difficult for a proxy advisor to achieve the level of an information trader when forming its voting recommendations. As I discussed in my October 12, 2018 comment letter, proxy advisors are resource constrained and therefore have difficulty in becoming adequately informed.[29] This constraint is very much a result of client preference.[30] Institutional investors are very happy to purchase low cost, low value voting recommendations in order to fulfill their voting obligations.[31] As observed by Enriques and Romano, "The core function of proxy advisors is to offer institutional investors relatively cheap suggestions on how to vote portfolio companies' shares."[32]

Being resource constrained means that a proxy advisor has to take short cuts in order to generate voting recommendations. The inevitable result is a one-size-fits-all approach. Both ISS and Glass Lewis provide detailed voting policies that provide public companies and institutional investors with a roadmap on what their voting recommendations will be even before an issue is raised at a specific company.[33] The undesirability of this approach, at least to the extent it is currently used, is reflected in the following statement by Chairman Jay Clayton: "We also need clarity regarding the analytical and decision-making processes advisers employ, including the extent to which those analytics are company or industry specific. *On this last point, it is clear to me that some matters put to a shareholder vote can only be analyzed effectively on a company-specific basis, as opposed to applying a more general market or industry-wide policy*."[34]

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[24] *Id.*

[25] *Id*. at 723.

[26] *See generally* Sanford J. Grossman & Joseph E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. REV. 393 (1980) (Grossman and Stiglitz pointed out that it is not possible for securities markets to operate without market participants investing in information and earning positive returns for their efforts.)

[27] Goshen & Parchomovsky, *supra* note 23, at 723.

[28] *Id.*

[29] Letter from Bernard S. Sharfman to Mr. Brent J. Fields, Secretary, Securities and Exchange Commission (October 12, 2018), https://www.sec.gov/comments/4-725/4725-4513625-175932.pdf.

[30] *Id.*

[31] *Id.*

[32] Enriques and Romano, *supra* note 14, at 17.

[33] *See* Institutional Shareholder Services Inc., *Current Voting Policies* (2018), https://www.issgovernance.com/policy-gateway/voting-policies/ and Glass Lewis, Policy Guidelines (2018), http://www.glasslewis.com/guidelines/.

[34] Jay Clayton, Chairman, *U.S. Securities and Exchange Commission, Testimony on "Oversight of the U.S. Securities and Exchange Commission" Before the U.S. Senate Committee on Banking, Housing, and Urban*

Moreover, a lack of resources may create the situation where a company claims one or more significant errors in a proxy advisor's adverse voting recommendation (recommending a vote against management) but then is not given a reasonable amount of time to contest the error prior to its release.[35] According to a recent study commissioned by the American Council for Capital Formation (ACCF), almost 37% of companies sampled reported that ISS did not provide them with the opportunity to respond while 84% of companies said the same about Glass Lewis.[36]

Perhaps even more frustrating, "[w]hen a company did receive notice, it was often not enough time to generate a response."[37] In the sample's dealings with ISS, "nearly 85% of companies that were given notice … indicated they received less than 72 hours to respond …, with roughly 36% of these companies indicating they received less than 12 hours-notice…."[38]

The primary option for dealing with this problem is for the company to provide a supplemental proxy filing pointing out the errors in the proxy advisor's analysis.[39] Unfortunately, this is not a satisfactory solution.

Based on a review of supplemental proxy filings during the 2016, 2017 and 2018 (through September 30, 2018) proxy seasons, the ACCF study found that there were 107 filings from 94 different companies citing 139 significant problems including 90 factual or analytical errors.[40] While this number appears large, it probably represents just a small percentage of voting recommendations that could have been disputed as "many companies with objections to an advisor's recommendations decide not to make supplemental filings either because default electronic voting [robo-voting] or other timing issues limit their impact on voting, or because they know they have to face the recommendations of the proxy advisor in future years."[41]

In sum, the proxy advisor will typically have a very difficult time matching the precision of board voting recommendations.

Current SEC Policy on Board Voting Recommendations

In the SEC's 2014 Staff Bulletin, *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms*, the staff stated the following:

Affairs (December 11, 2018), https://www.banking.senate.gov/imo/media/doc/Clayton%20Testimony%2012-11-18.pdf.

[35] Frank M. Placenti, *Are Proxy Advisors Really a Problem?*, American Council for Capital Formation (October 2018), http://accfcorpgov.org/wp-content/uploads/2018/10/ACCF_ProxyProblemReport_FINAL.pdf.

[36] *Id.* at 7.

[37] *Id.* at 7-8.

[38] *Id.* at 8.

[39] *Id.* at 3.

[40] *Id.* at 11. For a summary of each of the 139 proxy advisor errors, *see* Frank M. Placenti, *Analysis of Proxy Advisor Factual and Analytical Errors in 2016, 2017, and 2018*, American Council for Capital Formation (October 2018), http://accfcorpgov.org/wp-content/uploads/Analysis-of-Proxy-Advisor-Factual-and-Analytical-Errors_October-2018.pdf.

[41] *Id.*

> An investment adviser and its client *may agree* that the investment adviser should exercise voting authority as recommended by management of the company …, absent a contrary instruction from the client or a determination by the investment adviser that a particular proposal should be voted in a different way if, for example, it would further the investment strategy being pursued by the investment adviser on behalf of the client.[42]

This statement provides that the investment adviser can use the voting recommendations of the board as long as it has permission from the client. Therefore, such use would not be a breach of its fiduciary duties under the Advisers Act. It also implies that board voting recommendations have value. However, the SEC has yet to explicitly opine on the value of such voting recommendations. This has been the case even though the SEC has periodically acknowledged the value of a proxy advisor's recommendations in shareholder voting, e.g., the Release implementing the Proxy Voting Rule stated that an investment adviser could avail itself of voting recommendations generated by an independent third party, such as a proxy advisor, to demonstrate that it was voting absent a conflict of interest.[43]

This omission has led to board voting recommendations being ignored in the discussion of how shareholders inform themselves prior to voting, providing institutional investors with the clear signal that if you want access to voting recommendations that help in fulfilling your fiduciary duties under the Investment Advisers Act of 1940, then proxy advisor recommendations are the only game in town and board voting recommendations are to be ignored.

The Issue of Agency Costs in Board Voting Recommendations and Mitigating Factors

Perhaps the SEC has avoided taking a position on the value of board voting recommendations because it suspects that all board voting recommendations are tainted with agency costs ("the economic losses resulting from managers' natural incentive to advance their personal interests even when those interests conflict with the goal of maximizing their firm's value"[44]) and therefore cannot

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[42] Division of Investment Management, Securities and Exchange Commission, *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms*, Staff Legal Bulletin No. 20 (IM/CF) (June 30, 2014), https://www.sec.gov/interps/legal/cfslb20.htm.

[43] Proxy Voting by Investment Advisers, Investment Advisers Act Release No. IA-2106, (2003), https://www.sec.gov/rules/final/ia-2106.htm; Securities and Exchange Commission, *Concept Release on the US Proxy System*, 75 Fed Reg 42981 (July 22, 2010)). The SEC endorsement of the use of a proxy advisor was reaffirmed in a subsequent staff bulletin, *see* Division of Investment Management, Securities and Exchange Commission, *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms*, Staff Legal Bulletin No. 20 (IM/CF) (June 30, 2014), https://www.sec.gov/interps/legal/cfslb20.htm.

[44] Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 775 (2017); *see also* Paul Rose, *Common Agency and the Public Corporation*, 63 VAND. L. REV. 1355, 1361 n.17 (2010) (citing Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976)). As explained by Professor Rose:

> Under a classic theory of the firm, agency costs in the corporate context increase as ownership is separated from control. As the manager's ownership of shares in the firm decreases as a percentage of the total, the manager will bear a diminishing fraction of the costs of any

be relied upon by shareholders. Such a position may result from a conscious or unconscious agreement with the following theory:

> [T]here is only one set of agents who must be constrained—corporate managers—and the world will be made a better place when corporations become direct democracies subject to immediate influence on many levels from a stockholder majority comprised not of those whose money is ultimately at stake, but of the money manager agents who wield the end-users' money to buy and sell stocks for their benefit.[45]

Besides ignoring the "agency costs of agency capitalism" (the agency costs generated by institutional investors), an issue that only recently has come to the fore,[46] this theory of corporate governance does not take into consideration what we know of the state and federal laws and stock exchange requirements that have been implemented to keep board members focused on the welfare of shareholders.

To begin, while shareholders are not generally involved in the governance of a public company, this being delegated to the board and executive management, the governance role that is provided shareholders signals to board members that the interests of shareholders must be their primary

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> nonpecuniary benefits he takes out in maximizing his own utility. To prevent the manager from maximizing his utility at the expense of the shareholders, shareholders will seek to constrain the manager's behavior by aligning the manager's interests with the shareholders' interests.

Id. at 1361 (citations omitted).

[45] Leo E. Strine, Jr., *Can we do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449, 451 (2014).

[46] There have been several recent writings on this topic, beginning with the seminal work by Gordon and Gilson. *See* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 890 (2013); Lucian A. Bebchuk, Alma Cohen, and Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89 (2017); Letter from Bernard S. Sharfman to Mr. Brent J. Fields, Secretary, Securities and Exchange Commission (October 12, 2018), https://www.sec.gov/comments/4-725/4725-4513625-175932.pdf (This letter focuses on the agency costs generated by institutional investors using proxy advisors as low cost, low value sources of voting recommendations.); Letter from Bernard S. Sharfman to Mr. Brent J. Fields, Secretary, Securities and Exchange Commission (October 8, 2018), https://www.sec.gov/comments/4-725/4725-4555147-176184.pdf. (This letter focuses on the potential agency costs generated by mutual fund advisers being delegated voting authority for trillions of dollars worth of equity securities.); Carmel Shenkar, Elke M. Heemskerk & Jan Fichtner, *The New Mandate Owners: Passive Asset Managers and the Decoupling of Corporate Ownership*, CPI ANTITRUST CHRON. 51 (Volume 3, June 2017), https://www.competitionpolicyinternational.com/wp-content/uploads/2017/06/CPI-Shenkar-Heemskerk-Fichtner.pdf; Jan Fichtner, Eelke M. Heemskerk and Javier Garcia-Bernardo, *Hidden power of the Big Three? Passive index funds, re-concentration of corporate ownership, and new financial risk*, 19 BUS. & POL. 328; Bernard S. Sharfman, *Commentary: Reforming a broken system*, Pensions & Investments (August 27, 2018), http://www.pionline.com/article/20180827/ONLINE/180829997/commentary-reforming-a-broken-system; Bernard S. Sharfman, *Mutual Fund Advisors' "Empty Voting" Raises New Governance Issues*, COLUM. L. SCHOOL: BLUE SKY BLOG (July 3, 2017), http://clsbluesky.law.columbia.edu/2017/07/03/mutual-fund-advisors-empty-voting-raises-new-governance-issues/; Bernard S. Sharfman, *The Agency Costs of Agency Capitalism and Corporate Law*, Delaware Corporate & Commercial Litigation Blog (August 29, 2018), https://www.delawarelitigation.com/2018/08/articles/commentary/the-agency-costs-of-agency-capitalism-and-corporate-law/.

concern. In that way, corporate law establishes the foundation for a shareholder wealth maximization norm. According to Leo Strine, Chief Justice of the Delaware Supreme Court:

> In American corporate law, only stockholders get to *elect directors*, *vote on corporate transactions and charter amendments*, and *sue to enforce the corporation's compliance with the corporate law and the directors' compliance with their fiduciary duties*.[47] An unsubtle mind might believe that this statutory choice to give only stockholders these powers might have some bearing on the end those governing a for-profit corporation must pursue. But regardless of whether that is so as a matter of law, this allocation of power has a profound effect as a matter of fact on how directors govern for-profit corporations. When only one constituency has the power to displace the board, it is likely that the interests of that constituency will be given primacy.[48]

In addition, the board of directors owes fiduciary duties to the corporation for the benefit of shareholders. These duties, enforced by the courts by applying equitable principles, require directors to focus on shareholder interests or else be the subject of a shareholder suit for breach of those duties. According to the Delaware Supreme Court in *NACEPF v. Gheewalla*:[49]

> Delaware corporate law provides for a separation of control and ownership. The directors of Delaware corporations have 'the legal responsibility to manage the business of a corporation for the benefit of its stockholder owners.' Accordingly, fiduciary duties are imposed upon the directors to regulate their conduct when they perform that function.[50]

Also, the *Gheewalla* Court stated that even when a corporation is in the zone of insolvency, a Board still owes fiduciary duties to stockholders and not to creditors:

> When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its stockholders by exercising their business judgment in the best interests of the corporation for the benefit of its stockholder owners.[51]

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[47] Stephen Bainbridge makes the interesting point that while directors have fiduciary duties that extend to shareholders, they are not agents of shareholders such that the law of agency would apply. Instead, they are sui generis actors under the law. *See* Stephen M. Bainbridge, *Directors are fiduciaries but they are not agents*, ProfessorBainbridge.com (August 25, 2015) https://www.professorbainbridge.com/professorbainbridgecom/2015/08/directors-are-fiduciaries-but-they-are-not-agents.html. *See also*, Restatement (Second) of Agency § 14C (1958) ("Neither the board of directors nor an individual director of a business is, as such, an agent of the corporation or of its members."); Arnold v. Soc'y for Sav. Bancorp, 678 A.2d 533, 539-40 (Del. 1996) ("Directors, in the ordinary course of their service as directors, do not act as agents of the corporation .... A board of directors, in fulfilling its fiduciary duty, controls the corporation, not *vice versa*."); U.S. v. Griswold, 124 F.2d 599, 601 (1st Cir 1941) ("The directors of a corporation for profit are 'fiduciaries' having power to affect its relations, but they are not agents of the shareholders since they have no duty to respond to the will of the shareholders as to the details of management.").

[48] Strine, *supra* note 45, at 453-455.

[49] N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007).

[50] *Id.* at 101.

[51] *Id.*

These fiduciary duties of care and loyalty (good faith is subsumed under the duty of loyalty under Delaware law), enforced under corporate law, direct a board to make decisions, including voting recommendations, that enhance shareholder value.[52] Moreover, Strine has argued that "the corporate law *requires* directors, as a matter of their duty of loyalty, to pursue a good faith strategy to maximize profits for the stockholders,"[53] and that directors should only receive the benefit of the business judgment rule if their decision was motivated by a desire to enhance shareholder value.[54]

But fiduciary duties enforced under state law are not the only means by which agency costs are mitigated in favor of shareholders. Federal securities laws covering insider trading and securities fraud under Section 10(b) of the Securities Exchange Act of 1934[55] and Rule 10b-5,[56] laws that may lead to civil and/or criminal penalties, keep shareholder interests clearly at the fore in board decision making.

In addition, the listing requirements of U.S. stock exchanges make sure that boards are composed of a majority of independent directors.[57] These requirements are to ensure that directors have ties to the corporation that are not so significant as to influence their judgment in corporate matters. That is, they help keep the board independent of management and focused on the interests of shareholders. The listing requirements also require that a board's audit, compensation, and nominating committees are to be composed entirely of independent members.[58] According to Spencer Stuart, 85% of S&P 500 directors were independent in 2017.[59]

Given these mitigating factors, it is hard to believe that even a small minority of board voting recommendations are riddled with significant agency costs. In sum, these agency costs should not stop the SEC from endorsing the value of board recommendations.

What can be done?

The Advisers Act of 1940 imposes fiduciary duties on investment advisers[60] when voting their proxies. As stated in the Release implementing the Proxy Voting Rule, "Under the Advisers Act …

[52] For a general discussion of how fiduciary duties are directed toward satisfying shareholder interests, *see* Bernard S. Sharfman, *The Importance of the Business Judgment Rule*, 14 N.Y.U. J. L. AND BUS. 27, 63-67 (Fall 2017).

[53] Leo E. Strine, Jr., *Our Continuing Struggle with the Idea that For-Profit Corporations Seek Profit*, 47 WAKE FOREST L. REV. 135, 155 (2012) (emphasis added).

[54] *Id.* at 147–48 ("Fundamental to the rule . . . is that the fiduciary be motivated by a desire to increase the value of the corporation for the benefit of the stockholders.").

[55] 15 U.S.C § 78j(b).

[56] 17 CFR 240.10b-5.

[57] *See, e.g.*, N.Y. STOCK EXCH., LISTED COMPANY MANUAL §§ 303A.01–.02 (2009).

[58] *See, e.g., id.* at §§ 303A.04–303A.06.

[59] Spencer Stuart, SPENCER STUART BOARD INDEX 2014 at 12 (2017), https://www.spencerstuart.com/~/media/ssbi2017/ssbi_2017_final.pdf.

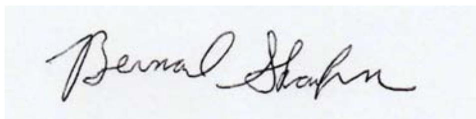
[60] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963). *See also*, Transamerica Mtg. Advisors, Inc. v. Lewis, 444 U.S. 11 (1979) ("As we have previously recognized, § 206 establishes "federal fiduciary standards" to govern the conduct of investment advisers, Santa Fe Industries, Inc. v. Green, *supra*, at 430 U. S. 471, n. 11; Burks v. Lasker, 441 U. S. 471, 441 U. S. 481-482, n. 10; SEC v. Capital Gains Research Bureau, Inc., 375 U. S. 180, 375 U. S. 191-192. Indeed, the Act's legislative history leaves no doubt that

an adviser is a fiduciary that owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting."[61] Moreover, "to satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interest of its client and must not subrogate client interests to its own."[62]

Investment advisers should not be in fear of breaching their fiduciary duties if they use board voting recommendations. The superior precision of board voting recommendations, being based on inside information and enhanced by the expertise of executive management, should give investment advisers the right to use them without fear of liability. The SEC needs to go further than just approving the use of board voting recommendations as long as the investment adviser has an agreement with the client to use them. By contrast, an investment adviser does not need to receive the permission of the client when using the recommendations of a proxy advisor. Therefore, the SEC needs to explicitly state in some way that an investment adviser will not be in breach of its fiduciary duties under the Advisers Act if it uses board voting recommendations when voting its proxies.[63]

To implement such a policy, this comment letter requests the SEC to provide investment advisers with a liability safe harbor under the Advisers Act when using board voting recommendations in voting their proxies as long as their clients do not prohibit their use and no significant business relationship exists between the investment adviser and the company whose shares are being voted. This will help ensure that the value inherent in board voting recommendations is reflected in the voting of proxies by investment advisers.

Very truly yours,



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Bernard S. Sharfman

Congress intended to impose enforceable fiduciary obligations. *See* H.R.Rep. No. 2639, 76th Cong., 3d Sess., 28 (1940); S.Rep. No. 1775, 76th").

[61] Proxy Voting by Investment Advisers, Investment Advisers Act Release No. IA-2106. This fiduciary approach was reaffirmed in Staff Legal Bulletin No. 20 (IM/CF) (June 30, 2014), https://www.sec.gov/interps/legal/cfslb20.htm and in the recently released Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, https://www.sec.gov/rules/proposed/2018/ia-4889.pdf.

[62] Proxy Voting by Investment Advisers, Investment Advisers Act Release No. IA-2106.

[63] This was one of the three recommendations put forth in my October 12, 2018 comment letter. *See* Letter from Bernard S. Sharfman to Mr. Brent J. Fields, Secretary, Securities and Exchange Commission at 14-15 (October 12, 2018), https://www.sec.gov/comments/4-725/4725-4513625-175932.pdf.