December 20, 2019

Ms. Vanessa Countryman
Secretary, Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549
rule-comments@sec.gov

File Number S7-22-19

RE: Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice

Submitted By: Bernard S. Sharfman[*]

Dear Ms. Countryman,

The SEC's recently proposed *Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice*[1] is an efficient and necessary response to the "collective action" problem that is imbedded in the shareholder voting of public companies and the deficiencies that this problem creates in the voting recommendations of proxy advisors. The amendments will enhance the value of voting recommendations by requiring proxy advisors to make much needed investments in a few key areas of the voting recommendation process.

Part I of this letter will describe the collective action problem that is at the heart of shareholder voting. Part II will discuss the problems that this collective action causes for the voting recommendations of proxy advisors, including the creation of a resource constrained business environment. Part III discusses how proxy advisors deal with such a business environment. Part IV will discuss how the market for voting recommendations is an example of a market failure, requiring the SEC to pursue regulatory action to mitigate the harm caused by two significant negative externalities. Part V will discuss how the collective action problem of shareholder voting and the market failure impacts corporate governance. Part VI will discuss the value of the proposed amendments.

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[1] SEC, *Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice*, Release No. 34-87457 (Nov. 5, 2019), https://www.sec.gov/rules/proposed/2019/34-87457.pdf. *See also*, SEC, *Amendments to Exemptions From the Proxy Rules for Proxy Voting Advice*, 84 Fed. Reg. 66518 (Dec. 4, 2019), https://www.govinfo.gov/content/pkg/FR-2019-12-04/pdf/2019-24475.pdf.

I. The Collective Action Problem Imbedded in Shareholder Voting

Shareholder voting suffers from a significant "collective action" problem.[2] According to Frank Easterbrook and Daniel Fischel, "When many are entitled to vote, none of the voters expects his votes to decide the contest. Consequently none of the voters has the appropriate incentive at the margin to study the firm's affairs and vote intelligently."[3] According to Paul Edelman, Randall Thomas, and Robert Thompson, "There is a serious collective action problem in shareholder voting: the benefits of a successful vote accrue to all shareholders *but the costs of voting* (for example, information acquisition, preparation and distribution of materials, mustering support) *are borne by each voter* separately so that shareholders may have inadequate incentives to vote."[4]

This collective action problem results in a low percentage of retail investors casting their ballots at stockholder meetings. Based on recent research by Alon Brav, Matthew Cain, and Jonathon Zytnick, retail investors are not inclined to vote unless they own a significant percentage of the company's stock or the company has experienced a recent track record of poor financial performance.[5]

The collective action problem also exists at the institutional investor level, but is manifested in a different way. As a result of regulatory guidance from the SEC and the Department of Labor, making shareholder voting a fiduciary duty, institutional investors such as investment advisers and ERISA plan managers feel compelled to cast their ballots on almost all issues presented for a vote.[6] This has resulted in many institutional investors casting ballots by proxy on tens if not hundreds of thousands

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[2] This collective action problem was noted in the proposed amendments, *see* SEC, *Amendments to Exemptions From the Proxy Rules for Proxy Voting Advice*, *supra* note 2, 84 Fed. Reg. at 66541-42 citing Andrey Malenko & Nadya Malenko, *Proxy Advisory Firms: The Economics of Selling Information to Voters*, 74 J. FIN. 2441 (2019) ("In this paper, we emphasize that the market efficiency view does not take into account the *collective action* problem among shareholders. We show that because shareholders do not internalize the effect of their actions on other shareholders, there may be excessive overreliance on proxy advisors' recommendations and, as a result, excessive conformity in shareholders' votes.").

[3] Frank H. Easterbrook and Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 402 (1983).

[4] Paul H. Edelman, Randall S. Thomas, and Robert B. Thompson, *Shareholder Voting in an Age of Intermediary Capitalism*, 87 S. CAL. L. REV. 1359, 1379 (2014).

[5] Alon Brav, Matthew D. Cain, and Jonathon Zytnick, *Retail Shareholder Participation in the Proxy Process: Monitoring, Engagement, and Voting*, HARV. L. SCHOOL F. ON CORP. GOV. & FIN. REG. (Nov. 19, 2019), HTTPS://CORPGOV.LAW.HARVARD.EDU/2019/11/19/RETAIL-SHAREHOLDER-PARTICIPATION/ ("On the decision whether to cast a ballot, we find that retail shareholders cast 32% of their shares, on average, which is significantly lower than the 80% rate of participation by the entire shareholder base. In total, 12% of the average firm's retail accounts choose to vote. Retail voter participation is higher among smaller firms. The decision to cast a ballot varies predictably with anticipated costs and benefits. It increases with stake size, when the company's return on assets is poor, and when there are ISS-opposed proposals on the ballot.").

[6] In 1988, the Department of Labor's "Avon letter" began the process of U.S. regulators putting pressure on institutional investors to vote all their proxies, whether or not their votes were informed. This pressure was given a big boost fifteen years later when the SEC implemented the *Proxy Voting Rule* and formally recognized the fiduciary duties of registered investment advisers when voting proxies. In addition, with the implementation of the *Proxy Voting Rule*, the SEC stated that the investment adviser could use an independent third party, such as a proxy advisor, to demonstrate that it was voting absent a conflict of interest. This SEC endorsement of the use of a proxy advisor was reinforced 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*. For a more detailed discussion of this history, *see* Bernard S. Sharfman, *Enhancing the Value of Shareholder Voting Recommendations*, 87 TENN. L. REV. at PARTS I and V (forthcoming 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3305372.

of votes per year.[7] However, because of the collective action problem, the amount of resources they are willing to spend on the acquiring of information internally or externally in order to be adequately informed on each and every vote is minimal, requiring them to seek the services of a low cost provider of voting recommendations.

A. The Collective Action Problem at Passive and Actively Managed Funds

For example, consider how the collective action problem and the regulatory pressure to vote encourages our largest investment advisers to index mutual funds (BlackRock, Vanguard, State Street Global Advisors, Fidelity, etc.) to adopt a low cost approach to shareholder voting. The management of passive funds exists in a super competitive industry with extremely thin profit margins, providing investment advisers with very little room to spend resources on shareholder voting. Moreover, since the goal of an index fund is to meet, not beat the market, the adviser would not derive any competitive benefit from receiving highly informed and precise recommendations and therefore would have no incentive to spend the money that the creation of such recommendations would require.[8]

This collective action problem also applies to actively managed funds. In general, it will always be more profitable for them to use their limited resources to invest in stock valuation, such as fundamental analysis provided by equity analysts, than to spend their resources on costly high-value voting recommendations.[9] While the benefits of fundamental analysis will be a private gain for that specific portfolio manager, the benefits of investing in high-value voting recommendations will be shared by its competitors.

Of course, there are always exceptions to the rule. Activist hedge funds, those unregulated hedge funds who take significant stock positions in a particular company in order to advocate for strategic change prior to selling their shares, will have strong financial motivations to vote on an informed basis.[10] But in general, as stated by Jill Fisch, Asaf Hamdani, and Steven Davidoff Solomon:

> This collective action problem, however, characterizes all institutional investor engagement in corporate governance - by both active and passive funds. Costly steps that investors may take to improve the performance of companies in their portfolio benefit all the investors that hold shares of these companies.[11]

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[7] *See*, e.g., VANGUARD, INVESTOR STEWARDSHIP 2018 ANNUAL REPORT 34 (2018), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2018_investment_stewardship_annual_report.pdf (On a global basis, Vanguard's Investor Stewardship team cast nearly 169,000 votes in the 2018 proxy year.).

[8] Lucian A. Bebchuk, Alma Cohen, and Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 98 (2017).

[9] Sharfman, *supra* note 6, at PART IV.

[10] Edelman, Thomas, and Thompson, *supra* note 4, at 1379.

[11] Jill E. Fisch, Asaf Hamdani, and Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, forthcoming, U. PENN. L. REV. (2020) at 14, https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=2985&context=faculty_scholarship.

II. How the Collective Action Problem Impacts the Creation of Voting Recommendations

The collective action problem of shareholder voting has major implications for proxy advisors. It means that they must exist in an environment where their institutional investor clients, including investment advisers, are only willing to pay a minimal fee for voting recommendations. As stated by Bryce Tingle, "Suboptimal outcomes are generated by proxy firms and accepted by institutional shareholders in exactly the same way that a negligent and inattentive management team is ultimately sustained by a disengaged or supine board of directors."[12] This is what I refer to as the "proactive agency costs of agency capitalism."[13] In the context of shareholder voting, these "[a]gency costs of agency capitalism are generated when an institutional investor," such as an investment advisor, manages its delegated voting authority to satisfy its own preferences and not the preferences of its beneficial investors.[14] It also explains why institutional investors are not demanding greater precision in the voting recommendations provided by their proxy advisors and "leading the charge for reform."[15] They simply don't want them if it means having to spend more money.

As a result of these agency costs, it should be expected that proxy advisors are resource constrained. The evidence appears to bear this out:[16]

> As of June 2017, the ISS Global Research team covered 40,000 shareholder meetings [approximately 250,000 votes] with approximately 270 research analysts [an estimated 800 plus votes per analyst during the proxy season] and 190 data analysts. However, it is not known how many research analysts are full-time, part-time or seasonal (proxy season only)….
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> In 2018, Glass Lewis reported that it covers 20,000 meetings each year with approximately the same number of analysts it had in 2014 [200]. However, it is not known if this number included data as well as research analysts.
>
> Perhaps the most egregious example of where the lack of resources impacts the precision of a proxy advisor's voting recommendations is in the critically important areas of proxy contests and mergers and acquisitions (M&A). For example, to provide these recommendations the ISS has created a Special Situations Research Team ("Research Team"). Remarkably, the Research Team is made up of only *eight* analysts….
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> It is extremely doubtful that the expertise required for any particular proxy contest could be found within the eight-member Research Team. That is because there are close to 4,000 public companies in the US alone and they exist in numerous of industries. For example, the

[12] Bryce C. Tingle, *The Agency Cost Case for Regulating Proxy Advisory Firms*, 49 U.B.C. L. REV. 725, 746-47 (2016).
[13] Bernard S. Sharfman, *How the SEC Can Help Mitigate the 'Proactive' Agency Costs of Agency Capitalism*, 8 AM. U. BUS. L. REV. 1, 3 (2019).
[14] *Id.* at 3-4.
[15] Michael T. Cappucci, Harvard Management Co., *The Proxy War Against Proxy Advisors*, HARV. L. SCHOOL F. ON CORP. GOV. & FIN. REG. (Nov. 27, 2019), https://corpgov.law.harvard.edu/2019/11/27/the-proxy-war-against-proxy-advisors/.
[16] Sharfman, *supra* note 6, at PART IV.

> Global Industry Classification Standard includes 11 sectors which are further subdivided into 24 industry groups, 69 industries and 158 sub-industries. In sum, it would be a rare occasion when the Research Team could find an analyst on staff that would have the expertise to do an adequate job in evaluating a proxy contest.
>
> This same lack of expertise would apply to M&A recommendations. Moreover, there are many more to deal with. On an average annual basis, … let's assume that the Research Team is faced with around 150 to 300 M&A per year…. For a team of eight without the proper expertise, doing an adequate job is an impossible task.[17]

This resource constrained business environment is further evidenced in a recent study by Ana Albuquerque, Mary Ellen Carter, and Susanna Gallani.[18] They find that the negative assessments provided by ISS on the executive compensation of public companies are significantly correlated with poor future accounting performance. However, this only occurs when the assessments are provided during the time of year not associated with the proxy season:[19]

> We provide empirical evidence showing that ISS appears to identify poor compensation practices *mainly* for the subsample of observations that have a non-December fiscal year end (FYE). This result suggests that during the proxy season when ISS is busier (evaluating firms with December FYE, which represent the majority of ISS's coverage) and more constrained regarding resources needed to analyze firms' compensation packages, their recommendations are of lower quality.[20]

Their empirical results provide evidence that ISS simply does not have sufficient resources to provide value enhancing recommendations during the proxy season, the time of year (March and April) when it creates the overwhelming majority of its voting recommendations.

In sum, proxy advisors exist in an industry where there is a clear mandate to produce low cost, low value voting recommendations within a resource constrained business environment.[21] Combining this result with a proxy advisory industry that has developed into an oligopoly where there are only two primary providers of these low cost voting recommendations, ISS and Glass Lewis, an excessive amount of conformity in voting recommendations may also result.

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[17] *Id.* (citations omitted)

[18] Ana Albuquerque, Mary Ellen Carter, and Susanna Gallani, *Are ISS Recommendations Informative? Evidence from Assessments of Compensation Practices* (Nov. 2019), https://community.bus.emory.edu/FacultySeminars/Shared%20Documents/Carter,%20Mary%20Ellen-workshop%20paper.pdf.

[19] *Id.*

[20] *Id.* In the sample used by Albuquerque, Carter, and Gallani, over 70% of the sample firms had a December FYE. *Id.* This is consistent with the Conference Board finding that approximately 85% of Russell 3000 companies hold their annual meetings during the first half of the year. *See* Matteo Tonello, *Proxy Voting Analytics, (2016*‒*2019)*, THE CONFERENCE BOARD, (2019), https://www.conference-board.org/press/pressdetail.cfm?pressid=9287.

[21] As observed by Chester Splatt, the former Chief Economist of the SEC, "During the SEC's roundtable on the proxy process held in November 2018, individual asset managers focused concern about greater regulation of proxy advisory firms upon the potential implications for the costs and resulting pricing of their services, rather than the equilibrium effects on the quality of governance." *See* Chester S. Splatt, *Proxy Advisory Firms, Governance, Market Failure, and Regulation*, MILKEN INSTITUTE at 6 (2019).

III. How a Proxy Advisor Deals with Significant Resource Constraints

Proxy advisors have developed two primary cost minimizing strategies to deal with a resource constrained business environment. The first is creating voting recommendations based on "mitigating governance risk"[22] and the second is creating broad-based recommendations based on interested party feedback, including feedback from clients.[23] In general, both strategies help avoid doing any real financial analysis regarding a particular shareholder vote, and, most importantly, spending the significant resources involved in doing such analysis.[24]

A. Creating Voting Recommendations Based on Mitigating Governance Risk

Instead of a proxy advisor investing the necessary resources to produce voting recommendations that are based on a thorough financial analysis of each vote; it creates voting recommendations based on corporate governance principles that are not fine tuned to the circumstances of any individual company. This "mitigating governance risk" strategy results in a significant economization of a proxy advisor's resources. It also results in a one-size-fits-all voting policy.

This strategy is very similar to what Lucian Bebchuk and Scott Hirst have observed when investor stewardship teams from the "Big Three" mutual fund families (Blackrock, Vanguard, and State Street Global Advisors), another resource constrained provider of voting recommendations, provide voting recommendations to their index fund clients: "Our analysis of the voting guidelines and stewardship reports of the Big Three indicates that their stewardship focuses on governance structures and processes and pays limited attention to financial underperformance."[25]

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[22] Statement of Gary Retelny, President & CEO, Institutional S'holder Servs. Inc., to Subcomm. on Capital Mkts. & Gov't Sponsored Enters., Comm. on Fin. Servs., U.S. House of Representatives, Legislative Proposals to Enhance Capital Formation, Transparency and Regulatory Accountability (May 17, 2016), at A-14, https://www.issgovernance.com/file/duediligence/iss-statement-hfsc-17-may-2016.pdf[https://perma.cc/NC9Y-W6WT]; Letter from Gary Retelny, President & CEO, Institutional S'holder Servs. Inc., to Bill Huizenga, Chairman, Subcomm. on Capital Mkts., Sec., & Inv., Comm. on Fin. Servs., U.S. House of Representatives, & Carolyn B. Maloney, Ranking Member, Subcomm. on Capital Mkts., Sec., & Inv., Comm. on Fin. Servs., U.S. House of Representatives, Re: July 18, 2017, Hearing Entitled "The Cost of Being a Public Company in Light of Sarbanes-Oxley and the Federalization of Corporate Governance" (July 27, 2017), at 2, https://www.issgovernance.com/file/duediligence/20170727-iss-letter-to-hfsc-subcommitee-on-captal-markets-securities-and-investment.pdf[https://perma.cc/PMQ4-3XKH].

[23] For example, ISS reports that it provides over 400 customized voting reports. *See* Institutional Shareholder Services Inc., Comment Letter on Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisors; Request for Comment on Enhancing Investment Advisor Regulations, S7-09-18 (Aug. 7, 2018), at p. 1, https://www.sec.gov/comments/s7-09-18/s70918-4184213-172552.pdf[https://perma.cc/32YC-8U6V]. Glass Lewis reports that it provides customized reports to a "supermajority" of its clients. *See* GLASS LEWIS, BEST PRACTICE PRINCIPLES FOR PROVIDERS OF SHAREHOLDER VOTING RESEARCH & ANALYSIS: GLASS LEWIS STATEMENT OF COMPLIANCE FOR THE PERIOD OF 1 JANUARY 2018 THROUGH 31 DECEMBER 2018 9-10 (2019).

[24] These cost minimizing strategies do not work where some sort of financial analysis must be applied in a voting recommendation and research report, such as addressing the desirability of a merger or acquisition. There, as already discussed in PART II, the issue is the quality of the financial analysis in a resource constrained environment.

[25] Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. (forthcoming 2019) (manuscript at 7), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3282794[https://perma.cc/CR8X-4SLR].

As described by Sean Griffith:

> Stewardship groups develop and work from a set of guidelines laying out a standard approach to recurring governance issues. These voting guidelines of each of the Big Three, for example, announce voting positions against staggered boards, poison pills and dual class shares. These positions lack nuance. In spite of recent research showing that these provisions can create value for some firms, stewardship group guidelines announce a one-size-fits-all approach to governance.[26]

Hence, the strategy of mitigating governance risk in the creation of voting recommendations, whether used by proxy advisors or investor stewardship teams, is a one-size-fits-all approach that leads to the creation of voting recommendations that are not very informed or precise, at least in terms of enhancing shareholder value.

B. Creating Voting Recommendations Based on Feedback

ISS makes public that in the development of its benchmark voting policy "it collects feedback from a diverse range of market participants through multiple channels: an annual Policy Survey of institutional investors and corporate issuers, roundtables with industry groups, and ongoing feedback during proxy season."[27] Glass Lewis is much more mysterious in how it goes about using feedback, saying only that it utilizes the advice of an independent body referred to as the Research Advisory Council.[28] The current composition of the Council is extremely impressive.[29] However, it is not known how they interact with Glass Lewis or what kind of inputs they use in developing their feedback or what kind of feedback they actually provide.

A significant problem in taking this low cost approach is that while the preferences of multiple stakeholders may potentially be revealed and taken into consideration, the preferences of beneficial investors and public pension fund beneficiaries may be ignored. Institutional investors should be the advocates of their own investors and pension fund beneficiaries, but this may not be the case. That is, they may have their own preferences which they will treat as their first priority. For example, an institutional investor with a strong preference for shareholder empowerment or some component of

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[26] Sean J. Griffith, *Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority*, 98 TEX. L. REV. 17-18 (forthcoming 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3404298[https://perma.cc/G9EU-PT23].

[27] Institutional Shareholder Services, *Policy Formulation Process* (accessed Dec. 12, 2019), https://www.issgovernance.com/policy-gateway/policy-formulation-application/. *See also*, Institutional Shareholder Services, *ISS Opens Global Policy Survey for 2020: Investors, Companies and Corporate Governance Organizations Encouraged to Participate in ISS' Annual Policy Development Process* (July 22, 2019), https://www.issgovernance.com/iss-opens-global-policy-survey-for-2020/ (noting the use of the survey for purposes of revising its benchmark voting policies).

[28] U.S. Government Accountability Office, CORPORATE SHAREHOLDER MEETINGS: PROXY ADVISORY FIRMS' ROLE IN VOTING AND CORPORATE GOVERNANCE PRACTICES, GAO-17-47 at 23 (Nov. 2016), https://www.gao.gov/assets/690/681050.pdf.

[29] Currently, David Nierenberg, Charles A. Bowsher, Jesse Fried, Bonnie Hill, Stéphanie Lachance, and Katherine Rabin sit on the Research Advisory Council. *See* Glass Lewis, *Leadership: Research Advisory Council* (accessed Dec. 12, 2019), https://www.glasslewis.com/leadership-2/.

ESG may prioritize that preference over the default objective of shareholder wealth maximization.[30] This type of result can be inferred from the recent research of Alon Brav, Matthew Cain, and Steven Davidoff Solomon:

> Retail shareholders and institutional investors vote substantially differently. Retail shareholder support for management proposals is strongly related to lagged firm stock price performance, even with account-firm fixed effects, consistent with a focus on disciplining poorly-performing firms, whereas the voting of the Big Three institutional investors is not statistically significantly correlated with recent stock performance. On the other hand, ISS opposition is associated with a 35 percentage point decrease in Big Three support, but only a 5 percentage point decrease in retail shareholder support. Retail shareholders do not support environmental, social, and governance (ESG) proposals to the same degree as institutional investors. This is driven by the tendency of retail shareholders with large stake sizes, who participate more often, to vote against such proposals. We find that shareholders with smaller stake sizes, whose turnout rate is low, provide stronger support for ESG proposals when they choose to engage.[31]

Moreover, relying on stakeholder preferences creates plenty of room for those with the most influence at a proxy advisor, e.g., their biggest and best clients, to overweight and therefore bias a proxy advisor's benchmark voting policy with their own preferences. For example, in its 2019 Global Policy Survey for US companies, Institutional Shareholder Services (ISS) "asked investors whether a time-based sunset requirement of no more than seven years was seen as appropriate" for dual class share structures."[32] According to ISS, of "those investors who provided a response to the question, 55 percent agreed that a maximum seven-year sunset is appropriate."[33] As a result, ISS changed its

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[30] *See* Bernard S. Sharfman, *Now is the Time to Designate Proxy Advisors as Fiduciaries under ERISA*, forthcoming, STAN. J. L., BUS., & FIN. at 15-20, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3446291. *See also*, Sharfman, *supra* note 13, at 15-16. As stated in that writing:

> I cannot overstate the harm caused by an institutional investor adopting a shareholder empowerment approach to corporate governance. This is particularly true when it comes to the private ordering of corporate governance arrangements. Shareholder empowerment is a one-size-fits-all approach and should not be confused with our traditional understanding of private ordering. This understanding assumes that, "observed governance choices are the result of value-maximizing contracts between shareholders and management." For example, it may or may not include such corporate governance arrangements as dual class shares (with or without time-based sunset provisions), staggered boards, or super-majority shareholder voting. That is the whole point of private ordering and why it has value; it "allows the internal affairs of each corporation to be tailored to its own attributes and qualities, including its personnel, culture, maturity as a business, and governance practices."
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> Private ordering that results from shareholder empowerment disregards what is wealth maximizing for shareholders at each company. I refer to this phenomenon as the "bastardization of private ordering" or "sub-optimal private ordering."

Id.

[31] Brav, Cain, and Zytnick, *supra* note 5.

[32] Subodh Mishra, Institutional Investor Services, Inc., *ISS Benchmark Policy Updated-Executive Summary*, HARV. L. SCHOOL F. ON CORP. GOV. & FIN. REG. (Dec. 2, 2019), HTTPS://CORPGOV.LAW.HARVARD.EDU/2019/12/02/ISS-BENCHMARK-POLICY-UPDATED-EXECUTIVE-SUMMARY/.

[33] *Id.*

benchmark policy such that "no sunset period of more than seven years from the date of the IPO will be considered to be reasonable."[34]

Besides the problem of how the question was phrased (the question could have simply been opened ended without leading the investor to a predetermined maximum number of years), this policy change was based on the responses of only 89 unidentified institutional investors,[35] of which 49 (estimated) of them said yes.[36] With an institutional client base of approximately 2,000,[37] this seems to be an incredibly small sample size of institutional investors to use when making a very important policy change. In addition, the sample may have been significantly over-weighted with representatives of those who support shareholder empowerment, such as public pension and union-related funds. Moreover, it should be noted that the Council of Institutional Investors has strongly advocated for a seven-year sunset.[38] Based on these facts, a potential inference is that the phrasing of the question and the resulting policy change was simply meant to please those clients who espouse shareholder empowerment, such as the CII and its public pension and union-related fund members.

It should be noted that this is not the first time that the use of feedback and survey results has been criticized as being opaque and bias. A number of years ago David Larcker, Allan McCall, and Brian Tayan found that, "the ISS data collection process relies on a very small number of participants"; "the composition of the respondent pool that ISS does reach is not well disclosed"; "the survey suffers from design errors that are likely to confuse and/or bias respondents"; and "it is unclear how ISS incorporates the feedback that it receives during the open comment period to finalize voting policies."[39]

In sum, this strategy of using stakeholder preferences, especially client preferences, may create significant bias in voting recommendations. It also leads to the conclusion that "proxy advisory firms are concerned that their voting recommendations reflect the opinions and prejudices of their clients, the institutional investors; it matters less to proxy firms whether the governance regime reflected in their voting guidelines is correct."[40]

IV. A Market Failure

In the market for voting recommendations, there are two parties that contract with each other, the providers of voting recommendations, proxy advisors, and their clients, institutional investors.

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[34] *Id.*
[35] Institutional Investor Services, Inc., 2019 GLOBAL POLICY SURVEY, SUMMARY OF RESULTS at 27 (Sept. 11, 2019), https://www.issgovernance.com/file/policy/2019-2020-iss-policy-survey-results-report.pdf.
[36] *Id.*
[37] ISS, *About* (accessed on Sept. 28, 2019), https://www.issgovernance.com/about/about-iss/.
[38] *Dual-Class Stock*, COUNCIL INSTITUTIONAL INV., https://www.cii.org/dualclass_stock (archived Dec. 2, 2019).
[39] David F. Larcker, Allan L. McCall, and Brian Tayan, *And Then A Miracle Happens!: How Do Proxy Advisory Firms Develop Their Voting Recommendations?*, STANFORD CLOSER LOOK SERIES (2013), https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-closer-look-31-proxy-firms-voting-recommendations.pdf.
[40] Bryce C. Tingle, *Bad Company! The Assumptions behind Proxy Advisors' Voting Recommendations*, 37 DALHOUISE L. REV. 709, 723 (2014).

Unfortunately, the two parties most impacted by the quality of the voting recommendations are not parties to the contract, the public companies whose shareholders are being asked to vote and the beneficial investors of the proxy advisor's clients.[41]

As already argued, there is a collective action problem in shareholder voting that has resulted in a resource constrained proxy advisory industry, creating the need for cost minimizing strategies in the creation of voting recommendations. These strategies, not based on financial analysis, lead to voting recommendations that are not adequately informed or precise. As a result, two significant negative externalities are created.

The first negative externality is the negative impact that uninformed and inadequately precise voting recommendations will have on the decision making of public companies.[42] For example, if an activist hedge fund is utilizing a proxy contest to change the strategic direction of the company and the shareholder vote is significantly influenced by inadequate voting recommendations. As a result, the company's market and financial performance will suffer as well as its ability to successfully compete against its' rivals.

The second externality is the negative impact that such voting recommendations will have on beneficial investors.[43] These investors will suffer economic losses because suboptimal voting recommendations will lead to value reducing decisions at public companies.[44] For example, if the result of a merger vote is significantly influenced by imprecise voting recommendations.

This second negative externality makes understandable Commissioner Roisman's strong rebuke to those who think only the interests of proxy advisor clients are of concern in the regulation of proxy advisors:

> For example, I have heard that the Commission should not take any action related to proxy voting advice provided by proxy advisory firms because "... the investors themselves... the ones paying for proxy advice... are not asking for protection." To be clear, in this context, I do not consider asset managers to be the "investors" that the SEC is charged to protect.

[41] Tingle, *supra* note 12, at 782.
[42] *Id.*
[43] *Id.*
[44] The empirical research on how voting recommendations impacts shareholder value is not extensive. *See* David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, *Outsourcing Shareholder Voting to Proxy Advisory Firms*, 58 J. L. & ECON. 173 (Feb. 2015) ("These results suggest that the outsourcing of voting to proxy advisory firms appears to have the unintended economic consequence that boards of directors are induced to make choices that decrease shareholder value."); David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, *Proxy Advisory Firms and Stock Option Repricing*, 56 J. OF ACCT. AND ECON. 149 (2013) ("Using a comprehensive sample of stock option repricings announced between 2004 and 2009, we find that repricing firms following the restrictive policies of proxy advisors exhibit statistically lower market reactions to the repricing, lower operating performance, and higher employee turnover. These results are consistent with the conclusion that proxy advisory firm recommendations regarding stock option repricings are not value increasing for shareholders."); James R. Copland, David F. Larcker, and Brian Tayan, *The Big Thumb on the Scale, An Overview of the Proxy Advisory Industry*, STANFORD CLOSER LOOK SERIES (May 30, 2018) ("The research literature therefore shows mixed evidence on the degree to which proxy advisory firms influence firm voting and the impact they have on corporate behavior and shareholder returns. For the most part, their influence on voting is shown to be - at a minimum - moderate and their influence on corporate behavior and shareholder value is shown to be negative. Nevertheless, conflicting evidence exists.").

> Rather, the investors that I believe today's recommendations aim to protect are the ultimate retail investors, who may have their life savings invested in our stock markets. These Main Street investors who invest their money in funds are the ones who will benefit from (or bear the cost of) these advisers' voting decisions.[45]

Without these negative externalities "market forces rather than regulation are the most appropriate and effective oversight mechanism for the proxy advisory industry."[46] However, that is not where we are. Even if the voting recommendations are tainted with significant errors in facts, conflicts, or methodological weaknesses, institutional investors are very happy to purchase and use them. In sum, these negative externalities create a market failure, requiring regulatory action such as the SEC's proposed amendments.[47]

V. Shareholder Voting as a Corporate Governance Arrangement

Because of the collective action problem imbedded in shareholder voting and the market failure that occurs in the market for voting recommendations, it is not difficult to conclude that shareholder voting is not a very efficient way to make decisions at a public company. That is, it may lead to a lot of uninformed decision making. This problem is something that the marketplace for corporate governance arrangements appears to reflect. Shareholder voting is rarely used when it comes to decision making at a public company. The default rule under corporate law,[48] whether or not a public company, is that corporate decision making is to be left in the hands of those who are the most informed about the affairs of the company, the board of directors and its executive management. Nevertheless, it can be argued that there is significant value in shareholder voting if it is used sparingly and wisely. As I have previously stated:

> Shareholder voting, when it happens, has an obvious and very important impact on a publicly traded company; it shines light on corporate decision-making, moving decision-making away from the private confines of the boardroom and into the public arena where the board's approach on how to proceed can be debated by those who have the authority to vote. According to Leo Strine, Chief Justice of the Delaware Supreme Court, shareholder voting, even in its limited scope, is one of the components of corporate law that encourages the board to view decision-making through the lens of shareholder interests. However, at the same time, shareholder voting makes corporate decision-making much more unwieldy and

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[45] Commissioner Elad L. Roisman, *Statement at the Open Meeting on Commission Guidance and Interpretation Regarding Proxy Voting and Proxy Voting Advice*, Public Statement, U.S. SEC. AND EXCH. COM. (August 21, 2019), https://www.sec.gov/news/public-statement/statement-roisman-082119.

[46] Tingle, *supra* note 12, at 779 quoting Comment letter from Debra L Sisti, Vice President & Martha Carter, Managing Director of Institutional Shareholder Services, *Re: Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms* at 15 (Aug. 10, 2012), https://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120810_25-401_sistid_carterm.pdf.

[47] *Id.* at 729 ("Modern securities regulation has traditionally been justified on the grounds that it addresses two particular types of market failure: the underproduction of information and the production of fraudulent information.") citing Frank Easterbrook & Daniel R Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 669 (1984). *See also* John C Coffee, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 722 (1984).

[48] *See* DEL. CODE ANN. tit. 8, § 141(a) and § 142(a).

> potentially subject to the whims of uninformed and/or opportunistic shareholders. Hence, a good rationale for why shareholders are given limited opportunities to weigh in and participate in corporate decision-making.[49]

As a result, corporate law, in order to realize its shareholder-centric objective, still requires shareholder input on a small number of corporate matters, including some important ones, such as the appointment of directors, mergers and acquisitions, sale of a significant amount of company assets, and proxy contests. When that occurs,

> [S]hareholder voting in a public company cannot be looked at as simply another tool of accountability, i.e., a device to minimize agency costs or enhance efficiency, such as when shareholders file a direct or derivative lawsuit, initiate a proxy contest, attempt a hostile takeover, or take significant positions in the company and then advocate for change (hedge fund activism). When shareholders vote they are also participating, alongside the board, in corporate decision-making. That is, they are temporarily transformed into a locus of corporate authority that rivals the authority of the board. As co-decision makers, it is critical that shareholders and those with delegated voting authority, such as mutual fund advisers, have informed and sufficiently precise voting recommendations at their disposal, ...[50]

Shareholder voting is part of a joint decision making function that requires investment advisers with delegated voting authority to participate by casting their ballots. But that is only part of the story; shareholder voting also requires an adequate level of being informed and precision. This can only happen if the collection action problem of shareholder voting and the market failure that exists in the voting recommendations market is overcome through regulatory action, making the proposed amendments so critical to our current state of corporate governance.

VI. The Proposed Amendments

If there is no incentive for institutional investors to seek adequately informed and precise recommendations, then the SEC must act or else great harm may be done to the governance of our public companies. The proposed amendments are an attempt to deal with the collective action problem that is associated with shareholder voting and the market failure that exists in the market for voting recommendations. The proposed amendments direct proxy advisors to move away from their low-cost, low-value approach, but in only a few key areas of the voting recommendation process. For example, when providing voting recommendations, proxy advisors will be required to provide additional disclosures on conflicts of interest.[51] They will also be subject to potential disclosures of methodologies used and sources of information in order to meet the anti-fraud prohibitions found in the proposed amendment to Rule 14a-9.[52] These new disclosure requirements should discourage bad practices and result in voting recommendations that are much more precise, being less biased

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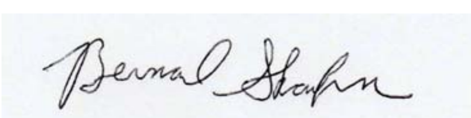
[49] Sharfman, *supra* note 6, at PART I.
[50] *Id.* at INTRODUCTION.
[51] SEC, *Amendments to Exemptions From the Proxy Rules for Proxy Voting Advice*, *supra* note 1, 84 Fed. Reg. at 66526.
[52] *Id.* at 66538.

(reduced conflicts of interest involved in the creation process) and more informed (use of better methodologies and sources of information).

Most interestingly, under proposed Rule 14a-2(b)(9)(ii), a proxy advisor must provide companies "a limited amount of time to review and provide feedback on" a voting recommendation before it is revealed to the advisor's clients.[53] Such a review process is not as burdensome as it sounds and should not lead to a "*chilling* effect on proxy advisors' willingness to issue truly independent advice."[54] In terms of current practice, both ISS and Glass Lewis already offer a number of companies the ability to participate in a circumscribed review process.[55] The proposed requirements would initially boil down to a proxy advisor determining if the recommendation is being contested because of a difference of opinion, which would not require much further work, or if there is a true dispute regarding the facts or methodology. If it is the later, then there is good reason to pursue further investigation. In terms of time requirements under the proposed rule, if a company "files its definitive proxy statement less than 25 calendar days before" its meeting of shareholders, the proxy advisor would be under no obligation to provide its voting recommendations to the company for review.[56] Moreover, it cannot be expected that more than a small percentage of voting recommendations will be contested. After all, proxy advisors concur with or simply follow the recommendations of the board of directors around 90% of the time.[57]

On the other hand, boards of directors will most likely contest those voting recommendations that are most important to their company and its shareholders, such as in the areas of executive compensation, mergers and acquisitions, and proxy contests. These recommendations are arguably the most analytically complex. This means that a proxy advisor may need to invest additional resources to adequately participate in the review process. Nevertheless, that should be a good thing for shareholders because the back and forth between the company and the proxy advisor on these important matters should make each party better informed, allowing them to make sure that factual errors and inadequate analytics are not tainting their respective voting recommendations. That is, the benefits should greatly outweigh the costs.

Very truly yours,



Bernard S. Sharfman

[53] *Id.* 66531.
[54] Cappucci, *supra* note 15.
[55] SEC, *Amendments to Exemptions From the Proxy Rules for Proxy Voting Advice*, *supra* note 3, 84 Fed. Reg. at 66545.
[56] *Id.* at 66531.
[57] Press Release, Council of Institutional Inv'rs, Investor Group Responds to Wall Street Journal Editorial: Proxy Advisory Firms Do Not Dictate Voting Outcomes (Aug. 13, 2018), https://www.cii.org/files/about_us/press_releases/2018/08-13-18_cii_press_release_WSJ_editorial.pdf (discussing proxy advisor recommendations for Russell 3000 companies).