January 31, 2020

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:

Dear Ms. Countryman,

I write to compile my prior comment letters submitted in response to the SEC's call for comments following the roundtable on the proxy process which was held on November 15, 2018.[1] I believe the following materials are also relevant for the proposed amendments to exemptions from the proxy rules for proxy voting advice. I commend the Commission for taking action on this issue and look forward to approval of a final rule.

My seventh letter[2] to the SEC discussed the guidance provided in Release No. IA-5325 and details why the SEC should take an additional step and recognize proxy advisors as investment advisers as defined by the Investment Advisers Act of 1940. As explained in my prior comments, your guidance takes an important step by clarifying that investment advisers with delegated voting authority take steps to ensure they are upholding their clients' best interests when voting their proxies. The SEC should issue additional guidance to clarify that proxy advisors are also investment advisers, so the firms are directly responsible for upholding this standard. Additional guidance would mitigate against the lack of competition within the proxy advisory industry, which leaves investment advisers with few alternatives when they are dissatisfied with a proxy advisor and would allow for easier enforcement since there are thousands of investment advisers and only two main proxy advisors.

My sixth letter[3] delves into the agency costs of agency capitalism and explores how the SEC can mitigate proactive agency costs by defining an investment adviser's fiduciary duties under the Investment Advisers Act referenced above. In this way, this letter expands upon topics discussed in my first submission[4], in which I discuss how additional disclosures by investment advisers to mutual funds would enhance the transparency of the proxy advisory system.

My second,[5] fourth[6] and fifth[7] letters advocate for reversing and correcting a long-standing SEC policy in which the value of proxy advisor recommendations is recognized in shareholder voting, but the value of board voting recommendations is not. In fact, the most precise voting recommendations are not provided by a proxy advisor but by the board of directors.

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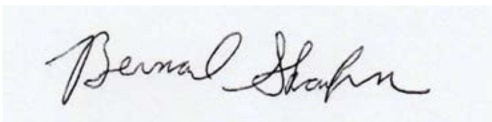
1 https://www.sec.gov/news/upcoming-events/roundtable-proxy-process
2 https://www.sec.gov/comments/4-725/4725-6293525-193381.pdf
3 https://www.sec.gov/comments/4-725/4725-5322436-183909.pdf
4 https://www.sec.gov/comments/4-725/4725-4555147-176184.pdf
5 https://www.sec.gov/comments/4-725/4725-4513625-175932.pdf
6 https://www.sec.gov/comments/4-725/4725-4780983-176889.pdf
7 https://www.sec.gov/comments/4-725/4725-5065405-183167.pdf

My first[8] and third[9] letters explore the lack of clarity regarding the fiduciary duties proxy advisors owe their clients under the Investment Advisers Act and how concentrated voting power has created an unmitigated conflict of interest whereby an adviser may use its voting power to support the activism of current and potential institutional clients in exchange for the ability to acquire more assets under management.

Please see all my comments submitted for the Roundtable below.

Very truly yours,



Bernard S. Sharfman

[8] https://www.sec.gov/comments/4-725/4725-4555147-176184.pdf

[9] https://www.sec.gov/comments/4-725/4725-4684881-176574.pdf

October 8, 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 (Investment Advisers to Mutual Funds)

Submitted By: Bernard S. Sharfman[*] (Revised as of October 23, 2018)

Dear Mr. Fields,

This submission is in response to Chairman Clayton's July 30 press release announcing a staff roundtable on the proxy process and calling for submissions from interested parties. It refers in particular to two of the topics under consideration, Voting Process and Shareholder Proposals. Specifically, it requests the Securities and Exchange Commission ("SEC" or "Commission"), in whatever form it deems appropriate, to clarify that investment advisers to mutual funds must disclose, under the Proxy Vote Rule,[1] their policies and procedures:

- to avoid using their voting power at public companies opportunistically to obtain new business from activists such as public pension funds and investment funds associated with labor unions;
- to eliminate pressures to support the activism of its own shareholders at its portfolio companies; and
- to identify an actual link between support for a shareholder proposal under Rule 14a-8 and the enhancement of shareholder value before voting in favor of any such proposal.

Introduction

According to the Release establishing the Proxy Voting Rule ("Release"),[2] an investment 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."[3] This was the rationale behind the Proxy

[*] Bernard S. Sharfman is the Chairman of the Main Street Investors Coalition Advisory Council, an associate fellow of the R Street Institute, and a member of the Journal of Corporation Law's editorial advisory board. This writing was supported by a grant provided by the Main Street Investors Coalition. Mr. Sharfman would like to thank Professors Joan Heminway and Benjamin Means for their helpful and insightful comments. The opinions expressed here are the author's and do not represent the official position of the Coalition or any other organization that he is affiliated with.

[1] 17 C.F.R. § 275.206(4)-6. The Proxy Voting Rule was promulgated under the Investment Advisers Act of 1940, 15 U.S.C. 80b-6.

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

[3] *Id.*

Voting Rule requiring investment advisers, including mutual fund advisers, to create and disclose their proxy voting policies and procedures. However, the SEC and its staff have yet to clarify what these fiduciary duties mean for the largest mutual fund advisers now that they control an extraordinary amount of shareholder voting power at many of our largest public companies.[4] This phenomenon did not exist at the time the Proxy Voting Rule was implemented.[5]

This concentration of voting power creates significant value for an adviser if it can be traded for something that the adviser wants in return. For example, an adviser may use its voting power to support the activism of current and potential institutional clients in exchange for the ability to acquire more assets under management. Or, an adviser may use its voting power to support the activism of its own shareholders at the advisor's portfolio companies in exchange for those shareholders agreeing not to target the adviser itself for such activism. The result is that an adviser has not cast its delegated voting authority "***in a manner consistent with the best interest of its client***"[6] and has subrogated the "***client interests to its own***,"[7] a breach in its fiduciary duties to its mutual fund clients and its shareholders.

The Commission should provide clarification that mutual fund advisers must disclose, consistent with their fiduciary duties to act in the best interests of their mutual fund clients and their shareholders, how they will deal with these new conflicts in their voting policies. In addition, shareholder proposals are a prime area where this opportunistic use of an adviser's voting power may be in play. Therefore, the adviser's voting policy must also explain how voting on these proposals are linked to maximizing shareholder value.

Furthermore, the Commission should clarify that voting inconsistent with these new policies and procedures or omission of such policies and procedures will be considered a breach of the Proxy Voting Rule.[8] Such guidance should apply to any mutual fund adviser that is delegated voting authority. I urge the SEC to be diligent in enforcing breaches of the Proxy Voting Rule.

Background

The Proxy Voting Rule requires mutual fund advisers, as registered investment advisers who have been delegated shareholder voting authority, to create and disclose their proxy **voting policies** and records:

> If you are an investment adviser registered or required to be registered under section 203 of the Act …, it is a fraudulent, deceptive, or manipulative act, practice or course of business within the meaning of section 206(4) of the Act …, for you to exercise voting authority with respect to client securities, unless you:

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[4] 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. *See also*, 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.

[5] *Id.*

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

[7] *Id.*

[8] *Id.*

(a) Adopt and implement written policies and procedures that are reasonably designed to ensure that you vote client securities in the ***best interest of clients***, which procedures must include how you address ***material conflicts*** that may arise between your interests and those of your clients;

(b) Disclose to clients how they may obtain information from you about how you voted with respect to their securities; and

(c) Describe to clients your proxy voting policies and procedures and, upon request, furnish a copy of the policies and procedures to the requesting client.[9]

This rule rests on two important premises. First, under the holding in *SEC v. Capital Gains Research Bureau, Inc.*,[10] the Investment Advisers Act of 1940 (Advisers Act) imposes a fiduciary duty on investment advisers, including mutual fund advisers.[11]

As stated in the Release, "Under the Advisers Act … 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."[12] 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 <u>subrogate</u> client interests to its own***."[13]

This fiduciary duty extends to the shareholders of mutual funds:

The investment adviser to a mutual fund is a fiduciary that owes the fund a duty of utmost good faith, and full and fair disclosure. This fiduciary duty extends to all functions undertaken on the fund's behalf, including the ***voting of proxies*** relating to the fund's portfolio securities. An investment adviser voting proxies on behalf of a fund, therefore, must do so in a manner consistent with the best interests of the fund and its shareholders.[14] (quotation marks omitted)

Second, the objective of this fiduciary duty is wealth maximization. According to the companion release, *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies*, "the amendments [regarding proxy voting disclosure] will provide better

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[9] 17 C.F.R. § 275.206(4)-6.

[10] 375 U.S. 180 (1963).

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

[12] 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.

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

[14] Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Investment Company Act Release No. IC-25922 (2003), https://www.sec.gov/rules/final/33-8188.htm.

information to investors who wish to determine: … whether their existing fund managers are ***adequately maximizing the value of their shares***."[15] This release also noted that "proxy voting decisions may play an important role in maximizing the value of a fund's investments for its shareholders," and can have "an enormous impact on the financial livelihood of millions of Americans."[16] In sum, the requirement of shareholder wealth maximization does not stop with portfolio management, it also must be adhered to when a mutual fund adviser votes the shares it has been delegated.

This objective is also consistent with the premise that the overwhelming majority of investors, including retail investors, simply want to earn the highest risk adjusted financial return possible,[17] including when they vote or have votes cast by investment advisers. Moreover, I believe this desire to earn the highest risk adjusted financial return possible is also shared by the overwhelming number of socially motivated investors who align their investments based on their moral or social values,[18] even though they give up some risk-adjusted return in terms of portfolio diversification and may pay higher management fees for this customization. That is, these investors are willing to exclude certain stocks from their portfolios because they find them to be socially undesirable, but are still looking for the highest risk adjusted return possible given their investment constraints.

Finally, it must be noted that this objective is consistent with corporate law's 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."[19]

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[15] *Id.* (Investment Advisers Act Release No. IA-2106 and Investment Company Act Release No. 25922 were published as companion pieces in the Federal Register. *See* 68 FED. REG. 6564 (February 7, 2003)).

[16] *Id.*

[17] Paul Brest, Ronald Gilson, and Mark Wolfson, *How Investors Can (and Can't) Create Social Value*, STAN. SOC. INNOV. REV. (Dec. 8, 2016), https://ssir.org/up_for_debate/article/how_investors_can_and_cant_create_social_value; *See also*, George David Banks and Bernard Sharfman, *Standing Up for the Retail Investor*, Harvard Law School Forum on Corporate Governance and Financial Regulation (June 10, 2018), https://corpgov.law.harvard.edu/2018/06/10/standing-up-for-the-retail-investor/.

[18] According to Brest, Gilson, and Wolfson:

> Socially motivated investors who seek value alignment would prefer to own stocks only in companies that act in accordance with their moral or social values. Independent of having any effect on the company's behavior, these investors may wish to affirmatively express their identities by owning stock in what they deem to be a good company, or to avoid "dirty hands" or complicity by refusing to own stock in what they deem to be a bad company. Value-aligned investors may be concerned with a firm's outputs–its products and services; for example, they might want to own stock in a solar power company or avoid owning shares in a cigarette company. Or the investors may be concerned with a firm's practices–the way it produces its outputs; they might want to own stock in companies that meet high environmental, social, and governance (ESG) standards, and eschew companies with poor ESG ratings. To achieve their goals, value-aligned investors must only examine their personal values and then learn whether the company's behavior promotes or conflicts with those values. *Id.*

[19] 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).

Types of Conflicts Identified in the Original Release and Enforcement Action

The Proxy Voting Rule was promulgated to address concerns that an investment adviser may vote its own preferences, not the preferences of its funds and their shareholders. If so, then an adviser would be in breach of its fiduciary duties and shareholder wealth maximization may not occur. In what fact patterns would this happen?

In the Release, the SEC focused on the concern that advisers would in some situations be reluctant to vote against management for fear that doing so would "threaten their ability to retain that company as a client for corporate retirement fund assets:"[20] As stated in the Release:

> [I]n some situations the interests of a mutual fund's shareholders may conflict with those of its investment adviser with respect to proxy voting. This may occur, for example, when a fund's adviser also manages or seeks to manage the retirement plan assets of a company whose securities are held by the fund. In these situations, a fund's adviser may have an incentive to support management recommendations to further its business interests.[21]

For example, in an op-ed piece in the Wall Street Journal, Todd Henderson and Dorothy Shapiro Lund[22] discuss how an activist hedge fund, acting with the support of the two leading proxy advisors, was allegedly impeded in moving forward on its proxy contest because several large mutual fund advisers balked at voting to support the hedge fund's director nominees for fear of losing the company's retirement fund business. This type of conflict of interest, a classic example of the agency costs that can be generated by mutual fund advisers, has been well documented and, according to Cvijanović, Dasgupta, and Zachariadis, appears to persist despite the implementation of the Proxy Voting Rule.[23]

Another type of conflict noted in the Release, and the one most relevant to the discussion below, is where "the adviser may also have business or personal relationships with other proponents of proxy proposals, participants in proxy contests, corporate directors or candidates for directorships."[24] For example, such a conflict may exist where "the adviser may manage money for an employee group."[25]

Such a conflict was described in the SEC's enforcement case against INTECH.[26] Here, the registered investment adviser, INTECH Investment Management LLC, had initially voted its proxies

[20] M. Todd Henderson & Dorothy Shapiro Lund, *Index Funds Are Great for Investors, Risky for Corporate Governance*, WALL ST. J. (June 22, 2017), https://www.wsj.com/articles/index-funds-are-great-for-investors-risky-for-corporate-governance-1498170623.

[21] Proxy Voting by Investment Advisers, Investment Advisers Act Release No. IA-2106 (2003). *See also*, Lucian A. Bebchuk, Alma Cohen, and Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 90 (2017) ("[T]he agency problems of institutional investors can be expected to lead them to … side excessively with corporate managers, ….").

[22] Henderson and Lund, *supra* note 20.

[23] Dragana Cvijanović, Amil Dasgupta, and Konstantinos E. Zachariadis, *Ties That Bind: How Business Connections Affect Mutual Fund Activism*, 71 J. FIN. 2933 (2016).

[24] Proxy Voting by Investment Advisers, Investment Advisers Act Release No. IA-2106 (2003).

[25] *Id.*

[26] Order Instituting Administrative Cease-and-Desist Proceedings Pursuant to Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940, Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order, File No. 3-13463 (May 7, 2009), available at http://www.sec.gov/litigation/admin/2009/ia-2872.pdf.

based on an Institutional Shareholder Services recommendation platform that was purposely designed to side with management. In 2003 to 2006, INTECH moved to a different ISS recommendation platform that followed the voting recommendations of the AFL-CIO. According to footnote 3 of the SEC's order instituting proceedings, such voting recommendations had the objective of promoting a "position that is consistent with the long-term economic best interests of plan members embodied in the principle of a worker-owner view of value."[27] Apparently, this approach was significantly different than the one taken in the original recommendation platform.

INTECH switched to this new platform in order "to retain and obtain business from existing and prospective union-affiliated clients."[28] Soon after, some of INTECH's original clients started making inquiries regarding the higher number of votes against management on shareholder proposals.

INTECH made the switch in voting platforms without having any written procedures or policies that addressed material potential conflicts between INTECH's interests in seeking more union-affiliated clients and those of its clients who did not favor the AFL-CIO. By doing so, it had subrogated its client interests to its own, a breach in its fiduciary duty of loyalty. Therefore, this was a clear violation of the Proxy Voting Rule. INTECH paid a civil penalty of $300,000.[29]

The Changing World of Proxy Voting

Of course, the world has changed since the Proxy Voting Rule first went into effect. Currently, an unprecedented concentration of voting power now resides in the hands of our largest mutual fund advisers. For example, BlackRock, Vanguard, and State Street Global Advisors (the Big Three) now control enormous amounts of proxy voting power without having any economic interest in the shares they vote. According to Shenkar, Heemskerk, and Fichtner, this concentration of voting power was and is being caused by a large shift from actively managed equity funds to equity index funds:

> In contrast to the fragmented and sizeable group of actively managed mutual funds, the fast-growing index fund sector is highly concentrated. It is dominated by just three giant U.S. asset managers: BlackRock, Vanguard and State Street – what we call the "Big Three." Together they stand for a stunning 71 percent of the entire Exchange Traded Fund (ETF) market and manage over 90 percent of all Assets under Management … in passive equity funds. As a consequence of this leading role in the market for passive investment, the Big Three have become dominant shareholders. Seen together, the Big Three are the largest single shareholder in almost 90 percent of all S&P 500 firms, including Apple, Microsoft, ExxonMobil, General Electric and Coca-Cola. Such concentration of corporate ownership is remarkable and may not have been seen since the days of the Gilded Age.[30]

This new concentration of voting power has its origin in the industry practice of centralizing the voting of mutual funds into the hands of their advisor's corporate governance department. In essence, not only would portfolio management be delegated to the mutual fund adviser, but also the voting of

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[27] *Id.*

[28] *Id.*

[29] For an excellent discussion of the INTECH settlement, *see* Ropes & Gray, SEC Brings Second Case Alleging Improper Proxy Voting by an Adviser (May 20, 2009), www.ropesgray. sec-brings-second-case-alleging-improper-proxy-voting-by-an-adviser.pdf.

[30] *See* Shenkar, Elke M. Heemskerk & Jan Fichtner, *supra* note 4.

proxies. I refer to this as the "empty voting of mutual fund advisers."[31] That is, they have the voting rights but not the economic interest in the underlying shares.

This low cost approach to proxy voting was innocuous enough when proxy voting was not concentrated. However, as the market share of equity index funds has grown, this empty voting has given rise to an *unintended* consequence.[32] The Big Three now control, without having any economic interest in the underlying shares, the voting rights associated with trillions of dollars worth of equity securities. For example, as of December 31, 2017, BlackRock had over $6.3 trillion of assets under management, with almost $3.4 trillion of those assets being equity securities.[33] This represents an astonishing amount of voting control. Therefore, at many public companies, the respective corporate governance departments of the Big Three, as well as other large mutual fund advisers, may now control the fate of a shareholder or management proposal, whether a nominated director receives a required majority of votes to remain on the board of directors, or if a proxy contest succeeds or fails.

Advisers Subrogating the Interests of Mutual Funds and Their Shareholders

Such a concentration of power always brings with it the potential for abuse. It is easy to envision scenarios where this voting power can generate significant value for the advisor if it decided to vote in a certain way, whether or not it is in the best interests of its clients to do so. In essence, the large mutual fund adviser will be tempted to breach its fiduciary duties and monetize or take special advantage of the delegated voting power it has accumulated.

The Courting of Public Pension Fund Assets

One scenario where a large mutual fund adviser may be tempted to monetize its newly found voting power is to vote in unison with public pension and union-related funds, such as on shareholder proposals these funds initiate or promote, if it will lead to bringing more assets under management. Public pension funds control approximately $4.2 trillion in assets,[34] a prime target for a mutual fund adviser looking to increase the size of its equity index funds. Since the objective of an index fund is not to beat the market, but simply to match it, increasing profitability through increased assets under management is a critical business strategy for the adviser.

Public pension funds are leaders in the shareholder empowerment movement. This form of shareholder activism advocates shifting corporate decision-making authority to shareholders, and thus away from boards of directors and executive management, and arguably without regard to the impact on the value of a public company's stock. That is, satisfaction with company performance does not factor into the decision to support a proposal that shifts decision making away from the board of directors. For example, consider their take-no-prisoners approach to dual class share structures even though these structures have been successfully used by companies such as Berkshire Hathaway,

[31] 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/.

[32] Bernard S. Sharfman, *Dual Class Share Voting versus the "Empty Voting" of Mutual Fund Advisors'*, CONFERENCE BOARD CORPORATE GOVERNANCE BLOG (July 2, 2018), https://www.conference-board.org/blog/postdetail.cfm?post=6812&blogid=8.

[33] BlackRock, Inc., *BlackRock 2017 Annual Report*, Part I at 2, http://ir.blackrock.com/Cache/1500109547.PDF?O=PDF&T=&Y=&D=&FID=1500109547&iid=4048287.

[34] National Association of State Retirement Administrators, *Public Pension Fund Assets: Quarterly Update (Q1 2018)*, https://www.nasra.org/content.asp?contentid=200.

Facebook, and Alphabet (Google).[35] Such zealous advocacy should not be a surprise since dual class shares are an obvious threat to the movement's power. As I have previously observed, "the more public companies that utilize a dual-class share structure, the more controlled companies exist and the less power the movement has."[36] Or, as another example, the New York City Public Pension Funds' crusade to implement proxy access at all public companies without regard to an individual company's performance.[37]

Incidentally, based on their 2018 voting guidelines,[38] the Big Three unanimously support a standardized form of proxy access and equal voting rights. This should be no surprise as it is consistent with their own preferences for retaining or increasing their public pension and union-related funds business.

I cannot overstate the harm to mutual fund investors caused by the shareholder empowerment movement. It is a one-size-fits-all approach to the private ordering of corporate governance arrangements where enhancing shareholder value is purely a chance occurrence. However, the private ordering that results from shareholder empowerment 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."[39] For example, it may or may not include dual class shares or proxy access. And 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."[40] 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."

When a mutual fund adviser adopts voting policies that include sub-optimal private ordering, whether or not they are inspired by a desire to retain or increase assets under management, it is a breach of its fiduciary duty under the Proxy Voting Rule. That is, the breach is a result of a failure to

[35] Bernard S. Sharfman, *A Private Ordering Defense of a Company's Right to Use Dual Class Share Structures in IPOs*, 63 VILL. L. REV. 1 (2018), https://digitalcommons.law.villanova.edu/vlr/vol63/iss1/1/.

[36] Bernard S. Sharfman, *Dual-class shares and the shareholder empowerment movement*, R Street Institute Blog (June 12, 2017), https://www.rstreet.org/2017/06/12/dual-class-shares-and-the-shareholder-empowerment-movement/.

[37] City of New York, Office of Comptroller, *Comptroller Stringer, NYC Funds: After Three Years of Advocacy, "Proxy Access" Now Close to a Market Standard* (Jan. 30, 2018), https://comptroller.nyc.gov/newsroom/comptroller-stringer-nyc-funds-after-three-years-of-advocacy-proxy-access-now-close-to-a-market-standard/.

[38] BlackRock, Inc., *Proxy voting guidelines for U.S. securities* (February 2018), https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf; State Street Global Advisors, *Proxy Voting and Engagement Guidelines North America (United States & Canada)* (March 2018), https://www.ssga.com/investment-topics/environmental-social-governance/2018/03/Proxy-Voting-and-Engagement-Guidelines-NA-20180301.pdf; Vanguard, *Vanguard's proxy voting guidelines*, https://about.vanguard.com/investment-stewardship/policies-and-guidelines/.

[39] David Larcker et al., *The Market Reaction to Corporate Governance Regulation*, 101 J. FIN. ECON. 431, 431 (2011).

[40] Troy A. Paredes, Comm'r, US Sec. & Exch. Comm'n, Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations (May 20, 2009), *available at* http://www.sec.gov/news/speech/2009/spch052009tap.htm.

disclose how such voting policies adequately maximize the wealth of its mutual fund clients and their shareholders.[41]

In sum, consistent with the Proxy Voting Rule's requirement that mutual fund advisers vote their proxies in the ***best interests*** of their clients, mutual fund advisers who have obtained concentrated voting power due to the delegation of voting authority, must disclose in their voting policies the ***procedures*** they will use to eliminate the temptation to use their voting power to retain or acquire more public pension and union-related fund assets under management.

Appeasing the Mutual Fund Adviser's Own Shareholder Activists

A mutual fund adviser may also utilize its delegated voting power to appease shareholder activists who attack the business decisions, procedures, and objectives of the adviser's management. For example, in early 2017, both BlackRock[42] and Vanguard (two of its equity funds received the proposals, 500 Index Fund and Total Stock Market Index Fund)[43] received shareholder resolutions from Walden Asset Management requesting a review of their proxy voting policies and practices related to climate change.[44] Yet, the clear intent of the proposals was not just to review, but to encourage the advisers to be a stronger supporter of climate change proposals. According to the language in both proposals:

> Vanguard [BlackRock] is a prestigious member of the Principles for Responsible Investment (PRI) a global network of investors and asset owners representing more than $62 trillion in assets. One of the Principles encourages investors to vote conscientiously on ESG issues.
>
> Yet Vanguard [BlackRock] funds' publicly reported proxy voting records reveals [sic] consistent votes against all climate related resolutions (except the few supported by management), such as requests for enhanced disclosure or adoption of greenhouse gas reduction goals, even when independent experts advance a strong business and economic case for support.[45]

In sum, the submitted proposals were intended to dictate to both BlackRock and Vanguard how they were to fulfill their fiduciary duties under the Proxy Voting Rule.

[41] *See* text associated with footnotes 15-19.

[42] Walden Asset Management, Review and report on ESG proxy voting (BLK, 2017 Resolution), https://engagements.ceres.org/ceres_engagementdetailpage?recID=a0l12000005OdxTAAS.

[43] Vanguard Funds, Preliminary Proxy Statement (August 21, 2017), https://www.sec.gov/Archives/edgar/data/34066/000093247117004594/pre14aproxystatement.htm.

[44] Rob Berridge, Ceres, Four Mutual Fund Giants Begin to Address Climate Change Risks in Proxy Votes: How About Your Funds? (Dec. 21, 2017), https://www.ceres.org/news-center/blog/four-mutual-fund-giants-begin-address-climate-change-risks-proxy-votes-how-about.

[45] Walden Asset Management, Review and report on ESG proxy voting (BLK, 2017 Resolution), https://engagements.ceres.org/ceres_engagementdetailpage?recID=a0l12000005OdxTAAS; Vanguard Funds, Preliminary Proxy Statement (August 21, 2017), https://www.sec.gov/Archives/edgar/data/34066/000093247117004594/pre14aproxystatement.htm.

It appears that the tactic worked. Walden Asset Management withdrew both proposals in return for commitments by the companies to address the request.[46] Moreover, both companies started to support 2-Degree Scenario Proposals, something neither company did prior to 2017.

Coincidental or not, subsequent to the agreement with Walden Asset Management, both companies had the exact same record on 2-Degree Scenario Proposals. In 2017, both BlackRock and Vanguard voted in favor of 2-Degree Scenario proposals at ExxonMobil and Occidental (both proposals received majority support[47]), while voting against 2-Degree Scenario proposals at twelve other companies.[48]

It is important to point out just how valuable the voting power of these two advisers are to climate change activists and why it should be expected that the Big Three will continue to use their power to maintain peace with climate change activists who are also shareholders. According to a 50/50 Climate Project report, if BlackRock would have voted 100% of their mutual fund shares in support of the twelve other 2-Degree Scenario proposals, even without the support of Vanguard, ten of the twelve rejected proposals would have received majority support.[49] If Vanguard would have done the same, even without the support of BlackRock, eight out of twelve additional proposals would have received majority support.[50]

In sum, this is another scenario where a mutual fund adviser may be tempted to trade its voting power for something that would be of value to it, no matter how it impinges on the fiduciary duties it owes to its mutual fund clients and their shareholders. Here, activists imbedded in the shareholder base of an adviser are telling the adviser how to go about implementing its fiduciary duty under the Investment Advisers Act of 1940 and the Proxy Voting Rule. Mutual fund advisers need to disclose how they will eliminate the pressures placed on them by their own shareholders when voting their proxies. Such pressures deserve the creation of a wall that needs to be disclosed pursuant to the Proxy Voting Rule.

Voting Policies on Shareholder Proposals and Wealth Maximization

Shareholder proposals provide a significant opportunity for mutual fund advisers to abuse their voting power for purposes other than shareholder wealth maximization. In 2017, at least 911 shareholder proposals were submitted to public companies for voting at their annual meetings.[51] Of these, at least 502 went to a vote.[52]

Unfortunately, many of these proposals have nothing to do with shareholder wealth maximization and may ultimately end up having a negative impact. A recent study by Kalt and Turki found that the

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[46] Berridge, *supra* note 44.
[47] *Id.*
[48] Marka Peterson, Jim Baker, and Kimberly Gladman, The 50/50 Climate Project, *Asset Managers and Climate-Related Shareholder Proposals: Report on Key Climate Votes* at 14 and 19 (March 2018).
[49] *Id.* at 14.
[50] *Id.* at 19.
[51] E-mail from Sebastian V. Niles, Partner, Wachtell, Lipton, Rosen & Katz, to Bernard S. Sharfman (June 22, 2018).
[52] *Id.*

adoption of climate change resolutions "has no statistically significant impact on company returns one way or the other."[53] They also found that this result should not be surprising:

> [T]here is no general expectation that corporate managers have special abilities in predicting tastes, preferences, voting behavior, and/or institutional capabilities across a wide and varied number of independent political actors operating within independently acting nations across the globe. Under such conditions, resolutions that, for example, compel disclosure of outcomes under particular political scenarios (e.g., the political paths that might put the world on a trajectory to achieve a goal such as the "not more than 2 degrees temperature rise" goal that came out of the Paris climate accords in 2015) do not add materially to the information already available to investors from other sources. As such, they cannot be expected to add to shareholder value.[54]

Matsusaka, Ozbas, and Yi found that labor unions use shareholder proposals as bargaining chips to extract side payments from management.[55] Matsusaka, Ozbas, and Yi, in a separate paper, found that the stock market reacted positively when the SEC permitted shareholder proposals to be excluded.[56]

Moreover, it is not difficult to assume that shareholder proposals that deal with human rights, political contributions, lobbying disclosure, greenhouse gas emissions, climate change, etc. are most likely not submitted for purposes of shareholder wealth maximization. This is something that activists most likely understand from the get go. Instead, the submission of such proposals is to try and resolve issues of national and international importance through shareholder activism, not the political process.

This does not mean that such issues are not extremely important to all of us. However, submitting shareholder proposals is not the way to solve them. According to Kalt and Turki,

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[53] Joseph P. Kalt and Adel Turki et al., Compass Lexecon, *Political, Social, and Environmental Shareholder Resolutions: Do They Create or Destroy Shareholder Value?* (June 2018), https://mainstreetinvestors.org/wp-content/uploads/2018/06/ESG-Paper-FINAL.pdf.

[54] *Id.* at 3-4.

[55] John G. Matsusaka, Oguzhan Ozbas, and Irene Yi, *Opportunistic Proposals by Union Shareholders* (July 8, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2666064. According to the authors,

> We find that in contract expiration years compared to nonexpiration years, unions increase their proposal rate by one fifth, particularly proposals concerning executive compensation, while nonunion shareholders do not increase their proposal rate in expiration years. Union proposals made during expiration years are less likely to be supported by other shareholders or a leading proxy advisor; the market reacts negatively to union proposals in expiration years; and withdrawn union proposals are accompanied with higher wage settlements. *Id.*

[56] John G. Matsusaka, Oguzhan Ozbas, and Irene Yi, *Can Shareholder Proposals Hurt Shareholders? Evidence from SEC No-Action Letter Decisions* (June 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2881408. According to the authors,

> We find that over the period 2007-2016, the market reacted positively when the SEC permitted exclusion. Investors appear to have been most skeptical about proposals related to corporate governance and proposals at high profit firms, suggesting that investors believe some proposals can hurt shareholders by disrupting companies that are already performing well. The evidence is compatible with the view that managerial resistance is based on a genuine concern that proposals can harm firm value. *Id.*

> None of this is to say that we should not be extremely concerned about such issues as global climate change, human trafficking, cybersecurity, and the like. Effectively dealing with such problems, however, will require that wise public policy measures be taken across a wide swath of the world's nations. While frustration with slow progress on this front is understandably accompanied by the desire to "do something', doing something effective in such arenas is the task of our political institutions. Shareholder resolutions targeted at prominent corporations is an ineffectual substitute for sound policy making via the political institutions of democracy.[57]

This lack of connection between shareholder proposals and shareholder wealth maximization is an issue that all retail investors must be concerned about. Shareholder proposals, if implemented subsequent to a shareholder vote or prior to through the process of engagement, while perhaps not reducing shareholder wealth, may at best do nothing to enhance it. If so, then wealth maximizing opportunities may be foregone as finite company resources are devoted to responding to and subsequently implementing these proposals.

Therefore, mutual fund advisers must disclose in their voting policies the procedures they utilize to identify an actual link between support for a shareholder proposal and the enhancement of shareholder value. This is necessary to make sure that mutual fund advisers are complying with a primary objective of their fiduciary duties under the Proxy Voting Rule, "***adequately maximizing the value of their shares.***"[58]

Conclusion

In *Transamerica Mortg. Advisors v. Lewis*,[59] the U.S. Supreme Court ruled that clients and their shareholders have no express or implied private right of action under Section 206 of the Investment Advisers Act of 1940. By extension, no private right of action exists under the Proxy Voting Rule. This makes it imperative that the Commission clarify the scope of an investment adviser's fiduciary duties under the Proxy Voting Rule as an integral part of the amendments it is considering to the proxy process.

According to Laby, "[b]y adopting rules and prosecuting enforcement actions, … the SEC fills in the details of what is required by the fiduciary duties of loyalty and care, and brings uniformity to the industry."[60] Unfortunately, there has been too little guidance provided by the SEC since it implemented the Proxy Voting Rule in 2003. There has only been the INTECH enforcement action and a staff legal bulletin, a bulletin that focuses on proxy advisors and does not address the issue of

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[57] *Id.* at 4.

[58] 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 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.

[59] 444 U.S. 11 (1979).

[60] Arthur B. Laby, *The Fiduciary Structure of Investment Management Regulation*, forthcoming, RESEARCH HANDBOOK ON MUTUAL FUNDS (John D. Morley & William A. Birdthistle, eds.) (Elgar Publishing) (April 21, 2017), available at SSRN: https://ssrn.com/abstract=2993429

how proxy voting policy disclosures needs to be updated to conform to our current proxy voting environment.[61] An update to the process, as outlined in the July 30 announcement, is overdue.

In a proxy voting world where voting is dominated by a handful of extremely large investment advisers, the Commission should provide clarification that mutual fund advisers must disclose in their voting policies, consistent with the Proxy Voting Rule's requirement that they vote proxies in the best interests of their clients, the ***procedures*** they will use to deal with the temptation to use their voting power to retain or acquire more assets under management and to appease activists in their own shareholder base.

In addition, shareholder proposals are a prime area where this opportunistic use of an adviser's voting power may be in play. Therefore, mutual fund advisers must disclose the ***procedures*** they will use to identify the link between support for a shareholder proposal at a particular company and the enhancement of that company's shareholder value. This is necessary to make sure that that advisers are complying with a primary objective of their fiduciary duties, ***"adequately maximizing the value of their shares."***[62]

Finally, consistent with these new disclosures and procedures, the Commission should clarify that voting inconsistent with these new policies and procedures or omission of such policies and procedures will be considered a breach of the Proxy Voting Rule. I urge the SEC to be diligent in enforcing all breaches of the Proxy Voting Rule. While enforcement most clearly applies to the Big Three mutual fund advisers, it should also apply to any mutual fund adviser that has delegated voting authority.

[61] SEC Divisions of Investment Management and Corporate Finance, *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.

[62] Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Investment Company Act Release No. IC-25922.

Very truly yours,

Bernard S. Sharfman

Cc: The Honorable Jay Clayton, Chairman
The Honorable Kara M. Stein, Commissioner
The Honorable Robert J. Jackson, Commissioner
The Honorable Hester M. Peirce, Commissioner
The Honorable Elad Roisman, Commissioner
Ms. Dalia Blass, Director, Division of Investment Management
Mr. William H. Hinman, Director, Division of Corporation Finance,
Ms. Stephanie Avakian, Co-Director, Division of Enforcement
Mr. Steven Peikin, Co-Director, Division of Enforcement

October 12, 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 (Proxy Advisors)

Submitted By: Bernard S. Sharfman*

Dear Mr. Fields,

This submission is in response to Chairman Clayton's July 30 press release announcing a staff roundtable on the proxy process and calling for submissions from interested parties. It refers in particular to proxy advisory firms and is distinguished from my October 8, 2018 comment letter that focused on additional disclosures by investment advisers to mutual funds.[1] Specifically, this submission requests the Securities and Exchange Commission ("SEC" or "Commission") to modify its rules, policies and guidelines to the extent that:

- When making a voting recommendation, the proxy advisor should be held to the standard of an *information trader*. If a proxy advisor cannot attest to the use of that standard when generating a voting recommendation, then the proxy advisor must abstain from making that recommendation to its clients. Making a recommendation that does not meet this standard would be a breach of a proxy advisor's fiduciary duty under the Advisers Act.

- The SEC, as well as the Department of Labor ("DOL"), should clarify that an institutional investor, as an alternative to using the voting recommendations of a proxy advisor, can meet its fiduciary voting duties by utilizing the voting recommendations provided by the board of directors.

- Consistent with the prior recommendation and assuming that technical issues can be overcome, retail investors who invest in voting stock indirectly through the use of investment advisers and beneficiaries of public pension funds should have the option of transmitting voting instructions to their institutional investor informing it that their pro rata investment in voting stock must be voted in conformity with the voting recommendations of the board of directors of each company held in portfolio.

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* Bernard S. Sharfman is the Chairman of the Main Street Investors Coalition Advisory Council, an associate fellow of the R Street Institute, and a member of the Journal of Corporation Law's editorial advisory board. The opinions expressed here are the author's and do not represent the official position of the Coalition or any other organization that he is affiliated with. This writing was supported by a grant provided by the Main Street Investors Coalition.

[1] Letter from Bernard S. Sharfman to Mr. Brent J. Fields, Secretary, Securities and Exchange Commission (October 8, 2018), https://www.sec.gov/comments/4-725/4725-4488888-175925.pdf.

INTRODUCTION

The essence of a proxy advisor's existence is to help an institutional investor decide how to cast its votes at a shareholder meeting of a public company. Its existence is essential for many institutional investors who may hold hundreds or thousands of stocks in their portfolios. For these investors, it is not feasible or desirable to internally perform independent research on the tens or even hundreds of thousands of votes they may face each year. Instead, the institutional investor leans heavily on one or more proxy advisors to provide them with voting recommendations.

As a result, it should not be surprising that a proxy advisor's voting recommendations can have a significant impact on the results of a shareholder vote.[2] For example, Malenko and Shen report that a negative Institutional Shareholder Services (ISS) recommendation on say-on-pay proposals led, on average, to a 25 percentage point reduction in voting support by shareholders during the sample period of 2010-11.[3] In a general review of the empirical research on proxy advisor recommendations, Copland, Larcker, and Tayan conclude that, "the evidence suggests that proxy advisors have a material, if unspecified, influence over institutional voting behavior and therefore also voting outcomes."[4] Moreover, they also conclude that an "against" recommendation from a proxy advisor "is associated with a reduction in the favorable vote count by 15%−30%."[5]

Given the potential for a proxy advisor's voting recommendations to have a significant impact on voting outcomes, it is critical that these recommendations be targeted toward enhancing long-term shareholder value. However, many critics of proxy advisors argue that a significant number of their voting recommendations incorporate various types of data, analytic, and methodological errors.[6] If implemented, such voting recommendations will lead to sub-optimal corporate decision-making and a reduction in shareholder value. Such *imprecision* cannot be tolerated in a proxy advisor's recommendations. Moreover, as argued in this writing, when such imprecision exists, the proxy advisor must abstain from releasing the recommendation to its clients or else be found in violation of its fiduciary duties under Section 206 of the Investment Advisers Act of 1940 ("Advisers Act").[7]

Part I of this writing identifies the objective of shareholder voting. This identification is critical to understanding when a proxy advisor's recommendations provide value. Part II argues that the primary source of informed voting is the recommendations provided by the board of directors. Part III delves into the limitations of recommendations provided by proxy advisors. Part IV explains why

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[2] Andrey Malenko and Nadya Malenko, *The Economics of Selling Information to Voters*, J. FIN. (forthcoming) (June 2018) ("By now, there is strong empirical evidence that proxy advisors recommendations have a large influence on voting outcomes."), https://ssrn.com/abstract=2757597; James R. Copland, David F. Larcker, and Brian Tayan, *Proxy Advisory Firms, Empirical Evidence and the Case for Reform*, The Manhattan Institute at 13 (May 2018), https://www.manhattan-institute.org/sites/default/files/R-JC-0518-v2.pdf.

[3] Nadya Malenko and Yao Shen, *The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design*, 29 REV. OF FIN. STUD. 3394, 3395 (2016).

[4] Copland, Larcker, and Tayan, *supra* note 2, at 13.

[5] *Id.*

[6] *Id. See also*, Charles M. Nathan and James D.C. Barrall, Latham & Watkins LLP, *Proxy Advisory Business: Apotheosis or Apogee?*, CORPORATE GOVERNANCE COMMENTARY at 5 (March 2011).

[7] 15 U.S.C. § 80b-6. *See also*, Nathan and Barrall, *supra* note 6, at 5 ("Additionally, factual and analytical errors, flawed methodologies and models and inadequate processes for detection and correction of error and mistake might also raise serious fiduciary duty issues.").

institutional investors have a preference for low cost, low value voting recommendations. Part V describes the fiduciary duties of proxy advisors and how low cost, low value recommendations are not consistent with those duties. Part VI provides recommendations that are geared toward aligning the recommendations of proxy advisors with their fiduciary duties.

I. THE OBJECTIVE OF SHAREHOLDER VOTING

This Article is based on 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."[8]

Shareholder wealth maximization as the objective of shareholder voting is also consistent with the rationale for why profit making companies create so much value for society. As SEC Commissioner Peirce reminds us in a recent speech at the University of Michigan Law School:

> The hunt for profit drives companies to strive to identify and meet people's needs using as few resources as possible. Companies communicate with their customers and suppliers through the price system. People tell companies what they value when they pay for the products and services those companies offer. Suppliers, by raising or lowering prices, tell companies how valuable the resources are that the companies use. Companies respond to what their customers and suppliers tell them. In this way, companies help to ensure that people spend their time wisely and that resources are used for the things society values most. Companies combine the diverse and complementary talents of their employees to research, develop, explore, produce, sell, and provide services to willing customers. In these activities, corporations play an important role in expanding scientific and technological knowledge, enabling people to profit from their hard work, and ensuring that society's resources are allocated to the uses we most value.[9]

It is also consistent with the premise that the overwhelming majority of those 100 million-plus retail investors in the United States who invest in voting stock indirectly through the use of investment advisers,[10] as well as the beneficiaries of public pension funds, simply want to earn the highest risk adjusted financial return possible,[11] including when they vote or have votes cast for them

[8] 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).

[9] Hester M. Peirce, *Wolves and Wolverines: Remarks at the University of Michigan Law School* (Sept. 24, 2018), https://www.sec.gov/news/speech/speech-peirce-092418.

[10] Inv. Co. Inst., 2018 INVESTMENT COMPANY FACT BOOK at 2017 Facts at a Glance (unnumbered page) (2018), http://www.icifactbook.org/deployedfiles/FactBook/Site%20Properties/pdf/2018/2018_factbook.pdf .

[11] Paul Brest, Ronald Gilson, and Mark Wolfson, *How Investors Can (and Can't) Create Social Value*, STAN. SOC. INNOV. REV. (Dec. 8, 2016), https://ssir.org/up_for_debate/article/how_investors_can_and_cant_create_social_value; *See also*, George David Banks and Bernard Sharfman, *Standing Up for the Retail Investor*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (June 10, 2018), https://corpgov.law.harvard.edu/2018/06/10/standing-up-for-the-retail-investor/.

by their investment advisers. Moreover, this desire to earn the highest risk adjusted financial return possible is also shared by the overwhelming number of socially motivated retail investors who align their investments based on their moral or social values,[12] even though they give up some risk-adjusted return in terms of portfolio diversification and may pay higher management fees for this customization.[13] That is, these investors are willing to exclude certain stocks from their portfolios because they find them to be socially undesirable, but are still looking for the highest risk adjusted return possible given their investment constraints.[14]

Finally, with the exception of a minority of funds that publicly disclose their willingness to sacrifice return in exchange for having a social impact (social funds), the shareholder voting objective of shareholder wealth maximization is the only way an investment adviser or public pension fund, as an agent representing the interests of tens or even hundreds of thousands of people, can come closest to representing the preferences of their retail investors or beneficiaries.

II. THE PRIMARY SOURCE OF INFORMED VOTING

According to Schouten, "shareholders need to have at least some information to ensure that they are more likely to be right than wrong."[15] That is, shareholder voting needs to be more than just a flip of the coin. Fortunately, the board of a public company already provides this foundational level of information in their own recommendations on how shareholders should vote.

The board of directors is not only the default locus of authority in a public company; it is also the most informed. 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."[16]

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[12] According to Brest, Gilson, and Wolfson, *supra* note 11:

> Socially motivated investors who seek value alignment would prefer to own stocks only in companies that act in accordance with their moral or social values. Independent of having any effect on the company's behavior, these investors may wish to affirmatively express their identities by owning stock in what they deem to be a good company, or to avoid "dirty hands" or complicity by refusing to own stock in what they deem to be a bad company. Value-aligned investors may be concerned with a firm's outputs–its products and services; for example, they might want to own stock in a solar power company or avoid owning shares in a cigarette company. Or the investors may be concerned with a firm's practices–the way it produces its outputs; they might want to own stock in companies that meet high environmental, social, and governance (ESG) standards, and eschew companies with poor ESG ratings. To achieve their goals, value-aligned investors must only examine their personal values and then learn whether the company's behavior promotes or conflicts with those values. *Id.*

[13] 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.

[14] *Id.*

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

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

The voting recommendations of the board, like all of its decisions, take advantage of this inside information as well as the expertise of executive management and are generated through the lens of shareholder wealth maximization:

> [D]etermining whether a business decision is shareholder wealth-maximizing is not just about plugging in a formula and calculating the result, which any computer or calculator can do. Rather, it refers to the specific formula that will be utilized by management to determine if a particular decision maximizes shareholder wealth. One can think of this in terms of a mathematical formula where the decision maker is given the responsibility of choosing the variables and estimating the coefficients of those variables. This requires many sources of knowledge and expertise…[which proxy advisors as well as the overwhelming majority of shareholders may lack], including experience in the particular business that the company may be in, product and company knowledge, management skills, financial skills, creative and analytical thinking pertinent to a company's business, confidential information, and so on. For example, who has the knowledge and expertise to decide whether a distinctive corporate culture enhances or detracts from shareholder value? The clear answer is that the board and its executive management are the proper locus of authority for making this decision.[17]

But this does not mean that the board of directors and its executive management are simply unconstrained shareholder wealth maximizing decision makers. They are constrained by both the law and their ethics. They are human beings after all, fearful of violating criminal law and potentially facing imprisonment or financial penalties, breaching their fiduciary duties of care and loyalty and thereby potentially facing financial liability, damaging their reputations, and violating their own ethical norms. According to Milton Friedman:

> In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible *while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom.*[18]

Such legal and ethical rules create boundaries that stop the board of directors and executive management from entering into unacceptably harmful corporate decisions.

Unfortunately, shareholder activists, regulators and many in the academic world prefer to ignore board recommendations, and the inside information they incorporate, as the foundational source of information when it comes to shareholder voting. However, it easily explains why, for example, proxy advisors vote in support of management's recommendations about 90% of the time.[19] Nevertheless, that means proxy advisors do not support management in thousands of votes, many of

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[17] Bernard S. Sharfman, *Shareholder Wealth Maximization and its Implementation under Corporate Law*, 66 FLA. L. REV. 389, (2014).

[18] Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, THE NEW YORK TIMES MAGAZINE (September 13, 1970), http://umich.edu/~thecore/doc/Friedman.pdf.

[19] Council of Institutional Investors, *Investor Group Responds to Wall Street Journal Editorial: Proxy Advisory Firms Do Not Dictate Voting Outcomes* (August 13, 2018, https://www.cii.org/files/about_us/press_releases/2018/08-13-18_cii_press_release_WSJ_editorial.pdf.

them critical to the success of the company's corporate governance. If so, are such voting recommendations actually providing value for the company and its shareholders?

III. The Limitations of Proxy Advisor Recommendations

As observed by Malenko and Malenko, "The presence of the proxy advisor increases firm value (the probability of a correct decision being made) only if the *precision* of its recommendations is sufficiently high."[20] That is, this precision must exceed that of the board. This is possible, given that the board, being so close in proximity to the firm, may have, at times, difficulty in being objective in its voting recommendations.[21] Unfortunately, based on the discussion found in this Part, it is doubtful that a proxy advisor can provide such precision in most of its recommendations.

A. Being Informed

As a foundational matter, for a proxy advisor to generate a recommendation that has value, the proxy advisor must be *truly* informed. For a proxy advisor to be truly informed it needs to be held to the standard of an informed investor or what Goshen and Parchomovsky would call an "information trader."[22] According to Goshen and Parchomovsky, an information 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,"[23] including the gathering of private information.[24] Moreover, "information traders have the ability and knowledge to collect, evaluate and price firm-specific and general market information."[25] Furthermore, "[s]earching for, verifying, analyzing, and pricing general market and firm-specific information are costly tasks."[26]

B. The Low Cost, Low Value Approach

Yet, this high cost, informed approach is not what proxy advisors appear to be providing. 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."[27] According to Nathan and Barrall, "As a result of the large number of voting recommendations that must be made in a short time period, it is inconceivable that proxy advisors' recommendations can or will be based on a thorough analysis of the facts and circumstances of each company in the context of each voting decision."[28]

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[20] Malenko and Malenko, *supra* note 2.

[21] Goshen & Parchomovsky, *supra* note 16, at 721–23.

[22] *Id.*

[23] *Id.* at 723.

[24] *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.)

[25] Goshen & Parchomovsky, *supra* note 16, at 723.

[26] *Id.*

[27] Luca Enriques and Alessandro Romano, *Institutional Investor Voting Behavior: A Network Theory Perspective*, ECGI Working Paper N° 393/2018 (July 2018), at 17.

[28] Nathan and Barrall, *supra* note 6, at 4.

The evidence for such a low cost, low value (not truly informed) approach is found in the resources that the two major proxy advisors, Institutional Shareholder Services (ISS) and Glass Lewis (ISS and Glass Lewis control approximately 97% of the proxy advisory market),[29] devote to the creation of voting recommendations. In 2014 the ISS had a global staff of 250 research analysts to provide recommendations on 250,000 shareholder votes.[30] Based on this information, the U.S. Chamber of Commerce stated that "it is clear that, on average, each ISS analyst is responsible for researching and preparing reports on 1,000 issues in the truncated period of the *usual* 'proxy season.' [primarily between March and June]"[31] As of June 2017, the ISS Global Research team covered 40,000 shareholder meetings with approximately 270 research analysts and 190 data analysts.[32] However, it is not known how many research analysts are full-time, part-time or seasonal (proxy season only).

According to the U.S. Chamber of Commerce, "Glass Lewis purports to analyze fewer issues, but has fewer analysts [approximately 200 in 2014] available to do so, ensuring that its analysts are equally overwhelmed with their responsibilities in a very short period of time."[33] Glass Lewis recently reported that it covers 20,000 meetings each year with approximately the same number of analysts it had in 2014.[34] However, it is not known if this number included data as well as research analysts.

Given this low level of resources devoted to analysis, it is not surprising that proxy advisors have been accused by management of providing uninformed voting recommendations. For example, in a 2015 survey by NASDAQ and the U.S. Chamber of Commerce, the responding companies reported that proxy advisors commonly gave them only 24 to 48 hours to respond to recommendations and sometimes only one hour was provided.[35] Perhaps most telling, only "25% of companies believed the proxy advisory firm carefully researched and took into account all relevant aspects of the particular issue on which it provided advice."[36] Confirming this belief, responding companies asked advisory firms to allow their input about 50% of the time, but that input was only allowed around half the

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[29] Harvey Pitt, *U.S. Chamber of Commerce Corporate Governance Update: Public Company Initiatives in Response to the SEC Staff's Guidance on Proxy Advisory Firms*, THE U.S. CHAMBER CENTER FOR CAPITAL MARKETS COMPETITIVENESS at 1, (January 2015), http://www.centerforcapitalmarkets.com/wp-content/uploads/2015/01/021874_ProxyAdvisory_final.pdf. Besides ISS and Glass Lewis, the U.S. proxy advisory industry is made up of only three other firms: Egan-Jones Proxy Services (Egan-Jones), Marco Consulting Group (Marco Consulting), and ProxyVote Plus. *See* U.S. Gov't Accountability Office, GAO-17-47, *Corporate Shareholder Meetings: Proxy Advisory Firms' Role in Voting and Corporate Governance Practices* (2016) at 6, http://www.gao.gov/assets/690/681050.pdf.

[30] Pitt, *supra* note 29, at 5, n. 7.

[31] *Id.*

[32] Institutional Shareholder Services Inc., *Due Diligence Compliance Package* (November 2017), https://www.issgovernance.com/file/duediligence/Due-Diligence-Package-November-2017.pdf.

[33] Pitt, *supra* note 29, at 5, n. 7.

[34] Glass Lewis, *Company Overview* (accessed on September 24, 2018), http://www.glasslewis.com/company-overview/.

[35] The U.S. Chamber Center for Capital Markets Competitiveness and Nasdaq, *2015 Proxy Season Survey: Public Company Experience during the Current Proxy Season* (2015), https://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/2015-Proxy-Season-Survey-Summary.pdf.

[36] *Id.*

time.[37] In addition, when responding companies formally requested previews of advisor recommendations, that request was granted only about half the time.[38]

C. The One-Size-Fits-All Approach

A one-size-fits-all approach to voting recommendations is the inevitable result of a proxy advisor that has significant resource constraints. Both ISS and Glass Lewis provide annually updated and extensively detailed voting policies that provide public companies and institutional investors with a roadmap on what the advisors recommendations will be even before an issue is raised at a specific company.[39] A one-size-fits-all approach in these policies are found everywhere, including when discussing hot button topics such as dual class shares, proxy access, and staggered boards. According to Choi, Lund, and Schonlau, "To the extent that their institutional shareholder clients care less about the issue, proxy advisor recommendations may be more likely to rely on simple, one-size-fits-all criteria so as to economize their resources."[40] Perhaps more to the point are the following quotes from Nathan and Barrell,

> [A]s everyone connected with the institutional shareholder voting process knows or should know, proxy advisors' voting recommendations are driven by inflexible, one-size-fits all *voting policies* and *simplistic analytic models* designed to utilize standard and easily accessible inputs that can be derived from readily available data and to avoid any need for particularized research or the application of meaningful judgment.[41]

Moreover,

> While proxy advisors may claim that each company and each vote is arrived at individually and reflects the particulars of the situation, this is true only in the most *superficial* sense. The analyses, in fact, are driven by checking boxes or inputting readily obtainable and relatively simple-to-find data, running this data through simplistic models and sticking inflexibly to whatever outcome is "spit out" of the process.[42]

If true, then this suggests that proxy advisors are, for the most part, providing institutional investors with uninformed voting recommendations.

IV. THE PREFERENCE FOR LOW COST, LOW VALUE RECOMMENDATIONS

The institutional investor demand for low cost, low value recommendations began thirty years ago when U.S. regulators started putting pressure on institutional investors to vote all their proxies,

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[37] *Id.*
[38] *Id.*
[39] *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/.
[40] Albert H. Choi, Andrew Lund, and Robert J. Schonlau, *Shareholder Voting on Golden Parachutes: Determinants and Consequences*, Virginia Law and Economics Research Paper No. 2018-13 (August 10, 2018), available at SSRN: https://ssrn.com/abstract=3229962.
[41] Nathan and Barrall, *supra* note 6, at 4.
[42] *Id.*

whether or not their votes were informed. Institutional investors, who don't find value in voting, have responded by seeking out low cost, low value recommendations from proxy advisors. This approach simply makes good economic sense for almost all institutional investors except for perhaps activist hedge funds who over-weight their portfolios with a small number of stocks and seek as much voting power as possible.[43]

A. The Regulatory Demand to Vote

Demand for low cost, low value recommendations began with the infamous 1988 DOL letter that is commonly referred to as the "Avon letter."[44] 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."[45] 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.[46]

This was followed a year later by the DOL's first Proxy Project Report.[47] According to the Report:

> 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.[48]

In 2003, with the implementation of the Proxy Voting Rule,[49] the SEC formally recognized the fiduciary duties of registered investment advisers when voting proxies:[50]

> 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

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[43] The activist hedge fund is a special type of information trader. They are distinguished from the most common type of information trader, the value investor, by their willingness to take a significant position in a company as a means to implement strategic changes, to spend resources to identify such changes, and to spend additional resources to try to get a company to implement those changes. *See* Bernard S. Sharfman, *Activist Hedge Funds in a World of Board Independence: Creators or Destroyers of Long-Term Value?*, 2015 COLUM. BUS. L. REV. 813, 827 (2016).

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

[45] *Id.*

[46] *Id.* 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.

[47] Pension and Welfare Benefits Administration, U.S. Department of Labor, Proxy Project Report (March 2, 1989).

[48] *Id.* at 8.

[49] 17 C.F.R. § 275.206(4)-6.

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

> 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.[51]

Moreover, 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.[52] 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*.[53] However, this endorsement was recently weakened when the SEC withdrew two long-standing no-action letters that supported this approach.[54]

As a result of this regulatory guidance, there is a general consensus that in order for institutional investors to meet their fiduciary obligations, they must vote all their shares unless they have good reason not to.[55] Moreover, employing a proxy advisor to provide voting recommendations is an appropriate means to meet these obligations.

B. The Preferences of Index Fund Managers

Low cost, low value recommendations are not only appealing to smaller institutional investors who cannot spread the cost of precise recommendations over a large asset base,[56] but they are also extremely appealing to the largest investment advisers of index funds. BlackRock, Vanguard, and State Street Global Advisors Fidelity, etc., the leading advisers to index funds, face tens if not hundreds of thousands of shareholder votes each year.[57] This would be an extremely costly undertaking if they were seeking precise voting recommendations. However, according to Bebchuk, Cohen and Hirst, since the goal of an index fund is to meet, not beat the market; the adviser would not derive any competitive benefit from receiving precise recommendations and therefore would have no incentive to spend the money that such recommendations would require:

> If the investment manager of a certain mutual fund that invests according to a given index increases its spending on stewardship at a particular portfolio company and thereby increases the value of its investment in that company, it will also increase the value of the index, so its expenditure would not lead to any increase in the performance of the mutual fund relative to

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[51] *Id.* at 4.

[52] *Id.* at 5.

[53] 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.

[54] Division of Investment Management, Securities & Exchange Commission, *Statement Regarding Staff Proxy Advisory Letters* (Sept. 13, 2018) ("[T]he staff of the Division of Investment Management has recently rexamined the letters that the staff issued in 2004 to Egan-Jones Proxy Services (May 27, 2004) and Institutional Shareholder Services, Inc. (Sept. 15, 2004). Taking into account developments since 2004, the staff has determined to withdraw these letters, effective today."), https://www.sec.gov/news/public-statement/statement-regarding-staff-proxy-advisory-letters.

[55] Enriques and Romano, *supra* note 27, at 18 (These requirements, while stopping short of mandating voting, are a powerful nudge in that direction for all institutions to which they apply.)

[56] *Id.*

[57] Vanguard, *Investor Stewardship 2018 Annual Report* at 34, 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.).

> the index. Nor would it lead to any increase relative to the investment manager's rivals that follow the same index, as any increase in the value of the corporation would also be captured by all other mutual funds investing according to the index, even though they had not made any additional expenditure on stewardship.
>
> Thus, if the investment manager were to take actions that increase the value of the portfolio company, and therefore also the portfolio that tracks the index, doing so would not result in a superior performance that could enable the manager to attract funds currently invested with rival investment managers.[58]
>
> Moreover,
>
> [I]f the index fund were to raise its fees and improve its stewardship, each individual investor in the fund would have an incentive to switch to rival index funds. That is, a move by any given index fund manager to improve stewardship and raise fees would unravel, because its investors would prefer to free-ride on the investment manager's efforts by switching to another investment fund that offers the same indexed portfolio but without stewardship or higher fees.[59]

Finally, in this current cut throat fee environment that index fund advisers now face,[60] they must be extremely pleased to have the low cost, low value option available.

C. Actively Managed Funds

Investment managers who actively manage their portfolios will also prefer the low cost, low value option. It will always be more profitable for them to use their limited resources to invest in stock valuation (e.g., fundamental analysis used by information traders) than to spend their money on high value voting recommendations.[61] 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. Moreover, Bebchuk, Cohen, and Hirst argue that many actively managed funds are in reality "closet indexers."[62] As such, they gain very little from more precise voting except perhaps for the stock of companies that are over-weighted in their portfolios relative to the appropriate benchmark index.[63] For those stocks that are under-weighted, the

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

[59] *Id.*

[60] Charles Stein and Annie Massa, *Fidelity Bets on Zero-Fee Index Funds*, BLOOMBERG BUSINESSWEEK (August 9, 2018), https://www.bloomberg.com/news/articles/2018-08-09/fidelity-bets-on-zero-fee-index-funds.

[61] 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) (I substitute high value voting recommendations for shareholder intervention in Gilson and Gordon's argument. This is an appropriate substitution as both are costly but are expected to enhance the corporate governance of a targeted firm.).

[62] Bebchuk, Cohen, and Hirst, *supra* note 58, at 98.

[63] *Id.* at 98-100. If resources were devoted to more precise voting at underweighted stocks, then the benchmark would benefit more than the investment manager's portfolio, harming the investment manager's competitive position. *Id.*

benchmark index would benefit more from the more precise voting, giving investment managers of actively managed funds a disincentive to make such an investment.[64]

V. FIDUCIARY DUTIES UNDER THE ADVISERS ACT

As argued in this Part, the problem proxy advisors face is that this low cost, low value approach conflicts with their fiduciary duties under the Investment Advisers Act of 1940 ("Advisers Act").[65] This Part begins with a discussion of where these fiduciary duties originated.

A. The Origin of a Proxy Advisor's Fiduciary Duties

According to the Securities and Exchange Commission in its 2010 Concept Release on the Proxy Process System,[66] the voting advice provided by a proxy advisor comes under the Advisers Act's definition of an investment adviser:[67]

> We understand that typically proxy advisory firms represent that they provide their clients with advice designed to enable institutional clients to ***maximize*** the value of their investments. In other words, proxy advisory firms provide analyses of shareholder proposals, director candidacies or corporate actions and provide advice concerning particular votes in a manner that is intended to assist their institutional clients in achieving their investment goals with respect to the voting securities they hold. In that way, *proxy advisory firms meet the definition of investment adviser* because they, for compensation, engage in the business of issuing reports or analyses concerning securities and providing advice to others as to the value of securities.[68]

The fiduciary duties of an investment adviser were formally recognized by the United States Supreme Court in *SEC v. Capital Gains Research Bureau, Inc.*[69] As stated by the Court,

> Nor is it necessary in a suit against a fiduciary, which Congress recognized the investment adviser to be, to establish all the elements required in a suit against a party to an arm's-length transaction. Courts have imposed on a fiduciary an affirmative duty of "utmost good faith, and full and fair disclosure of all material facts," "as well as an affirmative obligation "to employ reasonable care to avoid misleading" his clients.[70]

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[64] *Id.* at 99.

[65] 15 U.S.C. 80b-6.

[66] Securities and Exchange Commission, *Concept Release on the US Proxy System*, 75 Fed Reg 42981 (July 22, 2010) [hereinafter, *Concept Release*].

[67] 15 USC 80b-2(a)(11).

[68] *Concept Release*, *supra* note 66, at 43010.

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

[70] SEC v. Capital Gains, *supra* note 69, at 194.

As an investment adviser, a proxy advisor owes fiduciary duties to its clients[71] and, consistent with the release announcing the Proxy Voting Rule, extends to actual investors such as mutual fund shareholders and beneficiaries of public pension funds. Moreover, Section 206 of the Investors Act of 1940 applies to all persons that come within the definition of "investment adviser,"[72] including unregistered advisers. Therefore, the proxy advisor is a fiduciary under Section 206 of the Investment Advisers Act of 1940 even when, like Glass Lewis, it is not registered as an investment adviser with the SEC.

B. The Conflict

The Concept Release further stated that, "as a fiduciary, the proxy advisory firm has a duty of care requiring it to make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information."[73] If a proxy advisor provides voting recommendations based "on materially inaccurate or incomplete data," then we have a potential breach in the proxy adviser's duty of care.[74] But, perhaps more importantly, if the proxy advisor provides voting recommendations that are uninformed, i.e., having no value, wouldn't this also be considered a breach of fiduciary duty? In such a situation wouldn't the proxy advisor have a fiduciary duty to abstain from providing a recommendation and instead simply defer to the informed recommendation provided by the board of directors?

The harm caused by uninformed voting recommendations is aggravated when institutional investors take a herd mentality in following the advice of a dominant proxy advisor who provides low cost, low value voting recommendations. According to Malenko and Malenko,

> [W]hen shareholders follow the same signal (advisor's recommendation), their mistakes are perfectly correlated, which increases the probability that an incorrect decision will be made. Therefore, the collective action problem may lead to excessive overreliance on the advisor's recommendations and crowd out too much private information production. If the quality of the advisor's information is low, there is overreliance on its recommendations and insufficient private information production.[75]

In a similar vein, the voting recommendations provided by the board of directors, the most informed locus of authority in a corporation, are also crowded out by a proxy advisor's low cost, low value recommendations. This reduces the amount of informed voting that can take place. Why do regulators at the SEC and DOL prefer low cost, low value voting recommendations over more informed ones? This makes no sense as "the advisor's presence leads to more informative voting *only if* its information is sufficiently precise."[76] The fiduciary duties of a proxy advisor should be used to make sure this crowding out of board recommendations does not occur.

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[71] *Concept Release*, *supra* note 66, at 43010.
[72] *Id*.
[73] *Id.* at 43012.
[74] *Id*.
[75] Malenko and Malenko, *supra* note 2, at 3.
[76] *Id*.

VI. WHAT CAN BE DONE?

It cannot be expected that the preference of institutional investors for a low cost, low value approach to proxy advisor recommendations will change anytime soon. A forced change by federal regulators to a high cost, high value approach would most likely generate more private information, enhancing the quality of shareholder voting, but that approach will be extremely costly and ultimately result in retail investors and public pension fund beneficiaries paying the bill. However, there are still improvements that can be done without creating a significant cost burden for investors and beneficiaries:

Recommendation #1: When making a voting recommendation, the proxy advisor should be held to the standard of an *information trader* (as previously defined[77]). If a proxy advisor cannot attest to the use of that standard when generating a voting recommendation, then the proxy advisor must abstain from making that recommendation to its clients. Making a recommendation that does not meet this standard would be a breach of a proxy advisor's fiduciary duty under the Advisers Act.

In addition, not meeting this standard would include the fact pattern where the company claims one or more significant errors in the data used by the proxy advisor in generating its voting recommendation. A breach of fiduciary duty would occur if the advisor did not allow a reasonable amount of time for review and potential revision prior to the recommendation's release.

Unfortunately, for the vast majority of voting recommendations made by a proxy advisor, it is doubtful that it could attest to the use of that standard. However, there still is a low cost, high value alternative available.

Recommendation #2: The SEC, as well as the DOL, should clarify that an institutional investor, as an alternative to using the voting recommendations of a proxy advisor, can meet its fiduciary voting duties by utilizing the voting recommendations provided by the board of directors.

Despite some statements by the ISS to the contrary,[78] an institutional investor does not violate its fiduciary duties when it votes according to management's voting recommendations. This is

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[77] *See supra* text accompanying footnotes 22 to 26.

[78] In the recent past, the ISS has mistakenly asserted that the Department of Labor's Proxy Project Report of 1989 provided the guidance that "blindly voting all proxies with management are inconsistent with the fiduciary responsibility provisions of ERISA." *See* Gary Retelny, President, Institutional Shareholder Services to Ms. Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, Re: Proxy Advisory Firms Roundtable, File No. 4-670 at 2 (March 5, 2014), https://www.sec.gov/comments/4-670/4670-13.pdf; Statement of Gary Retelny, President and CEO Institutional Shareholder Services Inc. to the Subcommittee on Capital Markets and Government Sponsored Enterprises Committee on Financial Services United States House of Representatives, Legislative Proposals to Enhance Capital Formation, Transparency and Regulatory Accountability at A-14 (May 17, 2016), https://www.issgovernance.com/file/duediligence/iss-statement-hfsc-17-may-2016.pdf. The ISS cites the Proxy Project Report as its source for this assertion, but there is no such guidance in the report. *See* Pension and Welfare Benefits Administration, U.S. Department of Labor, Proxy Project Report (March 2, 1989).

This mistaken understanding of Department of Labor policy most likely originated from an article written many years ago by David George Ball, a former Assistant Secretary of Labor for Pension and Welfare Benefits Administration. In that article Secretary Ball stated, "A fiduciary who fails to vote, or casts a vote without consistent with the understanding that the voting recommendations provided by the board of directors are informed as they are based on inside information and enhanced by the expertise of executive management.

This is not to suggest that proxy advisors have no role to play in shareholder voting. There will be times when it will be of significant value to an institutional investor to a have an *informed* third party voting recommendation such as when the company is engaged in a proxy contest or a merger agreement that is subject to a shareholder vote or when the investment adviser has a conflict of interest as discussed in the Release to the Proxy Voting Rule,[79] assuming the third party does not have a similar conflict of interest. This is when an institutional investor would be most willing to pay for voting recommendations where the proxy advisor is being held to the standard of an information trader.

Recommendation #3: Consistent with the prior recommendation, retail investors who invest in voting stock indirectly through the use of investment advisers and beneficiaries of public pension funds should have the option of transmitting voting instructions to their institutional investor informing it that their pro rata investment in voting stock must be voted in conformity with the voting recommendations of the board of directors of each company held in portfolio.

This third and final recommendation allows the retail investor or public pension fund beneficiary the opportunity to make sure that the vote of their respective institutional investor will always be an informed one. However, this option may be hard to implement because of the technical issues involved, issues that are beyond the scope of this writing.

CONCLUSION

Institutional investors have a fiduciary duty to vote. However, the use of uninformed and imprecise voting recommendations as provided by proxy advisors should not be their only option. They should always be in a position of making an informed vote, whether or not a proxy advisor can help in making them informed. This issue is what the above recommendations are meant to address. If implemented, then the resulting reduced reliance on the imprecise voting recommendations of proxy advisors should lead to the enhancement of shareholder voting by institutional investors.

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considering the impact of the question, or votes *blindly* with management would appear to violate his duty to manage plan assets solely in the interests of the participants and beneficiaries of the plan." *See* David George Ball, Assistant Secretary of Labor for Pension and Welfare Benefits Administration, *Where the Government Stands on Proxy Voting*, 6 FIN. EXECUTIVE INST. at 31, 35 (No. 4, Jul 1990).

[79] Proxy Voting by Investment Advisers, Investment Advisers Act Release No. IA-2106 (2003).

Very truly yours,

Bernard S. Sharfman

Cc: The Honorable Jay Clayton, Chairman
The Honorable Kara M. Stein, Commissioner
The Honorable Robert J. Jackson, Commissioner
The Honorable Hester M. Peirce, Commissioner
The Honorable Elad Roisman, Commissioner
Ms. Dalia Blass, Director, Division of Investment Management
Mr. William H. Hinman, Director, Division of Corporation Finance,
Ms. Stephanie Avakian, Co-Director, Division of Enforcement
Mr. Steven Peikin, Co-Director, Division of Enforcement

November 27, 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 (Fiduciary Duties of a Proxy Advisor in a Specific Fact Pattern)

Submitted By: Bernard S. Sharfman*

Dear Mr. Fields,

The Securities and Exchange Commission's ("SEC") staff roundtable on the proxy process ("roundtable") is a great opportunity to explore the fiduciary duties of a proxy advisor under the Investment Advisers Act of 1940 ("Advisers Act"). This comment letter, my third to the roundtable (the first and second were dated October 8, 2018 and October 12, 2018, respectively), focuses on a very specific, but important, fact pattern where a proxy advisor may have breached its fiduciary duties because of a conflict of interest.

According to the SEC in its 2010 Concept Release on the Proxy Process System, the voting advice provided by a proxy advisor comes under the Advisers Act definition of an investment adviser. The fiduciary duties of an investment adviser were formally recognized by the United States Supreme Court in *SEC v. Capital Gains Research Bureau, Inc.* As an investment adviser, a proxy advisor owes fiduciary duties to its clients. As a fiduciary the proxy advisor should not be providing voting recommendations to its clients that are influenced by a conflict of interest, even if that conflict is publicly disclosed.

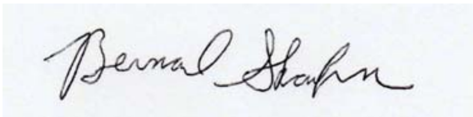
Given the fiduciary duties of a proxy advisor, what are we to make of a fact pattern where a major proxy advisor joins forces with a politically powerful trade organization that is a leader in the shareholder empowerment movement? Moreover, this alliance occurs at a time when a major piece of legislation on proxy advisors is making its way through Congress and the SEC is in the process of taking action that may lead to significant changes in the proxy advisor's business model or the level of its profitability? Doesn't such an alliance immediately raise a suspicion that whatever kind of political support the trade organization can provide is being exchanged for voting recommendations that move further in the direction of shareholder empowerment? That is, the alliance may represent a quid pro quo. If so, then this would be a breach in the proxy advisor's fiduciary duties to its clients.

As one outcome of the roundtable, the SEC should provide guidance on whether such an alliance would be grounds for a SEC investigation and could potentially result in the finding that the proxy

* The opinions expressed here are the author's and do not represent the official position of any organization that he is affiliated with.

advisor has breached its fiduciary duties. Such guidance will help enhance a proxy advisor's understanding of how it should carry out its fiduciary duties under the Adviser's Act.

Very truly yours,



Bernard S. Sharfman

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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[*] Bernard S. Sharfman is the Chairman of the Main Street Investors Coalition ("Coalition") Advisory Council, an associate fellow of the R Street Institute, and a member of the Journal of Corporation Law's editorial advisory board. The opinions expressed here are the author's and do not represent the official position of the Coalition or any other organization that he is affiliated with. This writing was supported by a grant provided by the Coalition.

[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]

[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.

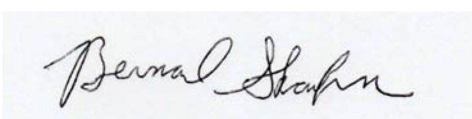
[60] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963). *See also*, Transamerica Mtg. Advisors, Inc. v. Lewis, 444 U.S. 11 (1979) ("As we have previously recognized, § 206 establishes "federal fiduciary standards" to govern the conduct of investment advisers, Santa Fe Industries, Inc. v. 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,



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.

March 10, 2019

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

File Number 4-725

RE: SEC Staff Roundtable on the Proxy Process (Enhancing the Value of Shareholder Voting Recommendations)

Submitted By: Bernard S. Sharfman*

Dear Mr. Fields,

This is my fifth comment letter to the SEC staff roundtable on the proxy process. My first four letters focused on the fiduciary duties required of a company that comes under the authority of the Investment Advisers Act of 1940 ("Advisers Act") by virtue of being defined as an investment adviser. The first comment letter targeted the fiduciary duties of investment advisers to mutual funds. The second and third comment letters concentrated on the fiduciary duties of proxy advisers, such as Institutional Shareholder Services and Glass Lewis. Proxy advisors come under the definition of investment adviser and therefore have fiduciary duties under the Advisers Act. The fourth comment letter was directed at the value of board voting recommendations and how they can be used to fulfill an investment adviser's fiduciary duties when voting client securities.

Using my second and fourth comment letters as its foundation, please find attached a draft article, *Enhancing the Value of Shareholder Voting Recommendations*, that delves further into how the SEC can enhance the value of shareholder voting recommendations under the Advisers Act. This article will eventually be published in the Tennessee Law Review, the flagship journal for the University of Tennessee College of Law.

My article encourages a greater use of board voting recommendations versus the current predominance of recommendations provided by proxy advisors. On its face, this may seem to be a very controversial approach. However, it becomes much less controversial if one looks at shareholder voting as not just simply another tool of accountability implemented to minimize agency costs, but also as a device that allows shareholders to be temporarily transformed into a locus of 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 at their disposal informed and sufficiently precise voting recommendations, no matter what the source, including the board of directors. If shareholders and investment advisers with delegated voting authority feel that the board can provide them with the most precise voting recommendations, then those are the recommendations that they should use.

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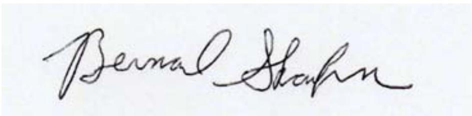
* Mr. Sharfman is chairman of the Main Street Investors Coalition Advisory Council, an associate fellow of the R Street Institute, and a member of the Journal of Corporation Law's editorial advisory board. The opinions expressed here are the author's and do not represent the official position of the coalition or any other organization with which he is affiliated.

I hope the Commission and its staff have the opportunity to read my article and incorporate it into their proxy process review.

Very truly yours,



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Bernard S. Sharfman

ENHANCING THE VALUE OF SHAREHOLDER VOTING RECOMMENDATIONS

By: Bernard S. Sharfman*

March 10, 2019

ABSTRACT

Investment advisers to mutual funds, exchange-traded funds, and separately managed accounts are typically delegated the authority to vote their clients securities. When this delegation occurs, these investment advisers have a fiduciary duty to vote their proxies, typically the voting rights associated with a company's common stock, in the best interest of their clients. This duty creates the following corporate governance issue: How can such institutional investors become informed voters without requiring them to read massive amounts of information on the hundreds or thousands of companies they have invested in for the thousands, tens of thousands, or even hundreds of thousands of shareholder votes they are confronted with each year?

A critical step in resolving this issue is maximizing the ability of institutional investors to avail themselves of voting recommendations that are made on an informed basis and with the expectation that they will lead to shareholder wealth maximization. One way to achieve this maximization is to make sure that the voting recommendations provided by proxy advisors are truly informed ones. This leads to the recommendation that the proxy advisor should be held to the standard of an *information trader*. Another way is for the SEC to recognize the value of board recommendations and explicitly state that their use will allow investment advisers to meet their fiduciary duties when voting their proxies.

INTRODUCTION

In the fall of 2018, I submitted four comment letters to the Securities and Exchange Commission's (SEC's) staff roundtable on the proxy process.[1] All four letters focused on the

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[1] Letter from Bernard S. Sharfman to Mr. Brent J. Fields, Secretary, Securities and Exchange Commission (October 8, 2018) (forthcoming, AM. U. BUS. L. REV.), https://www.sec.gov/comments/4-725/4725-4555147-176184.pdf. [hereinafter, COMMENT LETTER NO. 1]; Letter from Bernard S. Sharfman to Mr. Brent J. Fields, Secretary, Securities and Exchange Commission (October 12, 2018) (the text of this letter was reprinted in THE HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION on November 2, 2018)), https://www.sec.gov/comments/4-725/4725-4513625-175932.pdf. [hereinafter, COMMENT LETTER NO. 2]; 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 [hereinafter, COMMENT LETTER NO. 3]; Letter from Bernard S. Sharfman to Mr. Brent J. Fields, Secretary, Securities and

fiduciary duties required of a company that comes under the authority of the Investment Advisers Act of 1940 ("Advisers Act")[2] by virtue of being defined as an investment adviser.[3] The first comment letter targeted the fiduciary duties of investment advisers to mutual funds ("mutual fund advisers"), such as Vanguard, State Street Global Advisors, and Blackrock, when voting client securities. The second and third comment letters concentrated on the fiduciary duties of proxy advisers, such as Institutional Shareholder Services and Glass Lewis. Proxy advisors come under the definition of investment adviser and therefore have fiduciary duties under the Advisers Act.[4] The fourth comment letter was directed at the value of board voting recommendations and how they can be used to fulfill an investment adviser's fiduciary duties when voting client securities.

When writing my fourth comment letter I realized that I was actually addressing a fundamental issue in corporate governance. That is, how can investment advisers become informed voters without requiring them 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 shareholder votes they are confronted with each year, which is impossible to do, and then come to conclusions that none of them cannot adequately make?

This issue has major significant for corporate governance because investment advisers to mutual funds, exchange-traded funds, and professional money managers of separately managed accounts are typically delegated the authority to vote their clients securities. Most commonly, the voting rights associated with a company's common stock. Investment advisers manage well over 30% of all U.S. publicly traded equity securities[5] and have a fiduciary duty to vote their proxies[6] in their clients best interests.[7]

A critical step in resolving this issue is maximizing the ability of investment advisers to avail themselves of "voting recommendations that are made on an informed basis and with the expectation that they will lead to shareholder wealth maximization."[8] One way to achieve this maximization is to make sure that the voting recommendations provided by proxy advisors are truly informed ones. This leads to the recommendation that "the proxy advisor should be held to the standard of an *information trader*."[9] Moreover, "if a proxy advisor cannot attest to the use of that standard when generating a voting recommendation, then the proxy advisor must abstain from making that recommendation to its

Exchange Commission (December 17, 2018), https://www.sec.gov/comments/4-725/4725-4780983-176889.pdf [hereinafter, COMMENT LETTER NO. 4].

[2] 15 U.S.C. §§ 80b-1 to b-21.

[3] 15 USC 80b-2(a)(11).

[4] *See infra* Part VI.

[5] Inv. Co. Inst., 2018 Investment Company Fact Book at 2017 FACTS AT A GLANCE (2017), http://www.icifactbook.org/deployedfiles/FactBook/Site%20Properties/pdf/2018/2018_factbook.pdf.

[6] Proxies allow shareholders to vote at the annual meeting or any other shareholder meeting without having to be in attendance.

[7] *See infra* Part VI.

[8] COMMENT LETTER NO. 4 at 3-4.

[9] COMMENT LETTER NO. 2, *supra* note 1. *See infra* Part V, Section A for the definition of an information trader.

clients. Making a recommendation that does not meet this standard would be a breach of a proxy advisor's fiduciary duty under the Advisers Act."[10]

In addition, a voting recommendation provided by a proxy advisor that is based on a board's voting recommendations should be disclosed as such. If not, then the investment adviser will be misled into believing that the proxy advisor is providing an independent source of voting recommendations. Given such disclosure, the client may want to go somewhere else for an independent third party recommendation. As subsequently explained, for such recommendations, where there is primary reliance on the board for creating the voting recommendation, it would not be necessary for the proxy advisor to attest to the use of the information trader standard.

Another way to achieve shareholder wealth maximization is for the SEC to recognize the value of board voting recommendations. As argued in my October 12, 2018 comment letter to the SEC, the most precise voting recommendations are not provided by a proxy advisor but by the board of directors.[11] Moreover, shareholders can easily find them, without charge, in a public company's proxy statement."[12]

The recognition of the value of board voting recommendations would have significant policy implications. For example, it would change "a long-standing SEC policy where the value of proxy advisor recommendations is recognized but the value of board voting recommendations is not."[13] Such a paradigm shift will allow investment advisers to be less inhibited in using these informed and precise voting recommendations as a means to meet their fiduciary voting obligations. One way to implement this new policy is for "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."[14]

A ready argument against this recommendation is that shareholders would be giving up their role of keeping the board accountable if they simply followed the voting recommendations of the board. But this argument ignores the fact that shareholder voting cannot be looked at as simply another tool of accountability, i.e., a device to minimize agency costs, such as when shareholders file a direct or derivative lawsuit. When shareholders vote they are also participating, alongside the board, in corporate decision making. That is, they are temporarily transformed into a locus of 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 at their disposal informed and sufficiently precise voting recommendations, no matter what the source, including the board of directors. If shareholders and investment advisers with delegated voting authority feel that the board can provide them with the most precise voting recommendations, then those are the recommendations that they should use.

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[10] *Id.*
[11] COMMENT LETTER NO. 4, *supra* note 1, at 4.
[12] *Id.*
[13] *Id.*
[14] *Id.*

In sum, this Article encourages a greater use of board voting recommendations versus the current predominance of recommendations provided by proxy advisors. The voting recommendations provided by the board are simply more informed and therefore much more precise. Yes, significant bias may exist in some board recommendations, reducing their precision, either because of agency costs or having too narrow a focus, but voting recommendations have no value if they are not informed. As argued here, that is the major problem with the voting recommendations provided by proxy advisors.

The foundation for this Article can be found in my comment letters of October 12, 2018[15] and December 27, 2018.[16] As such, this Article shares much of the same textual language as found in those two letters. Given that the reader has this upfront knowledge, I do not believe it is necessary to continuously footnote quotes and cites from these two writings.

Also, the discussion that follows—when it references state corporate law—has been pragmatically framed in the context of Delaware corporate law. Delaware is the state where the vast majority of the largest United States companies are incorporated,[17] and its corporate law often serves as the authority that other states look to when developing their own statutory and common law.[18] Therefore, the primary examples are from Delaware, but the thinking is meant to be global.

Finally, the focus of this Article is what the SEC needs to do to make sure shareholder voting recommendations are informed. However, it appears highly likely that the recommendations provided here can also be applied in an analogous way by the DOL under Title I of The Employee Retirement Income Security Act of 1974 ("ERISA").

Part I of this Article discusses some of the state and federal requirements that govern shareholder voting. Part II identifies shareholder wealth maximization as the objective of shareholder voting. This identification is critical to understanding when voting recommendations provide value, whether they come from the board of directors or from a proxy advisor. Part III argues that the board of directors is the primary source of superior voting recommendations. Part IV discusses the limitations found in the voting recommendations of proxy advisors. Part V explains why institutional investors have a preference for low cost, low value voting recommendations. Part VI describes the fiduciary duties of proxy advisors and how low cost, low value recommendations are not consistent with those duties. Part VII discusses the SEC's current policy on board voting recommendations. Part VIII provides recommendations that are geared toward enhancing the value of shareholder voting recommendations.

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[15] COMMENT LETTER NO. 2, *supra* note 1.

[16] COMMENT LETTER NO. 4, *supra* note 1.

[17] *See* LEWIS S. BLACK, JR., WHY CORPORATIONS CHOOSE DELAWARE 1, 1 (2007), http://corp.delaware.gov/whycorporations_web.pdf (stating that Delaware is the "favored state of incorporation for U.S. businesses"). According to the State of Delaware website, Delaware is the legal home to "[m]ore than 66% of all publicly-traded companies in the United States including 66% of the Fortune 500." STATE OF DELAWARE, ABOUT AGENCY, http://corp.delaware.gov/aboutagency.shtml (last visited Oct. 10, 2017).

[18] *See* Nadelle Grossman, *Director Compliance with Elusive Fiduciary Duties in a Climate of Corporate Governance Reform*, 12 FORDHAM J. CORP. & FIN. L. 393, 397 (2007).

I. THE LEGAL FOUNDATION FOR SHAREHOLDING VOTING

Shareholder voting is a creation of corporate law and is only required for a very small number of corporate decisions. For example, major corporate actions such as merger agreements,[19] changes to the articles of incorporation,[20] and the election of directors at the annual meeting.[21]

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.[22] However, at the same time, shareholder voting makes corporate decision making much more unwieldy and potentially subject to the whims of uninformed and/or opportunistic shareholders.[23] Hence, a good rationale for why shareholders are given limited opportunities to weigh in and participate in corporate decision making.

Shareholder voting also makes the company vulnerable to a potential change of control, either through hedge fund activism, where the activist is seeking to persuade the board to put the company,[24] or a good part of it, up for sale;[25] or through a hostile takeover,[26] even though various takeover protections, such as the poison pill, have muted most of this type of activity over the last couple of decades.[27]

Corporate law requires a minimum level of shareholder participation by having quorum requirements for shareholder meetings. 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."[28] While this percentage can be modified in a corporation's

[19] DEL. CODE ANN. tit. 8, § 251(c).

[20] *Id.* at § 242.

[21] *Id.* at § 211(b).

[22] *See infra* Part III.

[23] *See* Bernard S. Sharfman, *How the SEC can Help Mitigate the "Proactive" Agency Costs of Agency Capitalism*, forthcoming, American University Business Law Review, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3329057.

[24] Bernard S. Sharfman, *A Simple Plan to Liberate the Market for Corporate Control*, THE CLS BLUE SKY BLOG (August 15, 2017), http://clsbluesky.law.columbia.edu/2017/08/15/a-simple-plan-to-liberate-the-market-for-corporate-control/.

[25] Bernard S. Sharfman, *A Theory of Shareholder Activism and its Place in Corporate Law*, 82 TENN. L. REV. 791, 808-810 (discussing how a hedge fund activist was able to persuade the board of Timken Inc. to spin off its steel division).

[26] *See* Henry G. Manne, *SOME THEORETICAL ASPECTS OF SHARE VOTING, An Essay in Honor of Adolf A. Berle*, 64 COLUM. L. REV. 1427 (1964); Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

[27] *See* Matthew D. Cain, Stephen B. McKeon and Steven Davidoff Solomon, *Do Takeover Laws Matter? Evidence from Five Decades of Hostile Takeovers* 124 J. FIN. ECON. 464, 465 (2017) ("As a proportion of total M&A equal-weighted volume, hostile activity peaked in 1967 at 40% immediately prior to the enactment of the Williams Act and declined to about 8.6% in 2014.")

[28] DEL. CODE ANN. tit. 8, § 216.

certificate of incorporation or bylaw, it cannot go below 1/3 of the shares entitled to vote.[29] 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 investment advisers with delegated voting authority. The voting requirements of corporate law 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."[30] 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."[31] That is, the parties responsible for managing voting stock in pension plans governed by Title I of ERISA have a fiduciary duty to vote their proxies.

This was followed a year later by the DOL's first Proxy Project Report.[32] According to the Report:

> 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.[33]

The DOL affirmed the Avon Letter in 1990,[34] 1994,[35] 2008,[36] and in 2016.[37]

In 2003, with the implementation of the Proxy Voting Rule,[38] the SEC formally recognized the fiduciary duties of registered investment advisers[39] when voting proxies:[40]

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[29] *Id.* at § 216(1).

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

[31] *Id.*

[32] Pension and Welfare Benefits Administration, U.S. Department of Labor, Proxy Project Report (March 2, 1989).

[33] *Id.* at 8.

[34] Letter from U.S. Dep't of Labor to Robert A.G. Monks, Institutional Shareholder Services, Inc. (Jan. 23, 1990) ("If either the plan or the investment management contract (in the absence of a specific plan provision) expressly precludes the investment manager from voting proxies, the responsibility for such proxy voting would be part of the trustees' exclusive responsibility to manage and control the assets of the plan.")

[35] *See* Department of Labor, *Interpretive bulletin relating to writing statements of investment policy, including proxy voting policy and guidelines*, 59 Fed. Reg. 38863 (July 29, 1994) ("… a statement of proxy voting policy would be an important part of any comprehensive statement of investment policy.").

[36] *See* Department of Labor, *Interpretive Bulletins Relating to the Employee Retirement Income Security Act of 1974*, 73 Fed. Reg. 61,732 (Oct. 17, 2008) ("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.")

[37] *See* Department of Labor, *Interpretive Bulletin Relating to the Exercise of Shareholder Rights and Written Statements of Investment Policy, Including Proxy Voting Policies or Guidelines*, 81 Fed. Reg. 95879 (Dec. 29, 2016) ("The Department's longstanding position is that the fiduciary act of managing plan assets which are shares of corporate stock includes decisions on the voting of proxies….").

[38] 17 C.F.R. § 275.206(4)-6.

[39] *See* 15 USC 80b-3 and 80b-3(a).

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

> 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.[41]

Absent an agreement with the client to the contrary,[42] there is a general consensus that in order for an investment adviser to meet its fiduciary obligations, it must vote all its proxies unless they have good reason not to.[43]

II. SHAREHOLDER WEALTH MAXIMIZATION AS THE OBJECTIVE OF SHAREHOLDER VOTING

This Article is based on 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."[44]

Shareholder wealth maximization as the objective of shareholder voting is also consistent with the rationale for why profit making companies create so much value for society. As SEC Commissioner Peirce reminds us in a recent speech at the University of Michigan Law School:

> The hunt for profit drives companies to strive to identify and meet people's needs using as few resources as possible. Companies communicate with their customers and suppliers through the price system. People tell companies what they value when they pay for the products and services those companies offer. Suppliers, by raising or lowering prices, tell companies how valuable the resources are that the companies use. Companies respond to what their customers and suppliers tell them. In this way, companies help to ensure that people spend their time wisely and that resources are used for the things society values most. Companies combine the diverse and complementary talents of their employees to research, develop, explore, produce, sell, and provide services to willing customers. In these activities, corporations play an important role in expanding scientific and technological knowledge,

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[41] *Id.* at 4.

[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. ("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."). [hereinafter, SEC, STAFF LEGAL BULLETIN NO. 20]

[43] 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.).

[44] 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).

> enabling people to profit from their hard work, and ensuring that society's resources are allocated to the uses we most value.[45]

Moreover, shareholder wealth maximization is also consistent with the premise that the overwhelming majority of those 100 million-plus retail investors in the United States who invest in voting stock indirectly through the use of investment advisers such as mutual fund advisers,[46] as well as the beneficiaries of public pension funds,[47] simply want to earn the highest risk adjusted financial return possible,[48] including when they vote or have votes cast for them by their investment advisers. Moreover, this desire to earn the highest risk adjusted financial return possible is also shared by the overwhelming number of socially motivated retail investors who align their investments based on their moral or social values,[49] even though they give up some risk-adjusted return in terms of portfolio diversification and may pay higher management fees for this customization.[50] That is, these investors are willing to exclude certain stocks from their portfolios because they find them to be socially undesirable, but are still looking for the highest risk adjusted return possible given their investment constraints.[51]

Finally, with the exception of a minority of funds that publicly disclose their willingness to sacrifice return in exchange for having a social impact ("social funds"), the shareholder voting objective of shareholder wealth maximization is the only way an investment adviser, as an agent

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[45] Hester M. Peirce, *Wolves and Wolverines: Remarks at the University of Michigan Law School* (Sept. 24, 2018), https://www.sec.gov/news/speech/speech-peirce-092418.

[46] Inv. Co. Inst., 2018 INVESTMENT COMPANY FACT BOOK at 2017 Facts at a Glance (unnumbered page) (2018), http://www.icifactbook.org/deployedfiles/FactBook/Site%20Properties/pdf/2018/2018_factbook.pdf .

[47] A discussion of public pension funds is outside the scope of this paper.

[48] Paul Brest, Ronald Gilson, and Mark Wolfson, *How Investors Can (and Can't) Create Social Value*, STAN. SOC. INNOV. REV. (Dec. 8, 2016), https://ssir.org/up_for_debate/article/how_investors_can_and_cant_create_social_value; *See also*, George David Banks and Bernard Sharfman, *Standing Up for the Retail Investor*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (June 10, 2018), https://corpgov.law.harvard.edu/2018/06/10/standing-up-for-the-retail-investor/.

[49] According to Brest, Gilson, and Wolfson, *supra* note 41:

> Socially motivated investors who seek value alignment would prefer to own stocks only in companies that act in accordance with their moral or social values. Independent of having any effect on the company's behavior, these investors may wish to affirmatively express their identities by owning stock in what they deem to be a good company, or to avoid "dirty hands" or complicity by refusing to own stock in what they deem to be a bad company. Value-aligned investors may be concerned with a firm's outputs–its products and services; for example, they might want to own stock in a solar power company or avoid owning shares in a cigarette company. Or the investors may be concerned with a firm's practices–the way it produces its outputs; they might want to own stock in companies that meet high environmental, social, and governance (ESG) standards, and eschew companies with poor ESG ratings. To achieve their goals, value-aligned investors must only examine their personal values and then learn whether the company's behavior promotes or conflicts with those values. *Id.*

[50] 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.

[51] *Id.*

representing the interests of tens, hundreds, thousands, or even millions[52] of investors, can come closest to representing the preferences of their retail investors or beneficiaries.

III. THE BOARD AS A PROVIDER OF SUPERIOR VOTING RECOMMENDATIONS

According to Schouten, "shareholders need to have at least some information to ensure that they are more likely to be right than wrong."[53] That is, shareholder voting needs to be more than just a flip of the coin. Where does this informed source of voting recommendations come from if not from proxy advisors? Fortunately, the board of a public company already provides this foundational level of information in their own recommendations on how shareholders should vote.

A. The Role of Corporate Law

Corporate law, by establishing the board of directors as the most important locus of decision-making authority in the corporation,[54] 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."[55] 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."[56] 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."[57]

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[52] Vanguard reports that it has 20 million investors as of January 31, 2018. See Vanguard, *Fast Facts about Vanguard*, https://about.vanguard.com/who-we-are/fast-facts/.

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

[54] DEL. CODE ANN. tit. 8, § 141(a).

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

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

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

B. The Formulation of Board Voting Recommendations

The voting recommendations of the board, like all of its decisions, take advantage of this inside information as well as the expertise of executive management and are generated through the lens of shareholder wealth maximization:

> [D]etermining whether a business decision is shareholder wealth-maximizing is not just about plugging in a formula and calculating the result, which any computer or calculator can do. Rather, it refers to the specific formula that will be utilized by management to determine if a particular decision maximizes shareholder wealth. One can think of this in terms of a mathematical formula where the decision maker is given the responsibility of choosing the variables and estimating the coefficients of those variables. This requires many sources of knowledge and expertise…[which proxy advisors as well as the overwhelming majority of shareholders may lack], including experience in the particular business that the company may be in, product and company knowledge, management skills, financial skills, creative and analytical thinking pertinent to a company's business, confidential information, and so on. For example, who has the knowledge and expertise to decide whether a distinctive corporate culture enhances or detracts from shareholder value? The clear answer is that the board and its executive management are the proper locus of authority for making this decision.[58]

The combination of being the most informed locus of authority and the one with the most analytical firepower at its disposal, executive management, provides the board with the greatest potential for creating the most precise shareholder voting recommendations.

C. The Problem of Bias

However, even with their significant informational and analytical advantages, it is not guaranteed that the board will be able to deliver the maximum precision in its voting recommendations. Bias may have a significant negative impact on the precision of these recommendations. First, the board, being so close in proximity to the firm, may have, at times, difficulty in being objective in its voting recommendations.[59] According to Goshen and Parchomovsky:

> Insiders' narrow focus on their own corporation, however, prevents them from exploiting economies of scale and scope in gathering, evaluating and pricing general market information. Moreover, due to their proximity to the firm, insiders cannot objectively assess the value of their own business decisions.[60]

That is, the insider problem of narrow focus may create bias in the board's voting recommendations, reducing their precision. Perhaps the poor performance of the company's stock price is the best indicator of when this bias is significant and therefore may also have a significant impact on the

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[58] Bernard S. Sharfman, *Shareholder Wealth Maximization and its Implementation under Corporate Law*, 66 FLA. L. REV. 389, (2014).

[59] Goshen & Parchomovsky, *supra* note 57, at 721–23.

[60] *Id.* at 722.

precision of a board's voting recommendations.[61] Or, when an activist hedge fund has taken a significant position in the company and is trying to encourage the board to change its business strategy or prepare the company for sale.[62] However, the occurrence of these two events is a signal not an affirmation that poor board decision making is occurring.[63] A determination whether board voting recommendations of any particular company are insufficiently precise because of a narrow focus and therefore a third party source of "informed" voting recommendations is required, can only be made based on the independent judgment of each investment adviser.

Second, there is also the issue of 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"[64]). As explained by Professor Paul 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 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.[65]

These classical agency costs would also create bias and reduce the precision of board voting recommendations.

But this does not mean that the board of directors and its executive management are simply unconstrained actors generating agency costs at will. They are constrained by the law and their ethics. They are human beings after all, fearful of violating criminal law and potentially facing imprisonment or financial penalties, breaching their fiduciary duties of care and loyalty and thereby potentially facing financial liability, damaging their reputations, and violating their own ethical norms. According to Milton Friedman:

> In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as

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[61] Bernard S. Sharfman, *Activist Hedge Funds in a World of Board Independence: Creators or Destroyers of Long-Term Value?*, 2015 COLUM. BUS. L. REV. 813, 842-847 (2016).

[62] *Id.*

[63] *Id.*

[64] 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)).

Id. at 1361 (citations omitted).

[65] Paul Rose, *Common Agency and the Public Corporation*, 63 VAND. L. REV. 1355, 1361 (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)).

much money as possible *while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom*.[66]

Such legal and ethical rules, which are allowed to change over time, create boundaries that discourage the board of directors and executive management from entering into unacceptably harmful corporate decisions.

Moreover, shareholder desires are what must guide the board of directors.[67] For example, while shareholders are not generally involved in the governance of a public company, this being delegated to the board under corporate law, the governance role that shareholders do play signals to board members that the interests of shareholders must be their primary concern. In that way, corporate law establishes the foundation for a shareholder wealth maximization norm. According to Leo Strine:

> 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*.[68] 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.[69]

In addition to the norm of shareholder primacy that these shareholder rights create, the board of directors also 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

[66] Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, THE NEW YORK TIMES MAGAZINE (September 13, 1970), http://umich.edu/~thecore/doc/Friedman.pdf.

[67] Christopher Conas interprets Friedman's quote to mean that "Profits are not ends-in-themselves; the only reason why executives are obligated to increase profits is because that is what the stockholders desire." Christopher Conas, *Does Milton Friedman Support a Vigorous Business Ethics?*, J. OF BUS. ETHICS 391, 392 (2008).

[68] 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.").

[69] 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, 453-455 (2014).

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*:[70]

> 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.[71]

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.[72]

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.[73] 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,"[74] 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.[75]

But the signals provided by corporate law that direct boards to focus on shareholder primacy and corporate law's fiduciary duties are not the only means by which agency costs are mitigated in favor of shareholders. Federal securities laws covering insider trading and securities fraud as found under Section 10(b) of the Securities Exchange Act of 1934[76] and Rule 10b-5 as promulgated thereunder,[77] 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.[78] 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.

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

[71] *Id.* at 101.

[72] *Id.*

[73] 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).

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

[75] *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.").

[76] 15 U.S.C § 78j(b).

[77] 17 CFR 240.10b-5.

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

The listing requirements also require that a board's audit, compensation, and nominating committees be composed entirely of independent members.[79] According to Spencer Stuart, 85% of S&P 500 directors were independent in 2017.[80]

Given these mitigating factors, it is hard to believe that even a small minority of board voting recommendations are riddled with significant agency costs. But like the issue of narrow focus, a determination of whether board voting recommendations of any particular company are insufficiently precise and therefore a third party source of informed voting recommendations is required, can only be made based on the independent judgment of each investment adviser.

IV. THE VOTING RECOMMENDATIONS OF A PROXY ADVISOR

The essence of a proxy advisor's existence is to help an institutional investor decide how to cast its votes at a shareholder meeting of a public company. Its existence is essential for many institutional investors who may hold hundreds or thousands of stocks in their portfolios. For these investors, it is not feasible or desirable to internally perform independent research on the tens or even hundreds of thousands of votes they may face each year. Instead, the institutional investor has traditionally leaned heavily on one or more proxy advisors to provide them with voting recommendations.

A. The Impact of a Proxy Advisor's Voting Recommendations

It should not be surprising that a proxy advisor's voting recommendations can have a significant impact on the results of a shareholder vote.[81] For example, Malenko and Shen report that a negative Institutional Shareholder Services (ISS) recommendation on say-on-pay proposals led, on average, to a 25 percentage point reduction in voting support by shareholders during the sample period of 2010-11.[82] In a general review of the empirical research on proxy advisor recommendations, Copland, Larcker, and Tayan conclude that, "the evidence suggests that proxy advisors have a material, if unspecified, influence over institutional voting behavior and therefore also voting outcomes."[83] Moreover, they also conclude that an "against" recommendation from a proxy advisor "is associated with a reduction in the favorable vote count by 15%−30%."[84]

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

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

[81] Andrey Malenko and Nadya Malenko, *The Economics of Selling Information to Voters*, J. FIN. (forthcoming) (June 2018) ("By now, there is strong empirical evidence that proxy advisors recommendations have a large influence on voting outcomes."), https://ssrn.com/abstract=2757597; James R. Copland, David F. Larcker, and Brian Tayan, *Proxy Advisory Firms, Empirical Evidence and the Case for Reform*, The Manhattan Institute at 13 (May 2018), https://www.manhattan-institute.org/sites/default/files/R-JC-0518-v2.pdf.

[82] Nadya Malenko and Yao Shen, *The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design*, 29 REV. OF FIN. STUD. 3394, 3395 (2016).

[83] James R. Copland, David F. Larcker, and Brian Tayan, *Proxy Advisory Firms, Empirical Evidence and the Case for Reform*, The Manhattan Institute at 13 (May 2018), https://www.manhattan-institute.org/sites/default/files/R-JC-0518-v2.pdf.

[84] *Id.*

Given the potential for a proxy advisor's voting recommendations to have a significant impact on voting outcomes, it is critical that these recommendations be targeted toward enhancing long-term shareholder value. However, many critics of proxy advisors argue that a significant number of their voting recommendations incorporate various types of data, analytic, and methodological errors.[85] If implemented, such voting recommendations will lead to sub-optimal corporate decision-making and a reduction in shareholder value. Such *imprecision* cannot be tolerated in a proxy advisor's recommendations.

B. The Limitations of Proxy Advisor Recommendations

As observed by Malenko and Malenko, "The presence of the proxy advisor increases firm value (the probability of a correct decision being made) only if the *precision* of its recommendations is sufficiently high."[86] However, based on the discussion subsequently found in this Part, it is doubtful that a proxy advisor can provide the same level of precision as a board of directors in the creation of most voting recommendations. Even if the bias found in their voting recommendations are significantly less than found in board recommendations, their recommendations, on average, are so less informed that it makes the potential bias differential irrelevant. That is, voting recommendations that are made on an uninformed basis have no value.

C. Being Informed

As a foundational matter, for a proxy advisor to generate a recommendation that is sufficiently precise, the proxy advisor must be *truly* informed. For a proxy advisor to be truly informed it needs to be held to the standard of an informed investor or what Goshen and Parchomovsky would call an "information trader."[87] According to Goshen and Parchomovsky, an information 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,"[88] including the gathering of private information.[89] Moreover, "information traders have the ability and knowledge to collect, evaluate and price firm-specific and general market information."[90] Furthermore, "[s]earching for, verifying, analyzing, and pricing general market and firm-specific information are costly tasks."[91]

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[85] *Id. See also*, Charles M. Nathan and James D.C. Barrall, Latham & Watkins LLP, *Proxy Advisory Business: Apotheosis or Apogee?*, CORPORATE GOVERNANCE COMMENTARY at 5 (March 2011).

[86] Malenko and Malenko, *supra* note 81.

[87] *Id.* at 721-723.

[88] *Id*. at 723.

[89] *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.)

[90] Goshen & Parchomovsky, *supra* note 57, at 723.

[91] *Id.*

D. The Low Cost, Low Value Approach

Yet, this high cost, informed approach is not what proxy advisors appear to be providing. 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."[92] According to Nathan and Barrall, "As a result of the large number of voting recommendations that must be made in a short time period, it is inconceivable that proxy advisors' recommendations can or will be based on a thorough analysis of the facts and circumstances of each company in the context of each voting decision."[93] Moreover, Larcker and Tayan observe that "robust evidence does not exist that the recommendations of advisory firms are correct...."[94]

There is strong evidence that the two major proxy advisors utilize a low cost, low value (not truly informed) approach to the creation of voting recommendations, leading to imprecise recommendations. This evidence is found in the resources that the two major proxy advisors, ISS (61% market share)[95] and Glass Lewis (37% market share),[96] devote to the creation of recommendations. In 2014 the ISS had a global staff of 250 research analysts to provide recommendations on 250,000 shareholder votes.[97] Based on this information, the U.S. Chamber of Commerce stated that "it is clear that, on average, each ISS analyst is responsible for researching and preparing reports on 1,000 issues in the truncated period of the *usual* 'proxy season. [primarily between March and June]"[98] As of June 2017, the ISS Global Research team covered 40,000 shareholder meetings with approximately 270 research analysts and 190 data analysts.[99] However, it is not known how many research analysts are full-time, part-time or seasonal (proxy season only).

According to the U.S. Chamber of Commerce, "Glass Lewis purports to analyze fewer issues, but has fewer analysts [approximately 200 in 2014] available to do so, ensuring that its analysts are equally overwhelmed with their responsibilities in a very short period of time."[100] In 2018, Glass Lewis reported that it covers 20,000 meetings each year with approximately the same number of

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[92] Luca Enriques and Alessandro Romano, *Institutional Investor Voting Behavior: A Network Theory Perspective*, ECGI Working Paper N° 393/2018 (July 2018), at 17.

[93] Nathan and Barrall, *supra* note 85, at 4.

[94] David F. Larcker and Brian Tayan, *Seven Myths of Corporate Governance*, STANFORD CLOSER LOOK SERIES at 3 (June 1, 2011).

[95] Center on Executive Compensation, *ISS*, http://www.execcomp.org/Issues/Issue/proxy-advisory-firms/iss (accessed on December 20, 2018).

[96] Center on Executive Compensation, *Glass Lewis*, http://www.execcomp.org/Issues/Issue/proxy-advisory-firms/glass-lewis (accessed on Dec. 20, 2018). Besides ISS and Glass Lewis, the U.S. proxy advisory industry is made up of only three other firms: Egan-Jones Proxy Services (Egan-Jones), Marco Consulting Group (Marco Consulting), and ProxyVote Plus. *See* U.S. Gov't Accountability Office, GAO-17-47, *Corporate Shareholder Meetings: Proxy Advisory Firms' Role in Voting and Corporate Governance Practices* (2016) at 6, http://www.gao.gov/assets/690/681050.pdf.

[97] U.S. Chamber of Commerce, *U.S. Chamber of Commerce Corporate Governance Update: Public Company Initiatives in Response to the SEC Staff's Guidance on Proxy Advisory Firms*, THE U.S. CHAMBER CENTER FOR CAPITAL MARKETS COMPETITIVENESS at 5, n. 7 (January 2015), http://www.centerforcapitalmarkets.com/wp-content/uploads/2015/01/021874_ProxyAdvisory_final.pdf.

[98] *Id.*

[99] Institutional Shareholder Services Inc., *Due Diligence Compliance Package* (November 2017), https://www.issgovernance.com/file/duediligence/Due-Diligence-Package-November-2017.pdf.

[100] U.S. Chamber of Commerce, *supra* note 97, at 5, n. 7.

analysts it had in 2014.[101] However, it is not known if this number included data as well as research analysts.

Given this low level of resources devoted to analysis, it should not be surprising that 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.[102] 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.[103]

Perhaps even more frustrating, "[w]hen a company did receive notice, it was often not enough time to generate a response."[104] 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…."[105]

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.[106] 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.[107] 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."[108]

In a 2015 survey by NASDAQ and the U.S. Chamber of Commerce, the responding companies reported that proxy advisors commonly gave them only 24 to 48 hours to respond to recommendations and sometimes only one hour was provided.[109] Perhaps most telling, only "25% of companies believed the proxy advisory firm carefully researched and took into account all relevant

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[101] Glass Lewis, *Company Overview* (accessed on September 24, 2018), http://www.glasslewis.com/company-overview/.

[102] 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.

[103] *Id.* at 7.

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

[105] *Id.* at 8.

[106] *Id.* at 3.

[107] *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.

[108] *Id.*

[109] The U.S. Chamber Center for Capital Markets Competitiveness and Nasdaq, *2015 Proxy Season Survey: Public Company Experience during the Current Proxy Season* (2015), https://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/2015-Proxy-Season-Survey-Summary.pdf.

aspects of the particular issue on which it provided advice."[110] Confirming this belief, responding companies asked advisory firms to allow their input about 50% of the time, but that input was only allowed around half the time.[111] In addition, when responding companies formally requested previews of advisor recommendations, that request was granted only about half the time.[112]

E. The One-Size-Fits-All Approach

A one-size-fits-all approach to voting recommendations is the inevitable result of a proxy advisor that has significant resource constraints. Both ISS and Glass Lewis provide annually updated and extensively detailed voting policies that provide public companies and institutional investors with a roadmap on what the advisors recommendations will be even before an issue is raised at a specific company.[113] A one-size-fits-all approach in these policies are found everywhere, including when discussing hot button topics such as dual class shares, proxy access, and staggered boards. According to Choi, Lund, and Schonlau, "To the extent that their institutional shareholder clients care less about the issue, proxy advisor recommendations may be more likely to rely on simple, one-size-fits-all criteria so as to economize their resources."[114]

Perhaps more to the point are the following quotes from Nathan and Barrell,

> [A]s everyone connected with the institutional shareholder voting process knows or should know, proxy advisors' voting recommendations are driven by inflexible, one-size-fits all *voting policies* and *simplistic analytic models* designed to utilize standard and easily accessible inputs that can be derived from readily available data and to avoid any need for particularized research or the application of meaningful judgment.[115]

Moreover,

> While proxy advisors may claim that each company and each vote is arrived at individually and reflects the particulars of the situation, this is true only in the most *superficial* sense. The analyses, in fact, are driven by checking boxes or inputting readily obtainable and relatively simple-to-find data, running this data through simplistic models and sticking inflexibly to whatever outcome is "spit out" of the process.[116]

The undesirability of this approach short-cut approach, at least to the extent it is currently used, is reflected in the following statement by current SEC Chairman Jay Clayton: "We also need clarity regarding the analytical and decision-making processes advisers employ, including the extent to

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[110] *Id.*
[111] *Id.*
[112] *Id.*
[113] *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/.
[114] Albert H. Choi, Andrew Lund, and Robert J. Schonlau, *Shareholder Voting on Golden Parachutes: Determinants and Consequences*, Virginia Law and Economics Research Paper No. 2018-13 (August 10, 2018), available at SSRN: https://ssrn.com/abstract=3229962.
[115] Nathan and Barrall, *supra* note 85, at 4.
[116] *Id.*

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*."[117]

F. The Undisclosed Following of Board Recommendations

Alternatively, a proxy advisor may be economizing on resources by simply accepting a board's voting recommendations as its own. This may explain why proxy advisors vote in support of management's recommendations about 89% of the time.[118] While this is not necessarily an undesirable approach, especially if you believe in the value of board recommendations, such an approach needs to be disclosed when it is used. If not, then the investment adviser will be misled into believing that the proxy advisor is providing an independent source of voting recommendations. Given such disclosure, the client may want to go somewhere else for an independent third party recommendation. However, once disclosed, it would not be necessary for the proxy advisor to attest to the use of the information trader standard for that particular voting recommendation.

G. Conflicts of Interest

There is much concern that the recommendations of a proxy advisor may be tainted with conflicts of interests. Such conflicts of interest would create bias in its voting recommendations, leading to something less than shareholder wealth maximization if they were implemented. There are two primary sources of these potential conflicts. First, the conflicts that may arise when a proxy advisor such as ISS sells not only voting recommendations but consulting services to a public company (Glass Lewis does not provide consulting services).[119] The concern is that the providing of consulting services may encourage a proxy advisor to recommend a vote for management for fear of losing this business. Or, a possible quid pro quo may result if the proxy advisor offers to provide support for board recommendations in exchange for the purchase of its consulting services.[120]

Another source of possible conflict arises when clients, who are not totally focused on maximizing the wealth of its investors or beneficiaries, try to influence a proxy adviser's voting recommendations. For example, according to James R. Copland of the Manhattan Institute, "ISS receives a substantial amount of income from labor-union pension funds and 'socially responsible'

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

[118] Council of Institutional Investors, *Investor Group Responds to Wall Street Journal Editorial: Proxy Advisory Firms Do Not Dictate Voting Outcomes* (August 13, 2018), https://www.cii.org/files/about_us/press_releases/2018/08-13-18_cii_press_release_WSJ_editorial.pdf.

[119] Timothy M. Doyle, American Council for Capital Formation, *The Conflicted Role of Proxy Advisors* at 7 (May 2018) ("In recent years, these institutions have drawn increased scrutiny for the conflicts of interest inherent in rating and providing voting recommendations concerning public companies while simultaneously offering consulting services to those same companies, including how they can improve their ratings and voting recommendations."), http://cdn.accf.org/wp-content/uploads/2018/05/ACCF-The-Conflicted-Role-of-Proxy-Advisor-FINAL.pdf.

[120] *Id.* at 8.

investing funds, which gives the company an incentive to favor proposals that are backed by these clients."[121] That is, pressure from these clients may lead to non-wealth maximizing voting recommendations.

Given this long-standing understanding of how conflicts may arise, it was surprising to see the ISS publicly enter into a new alliance with the Council of Institutional Investors ("CII"),[122] a powerful trade organization that represents the interests of public pension and labor union related funds and is a prominent leader in the shareholder empowerment movement.[123] The members of the CII hold assets totaling over $4 trillion.[124] According to the website formed by the two entities, *Protect the Voice of Shareholders*,[125]

> Protect the Voice of Shareholders is a joint project of the Institutional Shareholder Services (ISS), a leading provider of corporate governance and responsible investment solutions and the Council of Institutional Investors (CII), on behalf of its members. This site was developed and is managed through ISS funding. ISS is responsible for the site's editorial and content approval, with input and consent rights from CII.
>
> The work and goals of the Protect the Voice of Shareholders project are aligned with the concerns, public policy positions, and opposition to H.R. 4015 expressed by investment companies, state and municipal public retirement plans, consumer advocate organizations, labor union funds, and others capital market stakeholders.[126]

H.R. 4015 is a piece of legislation that has passed the House but is stalled in the Senate.[127] The legislation would have the effect of increasing the regulatory authority of the SEC over a proxy advisor with the intent of reducing both a proxy advisor's conflicts of interest and errors in its voting recommendations.

More pertinent to this discussion, such an alliance immediately raise a suspicion that whatever the trade organization can provide in terms of political support is being exchanged for voting recommendations that move further in the direction of shareholder empowerment. That is, the

[121] James R. Copland, Opinion, *Politicized Proxy Advisers vs. Individual Investors*, Wall Street Journal (October 7, 2012), http://online.wsj.com/article/SB10000872396390444620104578012252125632908.html.

[122] *See* COMMENT LETTER NO. 3, *supra* note 1 (discussing a fact pattern based on this alliance).

[123] Both ISS and Glass Lewis are associate members of CII. *See* Alicia McElhaney, *Council of Institutional Investors Questions Wall Street Journal Over Proxy Advisory Firms*, Institutional Investor (August 14, 2018), https://www.institutionalinvestor.com/article/b19j0gf9vscx87/Council-of-Institutional-Investors-Questions-Wall-Street-Journal-Over-Proxy-Advisory-Firms. According to CII's associate member application form, the annual fee for being an associate member is $12,000 per year, https://www.cii.org/files/Membership/2017_Associate_Member_Application.pdf.

[124] *See* Council of Institutional Investors, *About Us* (accessed on December 21, 2018), https://www.cii.org/about_us.

[125] *See* https://www.protectshareholders.org/. As a matter of full disclosure, the Protect the Voice of Shareholders website has promoted several articles and posts that are critical of my association with the Main Street Investors Coalition as well as my writings on proxy advisers, including my comment letter dated October 12, 2018. *See* https://www.protectshareholders.org/news-blog.

[126] *See* https://www.protectshareholders.org/about-us.

[127] H.R. 4015 - Corporate Governance Reform and Transparency Act of 2017, 115th Congress (2017-2018), Passed the House of Representatives December 20, 2017, https://www.congress.gov/bill/115th-congress/house-bill/4015/text.

alliance may represent a quid pro quo. If so, then this would be a breach in the proxy advisor's fiduciary duties to its clients and a major source of bias in its voting recommendations.

V. THE PREFERENCE FOR LOW COST, LOW VALUE RECOMMENDATIONS

As already discussed, the "Avon letter"[128] 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 15 years later when the SEC implemented the Proxy Voting Rule[129] and formally recognized the fiduciary duties of registered investment advisers when voting proxies.[130]

This has been a boon for proxy advisors. Institutional investors, who don't find value in voting, have responded by seeking out low cost, low value recommendations from proxy advisors so as to meet their fiduciary duties at the lowest cost possible. As subsequently discussed, this approach simply makes good economic sense for almost all institutional investors except for perhaps activist hedge funds who over-weight their portfolios with a small number of stocks and seek as much voting power as possible.[131]

Moreover, 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.[132] 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*.[133] This was another boon for proxy advisors. However, this endorsement was recently weakened when the SEC withdrew two long-standing no-action letters that supported this approach.[134]

In sum, the SEC, by following the lead of the DOL, has established the legitimacy of investment advisers using the voting recommendations of proxy advisors. However, the SEC has yet to provide guidance on the value of board voting recommendations.

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

[129] 17 C.F.R. § 275.206(4)-6.

[130] RELEASE, PROXY VOTING RULE.

[131] The activist hedge fund is a special type of information trader. They are distinguished from the most common type of information trader, the value investor, by their willingness to take a significant position in a company as a means to implement strategic changes, to spend resources to identify such changes, and to spend additional resources to try to get a company to implement those changes. *See* Bernard S. Sharfman, *supra* note 61, at 827.

[132] RELEASE, PROXY VOTING RULE at 5.

[133] STAFF LEGAL BULLETIN NO. 20.

[134] Division of Investment Management, Securities & Exchange Commission, *Statement Regarding Staff Proxy Advisory Letters* (Sept. 13, 2018) ("[T]he staff of the Division of Investment Management has recently rexamined the letters that the staff issued in 2004 to Egan-Jones Proxy Services (May 27, 2004) and Institutional Shareholder Services, Inc. (Sept. 15, 2004). Taking into account developments since 2004, the staff has determined to withdraw these letters, effective today."), https://www.sec.gov/news/public-statement/statement-regarding-staff-proxy-advisory-letters.

A. The Preferences of Index Fund Managers

Low cost, low value recommendations are not only appealing to smaller institutional investors who cannot spread the cost of precise recommendations over a large asset base,[135] but they are also extremely appealing to the largest investment advisers of mutual funds, especially those who specialize in managing index funds. BlackRock, Vanguard, State Street Global Advisors, Fidelity, etc., investment advisers who are responsible for managing trillions of dollars worth of equity securities, face tens if not hundreds of thousands of shareholder votes each year.[136] This would be an extremely costly undertaking if they were seeking precise voting recommendations. However, according to Bebchuk, Cohen and Hirst, since the goal of an index fund is to meet, not beat the market; the adviser would not derive any competitive benefit from receiving precise recommendations and therefore would have no incentive to spend the money that such recommendations would require:

> If the investment manager of a certain mutual fund that invests according to a given index increases its spending on stewardship at a particular portfolio company and thereby increases the value of its investment in that company, it will also increase the value of the index, so its expenditure would not lead to any increase in the performance of the mutual fund relative to the index. Nor would it lead to any increase relative to the investment manager's rivals that follow the same index, as any increase in the value of the corporation would also be captured by all other mutual funds investing according to the index, even though they had not made any additional expenditure on stewardship.
>
> Thus, if the investment manager were to take actions that increase the value of the portfolio company, and therefore also the portfolio that tracks the index, doing so would not result in a superior performance that could enable the manager to attract funds currently invested with rival investment managers.[137]

Moreover,

> [I]f the index fund were to raise its fees and improve its stewardship, each individual investor in the fund would have an incentive to switch to rival index funds. That is, a move by any given index fund manager to improve stewardship and raise fees would unravel, because its investors would prefer to free-ride on the investment manager's efforts by switching to another investment fund that offers the same indexed portfolio but without stewardship or higher fees.[138]

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135 *Id.*

136 Vanguard, *Investor Stewardship 2018 Annual Report* at 34, 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.).

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

138 *Id.*

Finally, in this current cut throat fee environment that index fund advisers now face,[139] they must be extremely pleased to have the low cost, low value option available.

B. Actively Managed Funds

Investment managers who actively manage their portfolios will also prefer the low cost, low value option. It will always be more profitable for them to use their limited resources to invest in stock valuation (e.g., fundamental analysis used by information traders) than to spend their money on high value voting recommendations.[140] 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. This applies to the time and resources spent by a portfolio manager and her securities analysts in determining how to vote. Moreover, Bebchuk, Cohen, and Hirst argue that many actively managed funds are in reality "closet indexers."[141] As such, they gain very little from more precise voting except perhaps for the stock of companies that are over-weighted in their portfolios relative to the appropriate benchmark index.[142] For those stocks that are under-weighted, the benchmark index would benefit more from the more precise voting, giving investment managers of actively managed funds a disincentive to make such an investment.[143]

VI. FIDUCIARY DUTIES UNDER THE ADVISERS ACT

As argued in this Part, the problem a proxy advisor faces is that the low cost, low value approach desired by its clients may potentially conflict with its fiduciary duties under the Advisers Act. This Part begins with a discussion of where these fiduciary duties originated.

A. The Origin of a Proxy Advisor's Fiduciary Duties

According to the Securities and Exchange Commission in its 2010 Concept Release on the Proxy Process System,[144] the voting advice provided by a proxy advisor comes under the Advisers Act's definition of an investment adviser:[145]

> We understand that typically proxy advisory firms represent that they provide their clients with advice designed to enable institutional clients to ***maximize*** the value of their investments. In other words, proxy advisory firms provide analyses of shareholder proposals,

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[139] Charles Stein and Annie Massa, *Fidelity Bets on Zero-Fee Index Funds*, BLOOMBERG BUSINESSWEEK (August 9, 2018), https://www.bloomberg.com/news/articles/2018-08-09/fidelity-bets-on-zero-fee-index-funds.

[140] 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) (I substitute high value voting recommendations for shareholder intervention in Gilson and Gordon's argument. This is an appropriate substitution as both are costly but are expected to enhance the corporate governance of a targeted firm.).

[141] Bebchuk, Cohen, and Hirst, *supra* note 137, at 98.

[142] *Id.* at 98-100. If resources were devoted to more precise voting at underweighted stocks, then the benchmark would benefit more than the investment manager's portfolio, harming the investment manager's competitive position. *Id.*

[143] *Id.* at 99.

[144] Securities and Exchange Commission, *Concept Release on the US Proxy System*, 75 Fed Reg 42981 (July 22, 2010) [hereinafter, *Concept Release*].

[145] 15 USC 80b-2(a)(11).

director candidacies or corporate actions and provide advice concerning particular votes in a manner that is intended to assist their institutional clients in achieving their investment goals with respect to the voting securities they hold. In that way, *proxy advisory firms meet the definition of investment adviser* because they, for compensation, engage in the business of issuing reports or analyses concerning securities and providing advice to others as to the value of securities.[146]

The fiduciary duties of an investment adviser were formally recognized by the United States Supreme Court in *SEC v. Capital Gains Research Bureau, Inc.*[147] As stated by the Court,

> Nor is it necessary in a suit against a fiduciary, which Congress recognized the investment adviser to be, to establish all the elements required in a suit against a party to an arm's-length transaction. Courts have imposed on a fiduciary an affirmative duty of "utmost good faith, and full and fair disclosure of all material facts," "as well as an affirmative obligation "to employ reasonable care to avoid misleading" his clients.[148]

As an investment adviser, a proxy advisor owes fiduciary duties to its clients.[149] Moreover, Section 206 of the Investors Act of 1940 applies to all persons that come within the definition of "investment adviser,"[150] including unregistered advisers. Therefore, the proxy advisor is a fiduciary under Section 206 of the Investment Advisers Act of 1940 even when, like Glass Lewis, it is not registered as an investment adviser with the SEC.

B. The Conflict

The Concept Release further stated that, "as a fiduciary, the proxy advisory firm has a duty of care requiring it to make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information."[151] If a proxy advisor provides voting recommendations based "on materially inaccurate or incomplete data," then we have a potential breach in the proxy adviser's duty of care.[152] Consistent with this approach, if the proxy advisor provides voting recommendations that are uninformed and therefore of insufficient precision, wouldn't this also be considered a breach of fiduciary duty? In such a situation wouldn't the proxy advisor have a fiduciary duty to abstain from providing a recommendation and instead simply defer to the informed recommendation provided by the board of directors?

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146 *Concept Release*, *supra* note 124, at 43010.

147 375 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 Congress intended to impose enforceable fiduciary obligations. See H.R.Rep. No. 2639, 76th Cong., 3d Sess., 28 (1940); S.Rep. No. 1775, 76th").

148 SEC v. Capital Gains, *supra* note 147, at 194.

149 *Concept Release*, *supra* note 146, at 43010.

150 *Id.*

151 *Id.* at 43012.

152 *Id.*

The harm caused by uninformed voting recommendations is aggravated when institutional investors take a herd mentality in following the advice of a dominant proxy advisor who provides low cost, low value voting recommendations. According to Malenko and Malenko,

> [W]hen shareholders follow the same signal (advisor's recommendation), their mistakes are perfectly correlated, which increases the probability that an incorrect decision will be made. Therefore, the collective action problem may lead to excessive overreliance on the advisor's recommendations and crowd out too much private information production. If the quality of the advisor's information is low, there is overreliance on its recommendations and insufficient private information production.[153]

In a similar vein, the voting recommendations provided by the board of directors, the most informed locus of authority in a corporation, are also crowded out by a proxy advisor's low cost, low value recommendations. This reduces the amount of informed voting that can take place. Why does the SEC prefer low cost, low value voting recommendations over more informed ones? This makes no sense as "the advisor's presence leads to more informative voting *only if* its information is sufficiently precise."[154] The fiduciary duties of a proxy advisor should be used to make sure this crowding out of board recommendations does not occur.

VII. CURRENT SEC POLICY ON BOARD VOTING RECOMMENDATIONS

With all the problems faced by proxy advisors in trying to create informed, precise, and non-biased voting recommendations, it is somewhat puzzling to find that the SEC has yet to endorse board voting recommendations as an alternative means by which an investment adviser can meet its fiduciary duties when voting its proxies. Even more puzzling, except for the following quote, the SEC has said very little about 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:

> 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.[155]

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

[153] Malenko and Malenko, *supra* note 81, at 3.
[154] *Id*.
[155] SEC, STAFF LEGAL BULLETIN NO. 20.

advisor's recommendations in shareholder voting. For example, 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[156] and in the just mentioned staff bulletin.[157]

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 Advisers Act, then proxy advisor recommendations are the only game in town and board voting recommendations are to be ignored.

VIII. WHAT CAN BE DONE?

It cannot be expected that the preference of institutional investors for a low cost, low value approach to proxy advisor recommendations will change anytime soon. Forcing proxy advisors to provide high cost, high value recommendations without also providing a low cost, high value alternative would be extremely costly and would ultimately result in retail investors and public pension fund beneficiaries paying the bill. Fortunately, a low cost, high value alternative already exists, it just needs to be recognized by the SEC.

A. Recommendation #1

Investment advisers should not be in fear of breaching their fiduciary duties if they use board voting recommendations.[158] The superior precision of board voting recommendations, being based on inside information and enhanced by the expertise of executive management, should give investment

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[156] RELEASE, PROXY VOTING RULE; Securities and Exchange Commission, *Concept Release on the US Proxy System*, 75 Fed Reg 42981 (July 22, 2010).

[157] STAFF LEGAL BULLETIN NO. 20.

[158] An argument has been made that following the voting recommendations of the board without more may violate an investment manager's fiduciary duties. Nevertheless, this argument does not appear to have any basis in the law. In the recent past, the ISS has mistakenly asserted that the Department of Labor's Proxy Project Report of 1989 provided the guidance that "blindly voting all proxies with management are inconsistent with the fiduciary responsibility provisions of ERISA." *See* Gary Retelny, President, Institutional Shareholder Services to Ms. Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, Re: Proxy Advisory Firms Roundtable, File No. 4-670 at 2 (March 5, 2014), https://www.sec.gov/comments/4-670/4670-13.pdf; Statement of Gary Retelny, President and CEO Institutional Shareholder Services Inc. to the Subcommittee on Capital Markets and Government Sponsored Enterprises Committee on Financial Services United States House of Representatives, Legislative Proposals to Enhance Capital Formation, Transparency and Regulatory Accountability at A-14 (May 17, 2016), https://www.issgovernance.com/file/duediligence/iss-statement-hfsc-17-may-2016.pdf. The ISS cites the Proxy Project Report as its source for this assertion, but there is no such guidance in the report. *See* Pension and Welfare Benefits Administration, U.S. Department of Labor, Proxy Project Report (March 2, 1989). This mistaken understanding of a investment manager's fiduciary duties most likely originated in an article written many years ago by David George Ball, a former Assistant Secretary of Labor for Pension and Welfare Benefits Administration. In that article Secretary Ball stated, "A fiduciary who fails to vote, or casts a vote without considering the impact of the question, or votes *blindly* with management would appear to violate his duty to manage plan assets solely in the interests of the participants and beneficiaries of the plan." *See* David George Ball, Assistant Secretary of Labor for Pension and Welfare Benefits Administration, *Where the Government Stands on Proxy Voting*, 6 FIN. EXECUTIVE INST. at 31, 35 (No. 4, Jul 1990).

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 should explicitly state that an institutional investor, as an alternative to using the voting recommendations of a proxy advisor, can meet its fiduciary voting duties by utilizing the voting recommendations provided by the board of directors.[159]
>
> To implement such a policy, the SEC needs 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.[160]

Of course, investment advisers are not required to use board voting recommendations, but they should always have the option to do so. This is consistent with the understanding that the voting recommendations provided by the board of directors are informed and sufficiently precise as they are based on inside information and enhanced by the expertise of executive management.

B. Recommendation #2

A voting recommendation provided by a proxy advisor needs to be competitive with the board's voting recommendations. Therefore,

> When making a voting recommendation, the proxy advisor should be held to the standard of an *information trader* (as previously defined[161]). If a proxy advisor cannot attest to the use of that standard when generating a voting recommendation, then the proxy advisor must abstain from making that recommendation to its clients. Making a recommendation that does not meet this standard would be a breach of a proxy advisor's fiduciary duty under the Advisers Act.

Correspondingly, it is hard to see how an investment adviser can fulfill its fiduciary voting obligations under the Adviser's Act if they knowingly utilize voting recommendations that are not informed. Requiring a proxy advisor to attest to meeting the standard of an information trader when generating a voting recommendation will allow the investment adviser to meet its fiduciary duties.

In addition, not meeting this standard would include the fact pattern where the company claims one or more significant errors in the data used by the proxy advisor in generating its voting recommendation. A breach of fiduciary duty would occur if the advisor did not allow a reasonable amount of time for review and potential revision prior to the recommendation's release.

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[159] COMMENT LETTER NO. 2, *supra* note 1.
[160] COMMENT LETTER NO. 4, *supra* note 1.
[161] *See* text associated with *supra* note 87 for the definition of an information trader.

C. Recommendation #3

A voting recommendation provided by a proxy advisor that is based on a board's voting recommendations should be disclosed as such. If not, then the investment adviser will be misled into believing that the proxy advisor is providing an independent source of voting recommendations. Given such disclosure, the client may want to go somewhere else for an independent third party recommendation. For such recommendations, where there is primary reliance on the board for creating the voting recommendation, it would not be necessary for the proxy advisor to attest to the use of the information trader standard.

D. Summary

All three recommendations, if implemented, would encourage a shift from the use of proxy advisor recommendations to board voting recommendations. However, this does mean that a proxy advisor or another type of third party advisor would have no role to play in shareholder voting. Investment advisors and other institutional investors should always have the option of using the voting recommendations of a proxy advisor if those recommendations meet the information trader standard. Moreover, there will be times when it will be of significant value to an investment adviser or any institutional investor to a have an "informed" third party voting recommendation. For example, when the investment adviser determines that the board's voting recommendations are so bias, because of a narrow focus or classical agency costs, that they are insufficiently precise; when the company is engaged in a proxy contest where an activist hedge fund seeks a change in operating strategy or to have the board put the company up for sale; a merger or acquisition agreement that is subject to a shareholder vote; or when the investment adviser has a conflict of interest as discussed in the Release to the Proxy Voting Rule,[162] assuming the third party does not have a similar conflict of interest. This is when an informed proxy advisor or another third party can help enhance the value of voting recommendations.

CONCLUSION

Investment advisers have a fiduciary duty to vote. However, the provision of voting recommendations by proxy advisors that are uninformed and therefore insufficiently precise should not be their only option. Investment advisors and other institutional investors should always be in a position of making a sufficiently precise vote, whether or not a proxy advisor can help them. This is what the above recommendations are meant to address. Analogous to the corporate law's business judgment rule, voting recommendations provided by the board of directors creates a presumption of being sufficiently informed and precise. Yes, significant bias may exist in some of these voting recommendations, but overall this is the best source of sufficiently informed and precise voting recommendations. The same presumption would apply to the voting recommendations provided by proxy advisors if they can attest to using an information trader standard when generating their recommendations. Moreover, bias may exist in these voting recommendations as well. If the recommendations provided above are implemented, then the expected shift in reliance board voting recommendations should lead to shareholder voting that is more precise and enhanced value for shareholders.

[162] RELEASE, PROXY VOTING RULE.

April 5, 2019

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

File Number 4-725

RE: SEC Staff Roundtable on the Proxy Process (How the SEC can help Mitigate the "Proactive" Agency Costs of Agency Capitalism)

Submitted By: Bernard S. Sharfman*

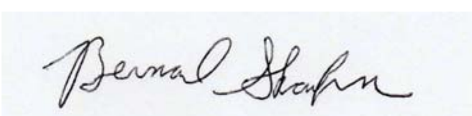
Dear Mr. Fields,

This is my sixth comment letter to the SEC staff roundtable on the proxy process. The first comment letter targeted the fiduciary duties of investment advisers to mutual funds. Using this comment letter as its foundation, please find attached the prepublication version of my article, *How the SEC can help Mitigate the "Proactive" Agency Costs of Agency Capitalism*. This article will soon be published in the American University Business Law Review.

This article is distinguished from the underlying comment letter by focusing on how the SEC can help mitigate the "agency costs of agency capitalism" through the mechanism of an investment adviser's fiduciary duties under the Investment Advisers Act of 1940. In the Introduction of the article I explain how the "proactive" agency costs of agency capitalism are distinguished from the agency costs of agency capitalism discussed in Gilson and Gordon and in Bebchuk, Cohen, and Hirst.

I hope the Commission and its staff have the opportunity to read my article and incorporate it into their proxy process review.

Very truly yours,



Bernard S. Sharfman

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* Mr. Sharfman is chairman of the Main Street Investors Coalition Advisory Council, an associate fellow of the R Street Institute, and a member of the Journal of Corporation Law's editorial advisory board. The opinions expressed here are the author's alone and do not represent the official position of the coalition or any other organization with which he is affiliated.

HOW THE SEC CAN HELP MITIGATE THE "PROACTIVE" AGENCY COSTS OF AGENCY CAPITALISM

BERNARD S. SHARFMAN*

To combat the "proactive" agency costs of agency capitalism, this Article proposes that the United States Securities and Exchange Commission ("SEC" or "Commission"), in whatever form it deems appropriate, requires mutual fund advisers to disclose, under the Proxy Voting Rule, their policies and procedures to: Avoid the opportunistic use of their voting power at public companies as a means to obtain new business from activists such as public pension funds and investment funds associated with labor unions; Eliminate pressures to support the activism of its own shareholders at its portfolio companies; and Identify an actual link between support for a shareholder proposal under Rule 14a-8 and the enhancement of shareholder value before voting in favor of any such proposal.

* Bernard S. Sharfman is the Chairman of the Main Street Investors Coalition Advisory Council ("Coalition"), an associate fellow of the R Street Institute, and a member of the Journal of Corporation Law's editorial advisory board. The opinions expressed here are the author's alone and do not represent the official position of the Coalition or any other organization that he is affiliated with.

I. INTRODUCTION

Investment advisers to mutual funds ("mutual fund advisers"), exchanged traded funds, and separately managed accounts are typically delegated the authority to vote their clients securities, including the voting rights associated with a public company's common stock. Therefore, it should not be surprising that the SEC, in its Release establishing the Proxy Voting Rule ("Release"),[1] took the position that an investment adviser[2] "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."[3] This was the rationale behind the Proxy Voting Rule requiring investment advisers, including mutual fund advisers, to create and disclose their proxy voting policies and procedures.[4]

However, the SEC and its staff have yet to clarify what these fiduciary duties mean for the largest mutual fund advisers, such as BlackRock, Vanguard, and State Street Global Advisors ("the Big Three"), now that they control an extraordinary amount of shareholder voting power at many of our largest public companies.[5] This phenomenon did not exist at the time the Proxy Voting Rule was implemented.[6]

Moreover, this concentration of voting power is expected to increase over time. In a recently posted article by John Coates, Professor Coates predicted that in the near future the majority of voting shares of U.S. public companies

1. Proxy Voting by Investment Advisers, Investment Advisers Act Release No. IA-2106, 79 SEC Docket 1673 (Jan. 31, 2003) [hereinafter Proxy Voting by Investment Advisers], https://www.sec.gov/rules/final/ia-2106.htm.

2. 15 U.S.C. 80b-2(a)(11) (2018) (defining investment advisor).

3. Proxy Voting by Investment Advisers, *supra* note 1.

4. 17 C.F.R. § 275.206(4)-6 (2018) (stating that the Proxy Voting Rule was promulgated under the Investment Advisers Act of 1940, 15 U.S.C. 80b-6(4)).

5. *See* Carmel Shenkar, Eelke M. Heemskerk & Jan Fichtner, *The New Mandate Owners: Passive Asset Managers and the Decoupling of Corporate Ownership*, CPI ANTITRUST CHRON., June 2017, at 1, https://www.competitionpolicyinternational.com /wp-content/uploads/2017/06/CPI-Shenkar-Heemskerk-Fichtner.pdf; *see also* Jan Fichtner, Eelke M. Heemskerk & Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298, 299 (2017) (discussing the recent shift from active to passive investment strategies in the United States ("U.S."), dominated by what the authors call "the Big Three" — BlackRock, Vanguard, and State Street — and their effect on shareholder power).

6. Fichtner, Heemskerk & Garcia-Bernardo, *supra* note 5.

will be held by only twelve mutual fund advisers.[7]

This concentration of voting power creates significant value for a mutual fund adviser if it can be traded for something that the adviser wants in return. For example, an adviser may use its voting power to support the activism of current and potential institutional clients in exchange for the ability to acquire more assets under management. Or, an adviser may use its voting power to support the activism of its own shareholders at the advisor's portfolio companies in exchange for those shareholders agreeing not to target the adviser itself for such activism. The result is that an adviser has not cast its delegated voting authority "*in a manner consistent with the best interest of its client*"[8] and has subrogated the "*client interests to its own*,"[9] a breach in its fiduciary duties to its mutual fund clients and its shareholders.

These examples demonstrate a certain type of agency cost, the "proactive" agency costs of agency capitalism.[10] Agency capitalism arises, as it has in the U.S. equity markets, when institutional investors, such as mutual fund advisers, not retail investors who provide the funds, come to dominate the voting of common stock and other voting instruments. According to the publication *Pensions & Investments*, institutional investors currently own approximately eighty percent of the market value of U.S. publicly traded equities.[11] This compares to approximately six percent in 1950.[12] Agency

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7. John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve*, SSRN (Sept. 20, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3247337 (referencing the "Problem of Twelve" which means that twelve individuals will hold voting power over U.S. companies).

8. Proxy Voting by Investment Advisers, *supra* note 1 (emphasis added).

9. *Id.* (emphasis added).

10. While this is the first paper where these agency costs of agency capitalism are defined as being "proactive," I do discuss, without definition, this particular type of agency cost in several blog posts. *See* Bernard S. Sharfman, *Mutual Fund Advisors' "Empty Voting" Raises New Governance Issues*, COLUM. L. SCH.: BLUE SKY BLOG (July 3, 2017), http://clsbluesky.law.columbia.edu/2017/07/03/mutual-fund-advisors-empty-voting-raises-new-governance-issues/ [hereinafter *Empty Voting*]; Bernard S. Sharfman, *On Governance: The First Critique of the 'Framework for U.S. Stewardship and Governance*, THE CONF. BOARD CORP. GOVERNANCE CTR. BLOG (Dec. 14, 2017), https://www.conference-board.org/blog/postdetail.cfm?post=6655; Bernard S. Sharfman, *Commentary: Reforming a Broken System*, PENSIONS & INV. (Aug. 27, 2018), http://www.pionline.com/article/20180827/ONLINE/180829997/commentary-reforming-a-broken-system; Bernard S. Sharfman, *The Agency Costs of Agency Capitalism and Corporate Law*, DEL. CORP. AND COM. LITIGATION BLOG (Aug. 29, 2018), https://www.delawarelitigation.com/2018/08/articles/commentary/the-agency-costs-of-agency-capitalism-and-corporate-law/.

11. Charles McGrath, *80% of Equity Market Cap Held by Institutions*, PENSIONS & INV. (Apr. 25, 2017), https://www.pionline.com/article/20170425/INTERACTIVE/170429926/80-of-equity-market-cap-held-by-institutions.

12. MATTEO TONELLO & STEPHAN RABIMOV, THE 2010 INSTITUTIONAL INVESTMENT

costs of agency capitalism are generated when an institutional investor utilizes its voting power to satisfy its own preferences (and thereby enhancing the welfare of the institutional investor or its managers) and not the preferences of investors who have provided it with the funds to purchase securities.

The understanding that proactive agency costs of agency capitalism exist is nothing new. For example, the SEC Release, *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies*, the companion release ("Companion Release")[13] to the release implementing the Proxy Voting Rule, recognized the agency costs generated when mutual fund advisers are reluctant to vote against a company's management for fear of losing the company's retirement business.[14] Even though it was not labeled as such, this type of agency cost falls in the proactive category.

Articles by Gilson and Gordon and by Bebchuk, Cohen, and Hirst also focus on the economic disincentives mutual fund advisers have in becoming informed prior to voting their proxies.[15] These can be referred to as the "passive" agency costs of agency capitalism. Therefore, this Article is distinguished from those articles by its recognition of additional types of agency costs of agency capitalism that fall into the "proactive" category, as well as the use of the term "proactive," and by categorizing the agency costs generated by the economic disincentives that discourage mutual fund advisers from becoming sufficiently informed voters as falling in the "passive" category.

This Article does not address the "passive" agency costs of agency capitalism or the agency costs traditionally associated with public companies.[16] Instead, the focus of this Article is only on the "proactive"

REPORT: TRENDS IN ASSET ALLOCATION AND PORTFOLIO COMPOSITION 22 TBL.10 (2010).

13. Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Investment Company Act Release No. IC-25922 (Jan. 31, 2003), 68 Fed. Reg. 6564 (Feb. 7, 2003) [hereinafter Disclosure of Proxy Voting Policies], https://www.sec.gov/rules/final/33-8188.htm (accompanying the release on the proxy voting rule).

14. *See* discussion *infra*, Section II.

15. *See* Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 95 (2017); Ronald J. Gilson & Jeffrey N. Gordon, *Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 889–95 (2013).

16. *See* Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 775 (2017) ("[T]he 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."); *see also* Paul Rose, *Common Agency and the Public Corporation*, 63 VAND. L. REV. 1355, 1361

agency costs generated by mutual fund advisers that hold large concentrations of delegated voting power. These are the agency costs that the SEC can help mitigate.

To combat the proactive agency costs of agency capitalism, the Commission should provide clarification that mutual fund advisers must disclose how they will deal with these new conflicts in their voting policies, consistent with their fiduciary duties to act in the best interests of their mutual fund clients and their shareholders. In addition, shareholder proposals are a prime area where this opportunistic use of an adviser's voting power may be in play. Therefore, the adviser's voting policy must also explain how voting on these proposals are linked to maximizing shareholder value.

Furthermore, the Commission should clarify that voting inconsistent with these new policies and procedures or omission of such policies and procedures will be considered a breach of the Proxy Voting Rule.[17] Such guidance should apply to any mutual fund adviser that is delegated voting authority. I urge the SEC to be diligent in enforcing breaches of the Proxy Voting Rule.

Finally, this article shares much of the same textual language with the October 8, 2018 comment letter I wrote to the Commission's staff roundtable on the proxy process.[18] Given that the reader has been provided this

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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)) ("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 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 1361–62 (citations omitted) (explaining that these agency costs are the province of corporate law and its fiduciary requirements).

17. Proxy Voting by Investment Advisers, *supra* note 1 (emphasis added).

18. Letter from Bernard S. Sharfman to Mr. Brent J. Fields, Sec'y, Sec. & Exch. Comm'n (Oct. 8, 2018), https://www.sec.gov/comments/4-725/4725-4555147-176184.pdf. I also wrote three other comment letters to the SEC's staff roundtable on the proxy process in the fall of 2018, and all four comment letters focused on the fiduciary duties required of institutional investors who are regulated under the authority of the Investment Advisers Act of 1940 ("Advisers Act") by virtue of being defined as investment advisers. *See* Letter from Bernard S. Sharfman to Mr. Brent J. Fields, Sec'y, Sec. and Exch. Comm'n (Oct. 12, 2018), https://www.sec.gov/comments/4-725/4725-4513625-175932.pdf, *reprinted in* HARV. L. SCH. FOR. ON CORP. GOVERNANCE AND FIN. REG. (Nov. 2, 2018), https://corpgov.law.harvard.edu/2018/11/02/comment-letter-in-advance-of-sec-staff-roundtable-on-the-proxy-process/; Letter from Bernard S. Sharfman to Mr. Brent J. Fields, Sec'y, Sec. and Exch. Comm'n (Nov. 27, 2018), https://www.sec.gov/co

knowledge upfront, I do not believe it is necessary to continuously footnote quotes and cites from this comment letter.

Part II of the Article discusses the Proxy Voting Rule and the fiduciary duties of mutual fund advisers when voting their proxies. Part III discusses how the SEC has historically dealt with the proactive agency costs of agency capitalism. Part IV describes the ever-increasing voting power of mutual fund advisers, how it may lead to proactive agency costs of agency capitalism, and what the SEC can do to mitigate them.

II. THE PROXY VOTING RULE AND FIDUCIARY DUTIES

The Proxy Voting Rule requires mutual fund advisers, as registered investment advisers who have been delegated shareholder voting authority, to create and disclose their proxy voting policies and records:

> If you are an investment adviser registered or required to be registered under section 203 of the Act, it is a fraudulent, deceptive, or manipulative act, practice or course of business within the meaning of section 206(4) of the Act, for you to exercise voting authority with respect to client securities, unless you:
>
> (a) Adopt and implement written policies and procedures that are reasonably designed to ensure that you vote client securities in the *best interest of clients*, which procedures must include how you address *material conflicts* that may arise between your interests and those of your clients;
>
> (b) Disclose to clients how they may obtain information from you about how you voted with respect to their securities; and
>
> (c) Describe to clients your proxy voting policies and procedures and, upon request, furnish a copy of the policies and procedures to the requesting client.[19]

This rule rests on two important premises. First, under the holding in *SEC v. Capital Gains Research Bureau, Inc.*,[20] the Investment Advisers Act of 1940 ("Advisers Act") imposes a fiduciary duty on investment advisers, including mutual fund advisers.[21] Second, the objective of this fiduciary duty

mments/4-725/4725-4684881-176574.pdf; Letter from Bernard S. Sharfman to Mr. Brent J. Fields, Sec'y, Sec. and Exch. Comm'n (Dec. 17, 2018), https://www.sec.gov/comments/4-725/4725-4780983-176889.pdf. However, while the first targeted the fiduciary duties of mutual fund advisers when voting client securities, the last three focused on the fiduciary duties of proxy advisers, namely Institutional Shareholder Services and Glass Lewis.

19. 17 C.F.R. § 275.206(4)-6 (2018) (emphasis added) (citations omitted).

20. 375 U.S. 180 (1963).

21. *See also* Transamerica Mtg. Advisors, Inc. v. Lewis, 444 U.S. 11, 17–18 (1979) ("As we have previously recognized, § 206 establishes 'federal fiduciary standards' to govern the conduct of investment advisers Indeed, the Act's legislative history leaves no

is shareholder wealth maximization.

A. The Fiduciary Duty of Mutual Fund Advisers

As stated in the Release, "[u]nder the Advisers Act . . . 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."[22] Moreover, "[t]o 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* <u>*subrogate*</u> *client interests to its own*."[23] This fiduciary duty extends to the shareholders of mutual funds:

> The investment adviser to a mutual fund is a fiduciary that owes the fund a duty of utmost good faith, and full and fair disclosure. This fiduciary duty extends to all functions undertaken on the fund's behalf, including the *voting of proxies* relating to the fund's portfolio securities. An investment adviser voting proxies on behalf of a fund, therefore, must do so in a manner consistent with the best interests of the fund and its shareholders.[24]

B. Shareholder Wealth Maximization is the Objective of the Fiduciary Duty

Second, the objective of this fiduciary duty is wealth maximization. According to the Companion Release, "the amendments [regarding proxy voting disclosure] will provide better information to investors who wish to determine: . . . whether their existing fund managers are *adequately maximizing the value of their shares*."[25] This release also noted that "proxy voting decisions may play an important role in maximizing the value of a fund's investments for its shareholders," and can have "an enormous impact on the financial livelihood of millions of Americans."[26] In sum, the

doubt that Congress intended to impose enforceable fiduciary obligations.").

22. Proxy Voting by Investment Advisers, *supra* note 1; *see* SEC Staff Legal Bulletin No. 20 (IM/CF) (June 30, 2014) [hereinafter SEC Staff Legal Bulletin No. 20], https://www.sec.gov/interps/legal/cfslb20.htm (reaffirming the fiduciary approach from the final rule on proxy voting); Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, Investment Advisers Act Release No. IA-4889 (Apr. 18, 2018), 83 Fed. Reg. 21203 (May 9, 2018), https://www.sec.gov/rules/proposed/2018/ia-4889.pdf.

23. Proxy Voting by Investment Advisers, *supra* note 1 (emphasis added).

24. Disclosure of Proxy Voting Policies, *supra* note 13.

25. *Id.* (emphasis added) (Investment Advisers Act Release No. IA-2106 and Investment Company Act Release No. 25922 were published as companion pieces in the Federal Register).

26. Disclosure of Proxy Voting Policies, *supra* note 13.

requirement of shareholder wealth maximization does not stop with portfolio management, it also must be adhered to when a mutual fund adviser votes the shares it has been delegated.

This objective is also consistent with the premise that the overwhelming majority of investors, including retail investors, simply want to earn the highest risk adjusted financial return possible,[27] including when they vote or have votes cast by investment advisers. Moreover, I believe this desire to earn the highest risk adjusted financial return possible is also shared by the overwhelming number of socially motivated investors who align their investments based on their moral or social values,[28] even though they give up some risk-adjusted return in terms of portfolio diversification and the possibility of losing out on the returns generated by those finite number of high performing stocks that allow the stock market to earn returns above Treasury rates[29] and may pay higher management fees for this customization. That is, these investors are willing to exclude certain stocks from their portfolios because they find them to be socially undesirable, but are still

27. Paul Brest, Ronald Gilson & Mark Wolfson, *How Investors Can (and Can't) Create Social Value*, STAN. SOC. INNOVATION REV. (Dec. 8, 2016), https://ssir.org/up_for_debate/article/how_investors_can_and_cant_create_social_value; *see also* George David Banks & Bernard Sharfman, *Standing Up for the Retail Investor*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (June 10, 2018), https://corpgov.law.harvard.edu/2018/06/10/standing-up-for-the-retail-investor/ (explaining the new advocacy group, Main Street Investors Coalition, which aims to "reunite voting rights with those who actually take the economic risk, the retail investor").

28. *See* Brest, Gilson & Wolfson, *supra* note 27 ("Socially motivated investors who seek value alignment would prefer to own stocks only in companies that act in accordance with their moral or social values. Independent of having any effect on the company's behavior, these investors may wish to affirmatively express their identities by owning stock in what they deem to be a good company, or to avoid "dirty hands" or complicity by refusing to own stock in what they deem to be a bad company. Value-aligned investors may be concerned with a firm's outputs — its products and services; for example, they might want to own stock in a solar power company or avoid owning shares in a cigarette company. Or the investors may be concerned with a firm's practices — the way it produces its outputs; they might want to own stock in companies that meet high environmental, social, and governance (ESG) standards, and eschew companies with poor ESG ratings. To achieve their goals, value-aligned investors must only examine their personal values and then learn whether the company's behavior promotes or conflicts with those values.").

29. Hendrik Bessembinder, *Do Stocks Outperform Treasury Bills?*, 129 J. FIN. ECON. 440, 440 (2018). Bessembinder observed that there is a significant amount of positive skewness in the returns of individual public companies that have made up the stock market from July 1926 to December 2016. He found that "in terms of lifetime dollar wealth creation the best-performing 4% of listed companies explain the net gain for the entire US stock market since 1926, as other stocks collectively matched Treasury bills." *Id.* at 440, 454, tbl.5 (defining wealth creation as "accumulated December 2016 value in excess of the outcome that would have been obtained if the invested capital had earned one-month Treasury bill returns").

looking for the highest risk adjusted return possible given their investment constraints.

It also must be noted that this objective is consistent with corporate law's 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."[30]

Finally, shareholder wealth maximization as the objective of shareholder voting is also consistent with the rationale for why profit making companies create so much value for society. As SEC Commissioner Peirce reminds us in a recent speech at the University of Michigan Law School:

> The hunt for profit drives companies to strive to identify and meet people's needs using as few resources as possible. Companies communicate with their customers and suppliers through the price system. People tell companies what they value when they pay for the products and services those companies offer. Suppliers, by raising or lowering prices, tell companies how valuable the resources are that the companies use. Companies respond to what their customers and suppliers tell them. In this way, companies help to ensure that people spend their time wisely and that resources are used for the things society values most. Companies combine the diverse and complementary talents of their employees to research, develop, explore, produce, sell, and provide services to willing customers. In these activities, corporations play an important role in expanding scientific and technological knowledge, enabling people to profit from their hard work, and ensuring that society's resources are allocated to the uses we most value.[31]

III. THE SEC AND THE PROACTIVE AGENCY COSTS OF AGENCY CAPITALISM

The Release and the Companion Release, with its particular emphasis on mutual fund advisers, were promulgated in 2003 to address concerns that an investment adviser may vote its own preferences, not the preferences of its funds and their shareholders. If that were to occur, then an adviser would be in breach of its fiduciary duties and shareholder wealth maximization may not occur. In what fact patterns would this happen?

In the Companion Release, the SEC focused on the concern that mutual

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30. 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).

31. Hester M. Peirce, Comm'r, U.S. Sec. & Exch. Comm'n, Wolves and Wolverines: Remarks at the University of Michigan Law School (Sept. 24, 2018), https://www.sec.gov/news/speech/speech-peirce-092418.

fund advisers would, in some situations, be reluctant to vote against management for fear that doing so would "threaten their ability to retain that company as a client for corporate retirement fund assets."[32] As stated in the Companion Release:

> [I]n some situations the interests of a mutual fund's shareholders may conflict with those of its investment adviser with respect to proxy voting. This may occur, for example, when a fund's adviser also manages or seeks to manage the retirement plan assets of a company whose securities are held by the fund. In these situations, a fund's adviser may have an incentive to support management recommendations to further its business interests.[33]

For example, in an op-ed piece in the *Wall Street Journal*, Todd Henderson and Dorothy Shapiro Lund discuss how an activist hedge fund, acting with the support of the two leading proxy advisors, was allegedly impeded in moving forward on its proxy contest because several large mutual fund advisers balked at voting to support the hedge fund's director nominees for fear of losing the company's retirement fund business.[34] This type of conflict of interest, a classic example of the agency costs that can be generated by mutual fund advisers, has been well documented and, according to Cvijanović, Dasgupta, and Zachariadis, appears to persist despite the implementation of the Proxy Voting Rule.[35] Thus, as far back as 2003, the SEC had recognized a type of proactive agency cost of agency capitalism but without identifying it as such.

Another type of conflict noted in the Release, and the one most relevant to the discussion below, is where "[t]he adviser may also have business or personal relationships with other proponents of proxy proposals, participants in proxy contests, corporate directors or candidates for directorships."[36] For example, such a conflict may exist where "the adviser may manage money for an employee group."[37]

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32. M. Todd Henderson & Dorothy Shapiro Lund, *Index Funds Are Great for Investors, Risky for Corporate Governance*, WALL STREET J. (June 23, 2017, 6:30 PM), https://www.wsj.com/articles/index-funds-are-great-for-investors-risky-for-corporate-governance-1498170623.

33. Disclosure of Proxy Voting Policies, *supra* note 13; *see also* Bebchuk, Cohen & Hirst, *supra* note 15 ("[T]he agency problems of institutional investors can be expected to lead them to . . . side excessively with corporate managers . . . .").

34. Henderson & Lund, *supra* note 32.

35. Dragana Cvijanović, Amil Dasgupta & Konstantinos E. Zachariadis, *Ties That Bind: How Business Connections Affect Mutual Fund Activism*, 71 J. FIN. 2933, 2934 (2016).

36. Proxy Voting by Investment Advisers, *supra* note 1.

37. *Id.* at n.4.

Such a conflict was described in the SEC's enforcement case against INTECH.[38] Here, the registered investment adviser, INTECH Investment Management LLC, had initially voted its proxies based on an Institutional Shareholder Services recommendation platform that was purposely designed to side with management. Between 2003 and 2006, INTECH moved to a different ISS recommendation platform that followed the voting recommendations of the AFL-CIO.[39] According to footnote 3 of the SEC's order instituting proceedings, such voting recommendations intended to promote a "position that is consistent with the long-term economic best interests of plan members embodied in the principle of a worker-owner view of value."[40] Apparently, this approach was significantly different than the one taken in the original recommendation platform.

INTECH switched to this new platform in order "to retain and obtain business from existing and prospective union-affiliated clients."[41] Soon after, some of INTECH's original clients started making inquiries regarding the higher number of votes against management on shareholder proposals.[42]

INTECH made the switch in voting platforms without having any written procedures or policies that addressed material potential conflicts between INTECH's interests in seeking more union-affiliated clients and those of its clients who did not favor the AFL-CIO.[43] By doing so, it had subrogated its client interests to its own, a breach in its fiduciary duty of loyalty. Therefore, this was a clear violation of the Proxy Voting Rule. INTECH paid a civil penalty of $300,000.[44]

Most importantly, this is an example of how the SEC has recognized another type of proactive agency cost of agency capitalism and has taken action to mitigate it. However, there are more proactive agency costs to be dealt with and most likely more SEC enforcement actions to be initiated.

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38. Order Instituting Administrative Cease-and-Desist Proceedings Pursuant to Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940, Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order, File No. 3-13463 (May 7, 2009), http://www.sec.gov/litigation/admin/2009/ia-2872.pdf.

39. *Id.* at 2.

40. *Id.* at 4 n.3.

41. *Id.* at 2.

42. *Id.* at 4.

43. *Id.* at 4–5.

44. *Id.* at 7; *see SEC Brings Second Case Alleging Improper Proxy Voting by an Adviser*, ROPES & GRAY (May 20, 2009), https://www.ropesgray.com/-/media/Files/alerts/2009/05/sec-brings-second-case-alleging-improper-proxy-voting-by-an-adviser.pdf (an excellent discussion of the INTECH settlement).

IV. THE EVER-INCREASING VOTING POWER OF MUTUAL FUND ADVISERS AND PROACTIVE AGENCY COSTS OF AGENCY CAPITALISM

This Part describes the ever-increasing voting power of mutual fund advisers, how it may lead to proactive agency costs of agency capitalism, and what the SEC can do to mitigate them.

A. The Increasing Voting Power of Mutual Fund Advisers

Of course, the world has changed since the Proxy Voting Rule first went into effect in 2003. Currently, an unprecedented concentration of voting power now resides in the hands of our largest mutual fund advisers. For example, BlackRock, Vanguard, and State Street Global Advisors ("the Big Three") now control enormous amounts of proxy voting power without having any economic interest in the shares they vote. According to Shenkar, Heemskerk, and Fichtner, this concentration of voting power was and is being caused by a large shift from actively managed equity funds to equity index funds:

> In contrast to the fragmented and sizeable group of actively managed mutual funds, the fast-growing index fund sector is highly concentrated. It is dominated by just three giant U.S. asset managers: BlackRock, Vanguard and State Street – what we call the "Big Three." Together they stand for a stunning seventy-one percent of the entire Exchange Traded Fund (ETF) market and manage over ninety percent of all Assets under Management . . . in passive equity funds. As a consequence of this leading role in the market for passive investment, the Big Three have become dominant shareholders. Seen together, the Big Three are the largest single shareholder in almost ninety percent of all S&P 500 firms, including Apple, Microsoft, ExxonMobil, General Electric and Coca-Cola. Such concentration of corporate ownership is remarkable and may not have been seen since the days of the Gilded Age.[45]

This new concentration of voting power originated in the industry practice of centralizing mutual funds' votes into the hands of their advisor's corporate governance department. In essence, not only would portfolio management be delegated to the mutual fund adviser, but also the voting of proxies. I refer to this as the "empty voting of mutual fund advisers."[46] That is, they have the voting rights but not the economic interest in the underlying shares.

This low cost approach to proxy voting was innocuous enough when proxy voting was not concentrated. However, as the market share of equity index funds has grown, this empty voting has given rise to an *unintended*

45. *See* Shenkar, Heemskerk & Fichtner, *supra* note 5.

46. *Empty Voting*, *supra* note 10.

consequence.[47] The Big Three now control, without having any economic interest in the underlying shares, the voting rights associated with trillions of dollars' worth of equity securities. For example, as of December 31, 2017, BlackRock had over $6.3 trillion of assets under management, with almost $3.4 trillion of those assets being equity securities.[48] This represents an astonishing amount of voting control. Therefore, at many public companies, the respective corporate governance departments of the Big Three, as well as other large mutual fund advisers, may now control the fate of a shareholder or management proposal, whether a nominated director receives a required majority of votes to remain on the board of directors, or if a proxy contest succeeds or fails.

B. The Courting of Public Pension Fund Assets

Such a concentration of power always brings with it the potential for abuse. It is easy to envision scenarios where this voting power can generate significant value for the advisor if it decided to vote in a certain way, whether or not it is in the best interests of its clients to do so. In essence, the large mutual fund adviser will be tempted to breach its fiduciary duties and monetize or take special advantage of the delegated voting power it has accumulated.

One scenario where a large mutual fund adviser may be tempted to monetize its newly found voting power is to vote in unison with public pension and union-related funds, such as on shareholder proposals these funds initiate or promote, if the vote will lead to bringing more assets under management. Public pension funds control approximately $4.3 trillion in assets,[49] a prime target for a mutual fund adviser looking to increase the size of its mutual funds, especially its equity index funds. Since the objective of an index fund is not to beat the market, but simply to match it, increasing profitability through increased assets under management is a critical business strategy for the adviser.

Public pension funds and union-related funds are leaders in the shareholder empowerment movement. This form of shareholder activism

47. Bernard S. Sharfman, *Dual Class Share Voting versus the "Empty Voting" of Mutual Fund Advisors'*, CONF. BOARD CORP. GOVERNANCE BLOG (July 2, 2018), https://www.conference-board.org/blog/postdetail.cfm?post=6812&blogid=8.

48. BLACKROCK, INC., BLACKROCK 2017 ANNUAL REPORT 2, http://ir.blackrock.com/Cache/1500109547.PDF?O=PDF&T=&Y=&D=&FID=1500109547&iid=4048287.

49. *Public Pension Fund Assets: Quarterly Update (Q2 2018)*, NAT'L ASS'N OF ST. RETIREMENT ADMINS., https://www.nasra.org/content.asp?contentid=200 (on file with author).

advocates shifting corporate decision-making authority to shareholders, and thus away from boards of directors and executive management, and arguably without regard to the impact on the value of a public company's stock. That is, satisfaction with company performance does not factor into the decision to support a proposal that shifts decision making away from the board of directors.

For example, consider the shareholder empowerment movement's take-no-prisoners approach to dual class share structures even though these structures have been successfully used by companies such as Berkshire Hathaway, Facebook, Comcast, Nike, and Alphabet (Google).[50] Such zealous advocacy should not be a surprise since dual class shares are an obvious threat to the movement's power. As I have previously observed, "the more public companies that utilize a dual-class share structure, the more controlled companies exist and the less power the movement has."[51] Or, as another example, the New York City Public Pension Funds' crusade to implement proxy access at all public companies without regard to an individual company's performance.[52]

Incidentally, based on their 2018 voting guidelines,[53] the Big Three unanimously support a standardized form of proxy access and equal voting rights. This should be no surprise as it is consistent with their own preferences for retaining or increasing their public pension and union-related funds business.

Shareholder empowerment reflects an agreement with the following theory as articulated by Delaware Supreme Court Chief Justice Leo Strine:

> [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

50. Bernard S. Sharfman, *A Private Ordering Defense of a Company's Right to Use Dual Class Share Structures in IPOs*, 63 VILL. L. REV. 1, 2 (2018).

51. Bernard Sharfman, *Dual-class Shares and the Shareholder Empowerment Movement*, R STREET INST. BLOG (June 12, 2017), https://www.rstreet.org/2017/06/12/dual-class-shares-and-the-shareholder-empowerment-movement/.

52. Press Release, City of N.Y., Office of Comptroller, Comptroller Stringer, NYC Funds: After Three Years of Advocacy, "Proxy Access" Now Close to a Market Standard, (Jan. 30, 2018), https://comptroller.nyc.gov/newsroom/comptroller-stringer-nyc-funds-after-three-years-of-advocacy-proxy-access-now-close-to-a-market-standard/.

53. STATE STREET GLOBAL ADVISORS, PROXY VOTING AND ENGAGEMENT GUIDELINES NORTH AMERICA (UNITED STATES & CANADA) 4 (Mar. 2018), https://www.ssga.com/our-insights/viewpoints/2018-proxy-voting-and-engagement-guidelines-north-america.html; BLACKROCK, INC., PROXY VOTING GUIDELINES FOR U.S. SECURITIES 8 (Feb. 2018); *Policies and Guidelines*, VANGUARD, https://about.vanguard.com/investment-stewardship/policies-and-guidelines/ (discussing proxy voting).

> 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.[54]

Such a theory ignores the continued need for the decision-making authority of the board of directors, as the most informed locus of authority in a corporation, to take precedence over the accountability that can be provided by the agents of investors, institutional shareholders such as mutual fund advisers, through their ability to vote and engage on corporate matters. As I have stated in the past, "corporate law concentrates decision-making authority in the Board because it recognizes that a centralized, hierarchical authority is necessary for the successful management of a corporation, especially if it is a public company."[55] This is the only way that shareholder wealth maximization can be achieved.

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."[56] For example, it may or may not include such corporate governance arrangements as dual class shares (with or without time-based sunset provisions),[57] 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."[58]

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54. Chief Judge 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).

55. Bernard S. Sharfman, *Activist Hedge Funds in a World of Board Independence: Creators or Destroyers of Long – Term Value?*, 2015 COLUM. BUS. L. REV. 813, 821 (2015).

56. David Larcker et al., *The Market Reaction to Corporate Governance Regulation*, 101 J. FIN. ECON. 431, 431 (2011) (emphasis added).

57. *See* Letter from Bernard S. Sharfman to Elizabeth King, Chief Regulatory Officer, Intercontinental Exch. Inc. (Mar. 21, 2019); Letter from Bernard S. Sharfman to John Zecca, Senior Vice President, Gen. Counsel, N. Am. & Chief Regulatory Officer, NASDAQ Stock Mkt. (Mar. 21, 2019). Both letters are reprinted in full at Bernard S. Sharfman, *Comment Letters to Nasdaq and NYSE: Time-Based Sunsets and the Problem of Early Unifications of Dual Class Share Structures*, SSRN (Mar. 21, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3352177.

58. Troy A. Paredes, Comm'r, U.S. Sec. & Exch. Comm'n, Statement at Open

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." When a mutual fund adviser adopts voting policies that include sub-optimal private ordering, whether or not they are inspired by a desire to retain or increase assets under management, it is a breach of its fiduciary duty under the Proxy Voting Rule. That is, the breach is a result of a failure to disclose how such voting policies adequately maximize the wealth of its mutual fund clients and their shareholders.[59]

Recommendation: Consistent with the Proxy Voting Rule's requirement that mutual fund advisers vote their proxies in the *best interests* of their clients, mutual fund advisers who have obtained concentrated voting power due to the delegation of voting authority, must disclose in their voting policies the *procedures* they will use to eliminate the temptation to use their delegated voting power to retain or acquire more public pension and union-related fund assets under management.

C. Appeasing the Mutual Fund Adviser's Own Shareholder Activists

A mutual fund adviser may also utilize its delegated voting power to appease shareholder activists who attack the business decisions, procedures, and objectives of the adviser's management. For example, in early 2017, both BlackRock[60] and Vanguard (two of its equity funds received the proposals, 500 Index Fund and Total Stock Market Index Fund)[61] "received shareholder resolutions from Walden Asset Management requesting a review of their proxy voting policies and practices related to climate change."[62] Yet, the clear intent of the proposals was not just to review, but to encourage the advisers to be a stronger supporter of climate change proposals. According to the language in both proposals:

Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations (May 20, 2009), http://www.sec.gov/news/speech/2009/spch052009tap.htm (emphasis added).

59. *See supra* text accompanying notes 27–32.

60. *Review and Report on ESG Proxy Voting (BLK, 2017 Resolution)*, CERES, https://engagements.ceres.org/ceres_engagementdetailpage?recID=a0l12000005OdxTAAS [hereinafter BlackRock Report] (filed by Walden Asset Management).

61. Vanguard Funds, Preliminary Proxy Statement (Schedule 14A), at 2–3 (Aug. 21, 2017), https://www.sec.gov/Archives/edgar/data/34066/000093247117004594/pre14aproxystatement.htm [hereinafter Vanguard Proxy Statement].

62. Rob Berridge, *Four Mutual Fund Giants Begin to Address Climate Change Risks in Proxy Votes: How About Your Funds?*, CERES (Dec. 21, 2017), https://www.ceres.org/news-center/blog/four-mutual-fund-giants-begin-address-climate-change-risks-proxy-votes-how-about.

> Vanguard [BlackRock] is a prestigious member of the Principles for Responsible Investment (PRI) a global network of investors and asset owners representing more than $62 trillion in assets. One of the Principles encourages investors to vote conscientiously on ESG issues.[63]
>
> Yet Vanguard [BlackRock] funds' publicly reported proxy voting records reveals [sic] consistent votes against all climate related resolutions (except the few supported by management), such as requests for enhanced disclosure or adoption of greenhouse gas reduction goals, even when independent experts advance a strong business and economic case for support.[64]

As worded, the submitted proposals were intended to dictate to both BlackRock and Vanguard how they were to fulfill their fiduciary duties under the Proxy Voting Rule.

It appears that the tactic worked. Walden Asset Management withdrew both proposals in return for commitments by the companies to address the request.[65] Moreover, both companies started to support 2-Degree Scenario Proposals, something neither company did prior to 2017.

Coincidentally or not, subsequent to the agreement with Walden Asset Management, both companies had the exact same record on 2-Degree Scenario Proposals. In 2017, both BlackRock and Vanguard voted in favor of 2-Degree Scenario proposals at ExxonMobil and Occidental (both proposals received majority support[66]), while voting against 2-Degree Scenario proposals at twelve other companies.[67]

It is important to point out just how valuable the voting power of these two advisers are to climate change activists and why it should be expected that the Big Three will continue to use their power to maintain peace with climate change activists who are also shareholders. According to a 50/50 Climate Project report, if BlackRock had voted 100% of their mutual fund shares in support of the twelve other 2-Degree Scenario proposals, even without Vanguard's, ten of the twelve rejected proposals would have received majority support.[68] If Vanguard had done the same, even without BlackRock's support, eight out of twelve additional proposals would have

63. BlackRock Report, *supra* note 60.

64. Vanguard Proxy Statement, *supra* note 61 (showing Walden Asset Management's identical proposals for both Vanguard and BlackRock).

65. Berridge, *supra* note 62.

66. *Id.*

67. MARKA PETERSON, JIM BAKER & KIMBERLY GLADMAN, ASSET MANAGERS AND CLIMATE-RELATED SHAREHOLDER PROPOSALS: REPORT ON KEY CLIMATE VOTES, THE 50/50 CLIMATE PROJECT 14, 19 (Mar. 2018), https://5050climate.org/wp-content/uploads/2018/03/AM-Report-3-13-FINAL.pdf.

68. *Id.* at 14.

received majority support.[69]

In sum, this is another scenario where a mutual fund adviser may be tempted to trade its voting power for something that would be of value to it, no matter how it impinges on the fiduciary duties it owes to its mutual fund clients and their shareholders. Here, activists imbedded in an adviser's shareholder base are telling the adviser how to go about implementing its fiduciary duty under the Investment Advisers Act of 1940 and the Proxy Voting Rule.

Recommendation: Mutual fund advisers must disclose how they will eliminate the pressures placed on them by their own shareholders when voting their proxies. Such pressures deserve the creation of a wall that needs to be disclosed pursuant to the Proxy Voting Rule. Such a wall will allow them to fulfill the fiduciary duties they owe their clients.

D. Voting Policies on Shareholder Proposals and Wealth Maximization

Shareholder proposals provide a significant opportunity for mutual fund advisers to abuse their voting power for purposes other than shareholder wealth maximization. In 2017, at least 911 shareholder proposals were submitted to public companies for voting at their annual meetings.[70] Of these, at least 502 went to a vote.[71]

Unfortunately, many of these proposals have nothing to do with shareholder wealth maximization and may ultimately end up having a negative impact. A recent study by Kalt and Turki found that the adoption of climate change resolutions "has no statistically significant impact on company returns one way or the other."[72] They also found that this result should not be surprising:

> [T]here is no general expectation that corporate managers have special abilities in predicting tastes, preferences, voting behavior, and/or institutional capabilities across a wide and varied number of independent political actors operating within independently acting nations across the globe. Under such conditions, resolutions that, for example, compel disclosure of outcomes under particular political scenarios (e.g., the

69. *Id.* at 20.

70. E-mail from Sebastian V. Niles, Partner, Wachtell, Lipton, Rosen & Katz, to Bernard S. Sharfman (June 22, 2018, 11:22 EST) (on file with author).

71. *Id.*

72. JOSEPH P. KALT ET AL., POLITICAL, SOCIAL, AND ENVIRONMENTAL SHAREHOLDER RESOLUTIONS: DO THEY CREATE OR DESTROY SHAREHOLDER VALUE? 3 (June 2018), MAINSTREET INVESTORS, https://mainstreetinvestors.org/wp-content/uploads/2018/06/ESG-Paper-FINAL.pdf.

> political paths that might put the world on a trajectory to achieve a goal such as the "not more than 2 degrees temperature rise" goal that came out of the Paris climate accords in 2015) do not add materially to the information already available to investors from other sources. As such, they cannot be expected to add to shareholder value.[73]

Matsusaka, Ozbas, and Yi found that labor unions use shareholder proposals as bargaining chips to extract side payments from management.[74] Matsusaka, Ozbas, and Yi, in a separate paper, found that the stock market reacted positively when the SEC permitted shareholder proposals to be excluded.[75]

Moreover, it is not difficult to assume that shareholder proposals that deal with human rights, political contributions, lobbying disclosure, greenhouse gas emissions, climate change, etc. are most likely not submitted for purposes of shareholder wealth maximization. This is something that activists most likely understand from the outset. Instead, the submission of such proposals is to try and resolve issues of national and international importance through shareholder activism, not the political process.

I do not mean to say that such issues are not extremely important to all of us. However, submitting shareholder proposals is not the way to solve them. According to Kalt and Turki,

> None of this is to say that we should not be extremely concerned about such issues as global climate change, human trafficking, cybersecurity, and the like. Effectively dealing with such problems, however, will require that wise public policy measures be taken across a wide swath of the world's nations. While frustration with slow progress on this front is

73. *Id.* at 3–4.

74. John G. Matsusaka, Oguzhan Ozbas & Irene Yi, *Opportunistic Proposals by Union Shareholders* (Marshall Sch. of Bus., Working Paper No. 17-3, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2666064 ("We find that in contract expiration years compared to nonexpiration years, unions increase their proposal rate by one fifth, particularly proposals concerning executive compensation, while nonunion shareholders do not increase their proposal rate in expiration years. Union proposals made during expiration years are less likely to be supported by other shareholders or a leading proxy advisor; the market reacts negatively to union proposals in expiration years; and withdrawn union proposals are accompanied with higher wage settlements.").

75. John G. Matsusaka, Oguzhan Ozbas & Irene Yi, *Can Shareholder Proposals Hurt Shareholders? Evidence from SEC No-Action Letter Decisions* (Marshall Sch. of Bus., Working Paper No. 17-7, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2881408 ("We find that over the period 2007–2016, the market reacted positively when the SEC permitted exclusion. Investors appear to have been most skeptical about proposals related to corporate governance and proposals at high profit firms, suggesting that investors believe some proposals can hurt shareholders by disrupting companies that are already performing well. The evidence is compatible with the view that managerial resistance is based on a genuine concern that proposals can harm firm value.").

> understandably accompanied by the desire to 'do something', [sic] doing something effective in such arenas is the task of our political institutions. Shareholder resolutions targeted at prominent corporations is an ineffectual substitute for sound policy making via the political institutions of democracy.[76]

This lack of connection between shareholder proposals and shareholder wealth maximization is an issue that should concern all retail investors. Shareholder proposals, if implemented subsequent to a shareholder vote or prior to through the process of engagement, while perhaps not reducing shareholder wealth, may at best do nothing to enhance it. If so, then wealth maximizing opportunities may be foregone as finite company resources are devoted to responding to and subsequently implementing these proposals.

Recommendation: Mutual fund advisers must disclose in their voting policies the procedures they utilize to identify an actual link between support for a shareholder proposal and the enhancement of shareholder value. This is necessary to make sure that mutual fund advisers are complying with a primary objective of their fiduciary duties: "*adequately maximizing the value of their shares*."[77]

V. CONCLUSION

In 2003, the SEC made the following statement in the Release:

> Investment advisers registered with us have discretionary authority to manage $19 trillion of assets on behalf of their clients, including large holdings in equity securities. In most cases, clients give these advisers authority to vote proxies relating to equity securities. This enormous voting power gives advisers significant ability collectively, and in many cases individually, to affect the outcome of shareholder votes and influence the governance of corporations. Advisers are thus in a position to significantly affect the future of corporations and, as a result, the future value of corporate securities held by their clients.

This is truer today than it was in 2003, and will most likely be truer in 2023, especially in terms of mutual fund advisers and their ability to generate proactive agency costs of agency capitalism.[78] Therefore, the SEC must become more active in helping to mitigate these costs.

In *Transamerica Mortgage Advisors v. Lewis*,[79] the U.S. Supreme Court ruled that clients and their shareholders have no express or implied private right of action under Section 206 of the Investment Advisers Act of 1940. By extension, no private right of action exists under the Proxy Voting Rule.

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76. KALT ET AL., *supra* note 72, at 4.
77. Disclosure of Proxy Voting Policies, *supra* note 13.
78. *See supra* note 8 and accompanying text.
79. 444 U.S. 11 (1979).

Therefore, it is imperative that the Commission clarify the scope of a mutual fund adviser's fiduciary duties under the Proxy Voting Rule as an integral part of the amendments it is considering to the proxy process.

According to Laby, "[b]y adopting rules and prosecuting enforcement actions, . . . the SEC fills in the details of what is required by the fiduciary duties of loyalty and care, and brings uniformity to the industry."[80] Unfortunately, there has been too little guidance provided by the SEC since it implemented the Proxy Voting Rule in 2003. The only guidance is the INTECH enforcement action and a staff legal bulletin: a bulletin that focuses on proxy advisors and does not address the issue of how proxy voting policy disclosures needs to be updated to conform to our current proxy voting environment.[81] An update to the process is long overdue.

In a proxy voting world where voting is dominated by a handful of extremely large investment advisers, the Commission should provide clarification that mutual fund advisers must disclose in their voting policies, consistent with the Proxy Voting Rule's requirement that they vote proxies in the best interests of their clients, the *procedures* they will use to deal with the temptation to use their voting power to retain or acquire more assets under management and to appease activists in their own shareholder base.

In addition, shareholder proposals are a prime area where this opportunistic use of an adviser's voting power may be in play. Therefore, mutual fund advisers must disclose the *procedures* they will use to identify the link between support for a shareholder proposal at a particular company and the enhancement of that company's shareholder value. This is necessary to ensure that that advisers are complying with a primary objective of their fiduciary duties, "*adequately maximizing the value of their shares*."[82]

Finally, consistent with these new disclosures and procedures, the Commission should clarify that voting inconsistent with these new policies and procedures or omission of such policies and procedures will be considered a breach of the Proxy Voting Rule. I urge the SEC to be diligent in enforcing all breaches of the Proxy Voting Rule. While enforcement most clearly applies to the Big Three mutual fund advisers, it should also apply to any investment adviser, large or small, that has delegated voting authority.

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80. ARTHUR B. LABY, THE FIDUCIARY STRUCTURE OF INVESTMENT MANAGEMENT REGULATION, RESEARCH HANDBOOK ON MUTUAL FUNDS (JOHN D. MORLEY & WILLIAM A. BIRDTHISTLE, EDS.) (FORTHCOMING ELGAR PUBLISHING), https://ssrn.com/abstract=2993429.

81. SEC Staff Legal Bulletin No. 20, *supra* note 22.

82. Disclosure of Proxy Voting Policies, *supra* note 13 (emphasis added).

October 15, 2019

Ms. Vanessa Countryman
Secretary, Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

File Number 4-725

RE: Release No. IA-5325 and the Fiduciary Duties of Proxy Advisors

Submitted By: Bernard S. Sharfman[*]

Dear Ms. Countryman,

The SEC's proxy process review[1] has so far led the SEC to approve two separate releases regarding proxy advisors.[2] The focus of this comment letter is on the guidance provided in one of those releases, Release No. IA-5325 (Release). This guidance identifies, under the Investment Advisers Act of 1940 (Advisers Act or Act), a "principles-based fiduciary duty" that requires investment advisers with delegated voting authority to closely monitor the voting recommendations and research provided them by their proxy advisors.[3] This comment letter recommends that the SEC provide additional guidance that recognizes a corresponding "principles-based fiduciary duty" owed by proxy advisors to their clients. This fiduciary duty would arise from the SEC recognizing proxy advisors as investment advisers under the Act. This duty would require proxy advisors to "implement policies and procedures" that result in voting recommendations that are in the *best interest* of their clients, supporting what is required of investment advisers under Release No. IA-5325. The burden of monitoring this new fiduciary duty would fall on the SEC, not the investment advisers. The following provides the argument for this additional guidance.

The Fiduciary Duties of Investment Advisers

In general, an '"investment adviser" means any 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

[*] Bernard S. Sharfman is the Chairman of the Main Street Investors Coalition Advisory Council and a member of the Journal of Corporation Law's editorial advisory board. This writing was supported by a grant provided by the Main Street Investors Coalition. The opinions expressed here are the author's alone and do not represent the official position of any organization with which he is affiliated.

[1] Chairman Jay Clayton, U.S. Securities and Exchange Commission, *Statement Announcing SEC Staff Roundtable on the Proxy Process*, (July 30, 2018), https://www.sec.gov/news/public-statement/statement-announcing-sec-staff-roundtable-proxy-process.

[2] SEC, *Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers*, Release Nos. IA-5325; IC-33605 (August 21, 2019), https://www.sec.gov/rules/interp/2019/ia-5325.pdf and SEC, *Commission Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice*, Release No. 34-86721(August 21, 2019), https://www.sec.gov/rules/interp/2019/34-86721.pdf.

[3] Release No. IA-5325, *supra* note 2, at 8.

compensation and as part of a regular business, *issues or promulgates analyses or reports concerning securities*; ⋯.'"[4]

Section 206 of the Advisers Act establishes "federal fiduciary standards" "to govern the conduct of investment advisers."[5] As stated by the United States Supreme Court in *SEC v. Capital Gains Research Bureau, Inc.*:

> Nor is it necessary in a suit against a fiduciary, which Congress recognized the investment adviser to be, to establish all the elements required in a suit against a party to an arm's-length transaction. Courts have imposed on a fiduciary an affirmative duty of "utmost good faith, and full and fair disclosure of all material facts," "as well as an affirmative obligation "to employ reasonable care to avoid misleading" his clients.[6]

According to the Proxy Voting Rule of 2003,[7] "[u]nder the Advisers Act . . . 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, …."[8] In regard to the duty of care, "an investment adviser's duty of care includes, among other things, the duty to provide advice that is in the best interest of the client."[9] In regard to the duty of loyalty, "an adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship.... In addition, an adviser must eliminate or at least expose through full and fair disclosure all conflicts of interest which might incline an investment adviser─consciously or unconsciously─to render advice which was not disinterested."[10] Moreover, acting in the "best interest" of the client pervades both duties:

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[4] 15 U.S.C. 80b-2(a)(11) (2018).

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

[6] SEC v. Capital Gains, *supra* note 5, at 194. Arthur Laby argues that the identification of federal fiduciary duties under the Advisers Act was based on a misreading of SEC v. Capital Gains. Nevertheless, "The advisers' federal fiduciary duty has become firmly entrenched in the law. The obligation appears in court decisions, SEC enforcement actions, and SEC administrative materials, such as rulemaking releases and decisions by administrative law judges. The principle appears unassailable." *See* Arthur B. Laby, *SEC v. Capital Gains Research Bureau and the Investment Advisers Act of 1940*, 91 B.U. L. REV. 1051, 1078 (2011).

[7] Proxy Voting by Investment Advisers, Investment Advisers Act Release No. IA-2106, 79 SEC Docket 1673 (Jan. 31, 2003) [hereinafter Proxy Voting by Investment Advisers], https://www.sec.gov/rules/final/ia-2106.htm.

[8] *Id.*; *see* SEC Staff Legal Bulletin No. 20 (IM/CF) (June 30, 2014) [hereinafter SEC Staff Legal Bulletin No. 20], https://www.sec.gov/interps/legal/cfslb20.htm (reaffirming the fiduciary approach from the final rule on proxy voting); Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, Investment Advisers Act Release No. IA-4889 (Apr. 18, 2018), 83 Fed. Reg. 21203 (May 9, 2018), https://www.sec.gov/rules/proposed/2018/ia-4889.pdf.

[9] Release No. IA-5325, *supra* note 2, at 4 citing Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248 (June 5, 2019), 84 FR 33669, 33672 (July 12, 2019) [hereinafter, Fiduciary Intrepretation].

[10] *Id.* at 6, n. 20 quoting Fiduciary Interpretation, 84 FR 33669, at 33675-76.

> [I]n our view, the *duty of care* requires an investment adviser to provide investment advice in the *best interest* of its client, based on the client's objectives. Under its *duty of loyalty*, an investment adviser must eliminate or make full and fair disclosure of all conflicts of interest which might incline an investment adviser -- consciously or unconsciously -- to render advice which is not disinterested such that a client can provide informed consent to the conflict. We believe this is another part of an investment adviser's obligation to act in the *best interest* of its client.[11]

The Fiduciary Duties of Investment Advisers and Shareholder Voting

The SEC first recognized that shareholder voting implicates the fiduciary duties of an investment adviser in its Proxy Voting Rule of 2003.[12] In that release the SEC took the position that an investment 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*."[13] Moreover, "To satisfy its fiduciary duty in making any voting determination, the investment adviser must make the determination in the *best interest* of the client and *must not place the investment adviser's own interests ahead of the interests of the client*."[14] For example, "for an investment adviser to form a reasonable belief that its voting determinations are in the best interest of the client, it should conduct an investigation reasonably designed to ensure that the voting determination is not based on materially inaccurate or incomplete information."[15]

Commissioner Elad Roisman, at the August 21, 2019 meeting where the Commission voted 3 to 2 to approve the two new releases, nicely summarized the SEC's approach to shareholder voting when he stated that: "[I] believe it is our job as regulators to help ensure that such advisers vote proxies in a manner consistent with their fiduciary obligations and that the proxy voting advice upon which they rely is complete and based on accurate information."[16]

Recognizing shareholder voting as part of an investor advisor's fiduciary duties followed in the footsteps of the Department of Labor's (DOL) famous "Avon Letter."[17] In the Avon letter, the Pension and Welfare Benefits Administration, the DOL department that preceded the Employee Benefits Security Administration in the administration of ERISA,[18] stated that "In general, the *fiduciary* act of managing plan assets that are shares of corporate stock includes the management of

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[11] Fiduciary Interpretation, *supra* note 9, at 33671.
[12] Proxy Voting by Investment Advisers, *supra* note 7.
[13] *Id.*
[14] Release No. IA-5325, *supra* note 2, at 3.
[15] *Id.* at 4.
[16] 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.
[17] Letter from U.S. Dep't of Labor to Helmuth Fandl, Chairman of Retirement Board, Avon Products, Inc. (Feb. 23, 1988) (Established the current DOL policy that the fiduciary act of managing plan assets also includes managing the voting rights associated with a plan's equity holdings.)
[18] Department of Labor, *History of EBSA and PWBA*, ("Until February 2003, EBSA was known as the Pension and Welfare Benefits Administration (PWBA)"), https://www.dol.gov/agencies/ebsa/about-ebsa/about-us/history-of-ebsa-and-erisa.

voting rights *appurtenant* to those shares of stock."[19] This DOL policy has been affirmed by the DOL in 1990,[20] 1994,[21] 2008,[22] 2016,[23] and 2018.[24]

It should be noted that a policy that includes shareholder voting in the fiduciary duties of investment advisors presumes that significant, not *de minimis*, value will accrue to their clients if an investment adviser, in accordance with her fiduciary duties, properly manages the shareholder voting rights it has been delegated. This value manifests itself in several ways. As argued by Thompson and Edelman, shareholder voting (in general, an uncommon occurrence because corporate decision making is typically delegated to the board of directors and executive management) is most needed when (1) "replacing entrenched directors who are blocking a value-increasing transaction" and (2) "blocking an empire building merger proposed by directors and managers."[25] More generally, "[w]hen 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."[26] But perhaps most importantly:

> 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 potentially subject to the whims of uninformed and/or opportunistic shareholders.[27]

When corporate law provides shareholder voting as a means to send the necessary message to the board that it should be doing its work through the lens of shareholder interests, it is taking a risk that shareholders will either be uninformed or acting opportunistically when they participate in corporate

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[19] *Id.*

[20] Letter from U.S. Dep't of Labor to Robert A.G. Monks, Institutional Shareholder Services, Inc. (Jan. 23, 1990) ("If either the plan or the investment management contract (in the absence of a specific plan provision) expressly precludes the investment manager from voting proxies, the responsibility for such proxy voting would be part of the trustees' exclusive responsibility to manage and control the assets of the plan.").

[21] *See* Department of Labor, *Interpretive bulletin relating to writing statements of investment policy, including proxy voting policy and guidelines*, 59 Fed. Reg. 38863 (July 29, 1994) ("… a statement of proxy voting policy would be an important part of any comprehensive statement of investment policy.").

[22] *See* Department of Labor, *Interpretive Bulletins Relating to the Employee Retirement Income Security Act of 1974*, 73 Fed. Reg. 61,732 (Oct. 17, 2008) ("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.")

[23] *See* Department of Labor, *Interpretive Bulletin Relating to the Exercise of Shareholder Rights and Written Statements of Investment Policy, Including Proxy Voting Policies or Guidelines*, 81 Fed. Reg. 95879 (Dec. 29, 2016) ("The Department's longstanding position is that the fiduciary act of managing plan assets which are shares of corporate stock includes decisions on the voting of proxies….").

[24] Department of Labor, Field Assistance Bulletin 2018-01 (April 23, 2018), https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-01.

[25] Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. 129, 132 (2009).

[26] Bernard S. Sharfman, *Enhancing the Value of Shareholder Voting Recommendations*, TENN. L. REV. (forthcoming, 2020) at 3, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3305372.

[27] *Id.* at 5.

decision making through voting. Such voting can create havoc in a firm and lead to a significant reduction in shareholder wealth and a corresponding drop in the value of a client's equity holdings. However, the voting recommendations and research of proxy advisors, if informed, unbiased, and sufficiently precise can help rectify this situation.

The Fiduciary Duties of Investment Advisers Under Release No. IA-5325

Based on the Release, it is the fiduciary duties of investment advisers that require them to implement the monitoring of proxy advisors that they retain. According to the Release:

> In order to act consistently with Rule 206(4)-6, an investment adviser that has retained a third party (such as a proxy advisory firm) to assist substantively with its proxy voting responsibilities and carrying out its fiduciary duty should adopt and implement policies and procedures that are reasonably designed to sufficiently evaluate the third party in order to ensure that the investment adviser casts votes in the best interest of its clients.[28]

As succinctly stated by Cydney Posner, '"the new SEC guidance posits the investment adviser as "enforcer," focusing on investment advisers' policies and procedures for due diligence and oversight, especially as applied to the proxy advisory firms they engage."'[29] For example, it is up to each investment adviser to make sure that a proxy advisor "has the capacity and competency to adequately analyze the matters for which the investment adviser is responsible for voting."[30] Moreover, "[i]n this regard, investment advisers could consider, among other things, the adequacy and quality of the proxy advisory firm's staffing, personnel, and/or technology."[31] In addition, "[s]uch an investment adviser should also consider whether the proxy advisory firm has an effective process for seeking timely input from issuers and proxy advisory firm clients with respect to, for example, its proxy voting policies, methodologies, and peer group constructions, including for "say-on-pay" votes."[32]

Another example found in Release No. IA-5325 involves the situation where an investment adviser becomes aware "of potential factual errors, potential incompleteness, or potential methodological weaknesses in the proxy advisory firm's analysis that may materially affect one or more of the investment adviser's voting determinations."[33] Here again, the burden is on the investment adviser: "the investment adviser's policies and procedures should be reasonably designed to ensure that its voting determinations are not based on materially inaccurate or incomplete information."[34]

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[28] *See* Release No. IA-5325, *supra* note 2, at 22.
[29] Cydney Posner, *SEC Guidance for Investment Advisers and Proxy Advisory Firms: An Analysis*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (Sept. 1, 2019), https://corpgov.law.harvard.edu/2019/09/01/sec-guidance-for-investment-advisers-and-proxy-advisory-firms-an-analysis/.
[30] Release No. IA-5325, *supra* note 2, at 17.
[31] *Id.*
[32] *Id.*
[33] *Id.* at 20-21.
[34] *Id.*

The Issues with this Approach

This "enforcer" approach is certainly a necessary first step in helping to make sure that proxy advisors provide investment advisers with informed, unbiased, and precise voting recommendations and research. However, this approach leaves unresolved two issues. First, given that the proxy advisor industry is dominated by two entities, Institutional Shareholder Services (ISS; 61% market share) and Glass Lewis (37% market share), being dissatisfied with one or both proxy advisors does not give an investment adviser much choice or leverage when trying to improve the quality of deficient voting recommendations and research. For example, Tamara Belinfanti describes the difficult situation a mutual fund is faced with when it wants to switch from ISS to a competing proxy advisor:

> [A] dissatisfied ISS mutual fund client who wants to employ a strategy of exit is constrained by, inter alia, *switching costs*, the *lack of vigorous competition* and by *the need to involve ISS in transferring proxy voting data from its voting platform to that of an ISS competitor*. Unlike stock which is a relatively liquid investment for common shareholders, the employment of ISS is a highly illiquid investment for ISS' mutual fund clients. Thus, although exit is generally thought to provide a powerful monitoring and sanctioning device, in the case of ISS, exit poses significant costs to a mutual fund, which in turn weakens its efficiency as an agency cost control tool.[35]

Second, who is going to monitor the investment advisors to make sure they are meeting their fiduciary duties as described in Release No. IA-5325? Institutional Shareholder Services has approximately 2,000 institutional clients[36] and Glass Lewis has over 1,300 such clients.[37] For sure, not all of them are investment advisers, e.g., public pension funds are not investment advisers, but it is likely that a significant number are. So, who is going to make sure that the 1,000 plus investment advisers that utilize proxy advisors are actually complying with Release No. IA-5325? It is doubtful that the SEC has the resources or interest to do so.

Such monitoring is critical because of the small economic incentive that investment advisers have to do so. Again, according to Belinfanti: "[V]oice is also an unrealistic sanctioning tool for ISS' mutual fund clients because mutual funds typically own a *de minimis* amount of any company's stock and have very little incentive to expend resources to exercise voice….[38] Mutual funds have little incentive to actively monitor and voice concerns, …." Therefore, without active monitoring by the SEC, it can be expected that investment advisers will not invest significant resources in voluntarily enforcing their fiduciary duties under Release No. IA-5325.

Recommendation

To address these issues, the SEC should consider additional guidance that recognizes a proxy advisor's fiduciary duty to "implement policies and procedures" that result in voting

[35] Tamara C. Belinfanti, The Proxy Advisory & Corporate Governance Industry: The Case for Increased Oversight and Control, 14 STAN. J.L. BUS. & FIN. 384, 426 (2009).
[36] ISS, About (accessed on Sept. 28, 2019), https://www.issgovernance.com/about/about-iss/.
[37] Glass Lewis, About Us (accessed on Oct. https://www.glasslewis.com/company-overview/.
[38] Belinfanti, *supra* note 35, at 426.

recommendations and research that are consistent with what is required of investment advisers under Release No. IA-5325. These fiduciary duties will substitute for a marketplace that does not allow for significant choice. That is, it will put the needed pressure on a proxy advisor to comply with the requirements of what investment advisers are looking for in order to meet their fiduciary duties when managing their delegated voting authority.

In addition, the SEC is in the best position to monitor how well proxy advisors are complying with their fiduciary duties and what needs to be done to correct deficiencies. Since there are relatively few proxy advisors to monitor, the resources required to adequately perform this monitoring should be relatively small. Moreover, the SEC's monitoring should be greatly aided by investment advisers and issuers' reporting to the SEC alleged deficiencies in a proxy advisor's voting recommendations and research that appear to result from a breach in a proxy advisor's fiduciary duties and suggestions on how to remediate those deficiencies.

Of course, the recommendation that the SEC recognize a proxy advisor's fiduciary duties in regard to voting recommendations and research hinges on the SEC being able to make the legal argument that a proxy advisor has fiduciary duties under the Advisers Act. This argument is provided below.

Proxy Advisers as Investment Advisers and Fiduciaries

The fact that ISS has voluntarily registered to be an investment adviser for more than 20 years[39] creates the presumption that it has the fiduciary duties of an investment adviser when it provides voting recommendations and research for its clients. This appears to the position taken by ISS: "As a registered investment adviser, we have a fiduciary obligation to our clients to provide advice that is in their best interest."[40] But even if ISS did not *voluntarily* register as an investment adviser, it still would be an investment adviser because it meets the definition of such under the Act. This means that all proxy advisors, including Glass Lewis,[41] are investment advisers with fiduciary duties.

According to the Advisers Act, a person meets the definition of an investment adviser when it "issues or promulgates analyses or reports concerning securities."[42] This is certainly what a proxy advisor does. It also meets the definition by providing advice to investment advisers that allow them to maximize the value, or meet the non-wealth maximizing objectives that they are contractually

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[39] Gary Retelny, President and Chief Executive Officer, Institutional Shareholder Services to Mr. Brent J. Fields, Secretary, U.S. Securities and Exchange Commission at 1 (August 7, 2018), https://www.sec.gov/comments/s7-09-18/s70918-4184213-172552.pdf.

[40] Gary Retelny, President and Chief Executive Officer, Institutional Shareholder Services to Mr. Brent J. Fields, Secretary, U.S. Securities and Exchange Commission at 2 (Nov. 7, 2018), https://www.sec.gov/comments/4-725/4725-4629940-176410.pdf.

[41] Glass Lewis does not take the position that it is an investment adviser under the Advisers Act. *See* Katherine Rabin, Chief Executive Officer, Glass Lewis to Jay Clayton, Chairman, U.S. Securities and Exchange Commission, attachment, Willkie Farr & Gallagher Memorandum at 2-5 (Nov. 14, 2018), https://www.sec.gov/comments/4-725/4725-4649188-176490.pdf.

[42] 15 U.S.C. 80b-2(a)(11) (2018).

required to seek,[43] of their investments under management. The SEC succinctly made both arguments when it issued its 2010 Concept Release on the Proxy Process System:[44]

> We understand that typically proxy advisory firms represent that they provide their clients with advice designed to enable institutional clients to ***maximize*** the value of their investments. In other words, proxy advisory firms provide analyses of shareholder proposals, director candidacies or corporate actions and provide advice concerning particular votes in a manner that is intended to assist their institutional clients in achieving their investment goals with respect to the voting securities they hold. In that way, proxy advisory firms meet the definition of investment adviser because they, for compensation, engage in the business of issuing reports or analyses concerning securities and providing advice to others *as to the value of securities*.[45]

This statement reflects the understanding that voting recommendations are always linked to shareholder value. A proxy advisor who provides voting recommendations to its clients that are adequately precise and lack bias may significantly increase a company's intrinsic value and its stock price. However, if a recommendation lacks precision and/or was created with significant bias, then it may significantly decrease its value.

Looked at in another way, if the voting recommendations and research of a proxy advisor are created in an informed and unbiased manner (the first steps in making sure that voting recommendations are adequately *precise*, not just a flip of the coin),[46] resulting in precise recommendations, then this *advice* can go a long way to helping cure the problem of shareholders being allowed to share decision making with the board through the vote, but not being adequately informed when voting. If voting recommendations and associated research are made with adequate precision, then shareholder voting will be reflective of this and corporate decision making will be enhanced.

In sum, a proxy advisory firm meets the definition of investment adviser because, for compensation, it provides voting recommendations and research to its clients as a means to enhance the value of their equity securities held in portfolio and achieve their investment goals.

Conclusion

As an investment adviser, the proxy advisor has fiduciary duties that it owes its clients.[47] This understanding creates the foundation for the SEC to provide additional guidance that recognizes a corresponding "principles-based fiduciary duty" owed by proxy advisors to their clients. This duty

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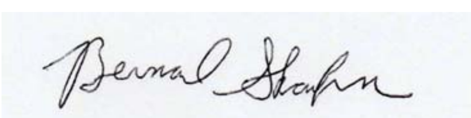
[43] At the end of 2018, it was reported that $1.2 trillion had been invested in funds that followed "non-economic guidelines." *See* Antony Currie and Neil Unmack, *Breakingviews - Breakdown: ESG investing faces sustainability test*, REUTERS (May 28, 2019), reuters.com/article/us-global-asset-management-breakingviews/breakingviews-breakdown-esg-investing-facessustainability-test-idUSKCN1SY1VM.
[44] Securities and Exchange Commission, *Concept Release on the US Proxy System*, 75 Fed Reg 42981 (July 22, 2010) [hereinafter, *Concept Release*].
[45] *Id.* at 43010.
[46] Sharfman, *Enhancing the Value of Shareholder Voting Recommendations*, *supra* note 26 at 3.
[47] *Concept Release*, *supra* note 44, at 43010.

would require proxy advisors to “implement policies and procedures” that result in voting recommendations that are in the *best interest* of their clients, supporting what is required of investment advisers under Release No. IA-5325. Such support appears to be consistent with the ISS’ desire to harmonize the fiduciary duties of investment advisers and proxy advisors:

> [A]s a proxy advisory firm that has been registered under the Advisers Act for more than twenty years, ISS believes that subjecting proxy advisers to the same fiduciary standards that apply to the asset managers who use their services provides a critical layer of protection for investors.” Having the option to receive proxy analyses and recommendations based on custom voting policies or a variety of ISS policies geared to different investor needs enables investment advisers to tailor their voting practices to each client's best interest. And the extensive array of policies and procedures ISS has adopted to satisfy its fiduciary duties of care and loyalty make it easier for investment managers to satisfy their own fiduciary obligation to conduct comprehensive due diligence before engaging a proxy advisory service. In short, a harmonized fiduciary standard around proxy voting provides end-to-end protection of investors' best interests.[48]

What Release No. IA-5325 has done is to lay the foundation for such harmonization. The next step is for the SEC to provide guidance that allows proxy advisors to “implement policies and procedures” that support what is required of their clients under Release No. IA-5325. These policies and procedures, as enforced by the SEC, will help correct for a marketplace where there is very few voting recommendation providers, resulting in few options for an investment adviser that wants to improve the quality of deficient voting recommendations and research, and support the ability of investment advisers to meet their fiduciary duties as described in the Release.

Very truly yours,



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[48] Gary Retelny (Nov. 7, 2018), *supra* note 40, at 9-10.