March 6, 2020

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

File Number S7-23-19

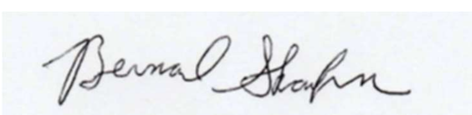
RE: Procedural Requirements and Resubmission Thresholds Under Exchange Act Rule 14a-8, Release No. 34-87458 (Nov. 5, 2019)

Submitted By: Bernard S. Sharfman[*]

Dear Secretary Countryman,

Please find attached the first draft article of my new article, *The Risks and Rewards of Shareholder Voting*. This article is meant for eventual publication in a law journal. In the process of writing my article I realized that my explanation of shareholder voting provides a compelling argument for why the SEC is justified in making its proposed changes to Rule 14a-8. A short discussion of the SEC's proposed rule changes is found in Part V, Section A of my article. However, it is important to read Parts I through IV in order to understand why I came to the conclusion that the SEC is justified in making the changes. I hope the Commission and its staff have the opportunity to read and incorporate my article as they go through the process of finalizing the changes to Rule 14a-8.

Very truly yours,



Bernard S. Sharfman

[*] Mr. Sharfman is 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 any organization Mr. Sharfman has previously been affiliated with.

THE RISKS AND REWARDS OF SHAREHOLDER VOTING

By: Bernard S. Sharfman*

Draft of 03/06/2020

INTRODUCTION

The Securities and Exchange Commission's ("SEC" or "Commission") recent staff roundtable on the proxy process,[1] and its resulting guidance, interpretation and proposed rules on limiting the use of shareholder proposals,[2] regulating proxy advisors and their creation of shareholder voting recommendations for investment advisers,[3] and increasing the fiduciary burden on investment advisers to make sure that the voting recommendations provided by proxy advisors are adequately informed and nonconflicted,[4] has made shareholder voting the most prominently debated corporate governance issue of recent times. The number of comment letters submitted to the SEC have been voluminous,[5] which includes eight submitted by this Article's author. Yet, I doubt many of the writers of these letters, except in the context of their political agendas, have really thought deeply about the role played by shareholder voting in the governance of corporations; the collective action problem that is imbedded in such voting and how this problem needs to be managed;[6] the inability of proxy advisors to solve the

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[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, *Procedural Requirements and Resubmission Thresholds Under Exchange Act Rule 14a-8*, Release No. 34-87458 (Nov. 5, 2019), https://www.sec.gov/rules/proposed/2019/34-87458.pdf. *See also*, SEC, *Procedural Requirements and Resubmission Thresholds Under Exchange Act Rule 14a-8*, 84 Fed. Reg. 66458 (Dec. 4, 2019),

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

[4] 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.

[5] SEC, *Comments on Statement Announcing SEC Staff Roundtable on the Proxy Process, File No. 4-725*, https://www.sec.gov/comments/4-725/4-725.htm; SEC, *Comments on Proposed Rule: Procedural Requirements and Resubmission Thresholds under Exchange Act Rule 14a-8*, Release No. 34-87458; File No. S7-23-19, https://www.sec.gov/comments/s7-23-19/s72319.htm; SEC, *Comments on Proposed Rule: Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice*, Release No. 34-87457; File No. S7-22-19, https://www.sec.gov/comments/s7-22-19/s72219.htm. *See also*, Jens Frankenreiter, Mapping the Landscape of Comments to the SEC's New Proxy Rules, Columbia Law School's Blue Sky Blog (Just on the proposed rules on proxy advisors alone, Frankenreiter identified the submission of over 500 comment letters.), https://clsbluesky.law.columbia.edu/2020/03/04/mapping-the-landscape-of-comments-to-the-secs-new-proxy-rules/.

[6] *See infra*, Part I.

collective action problem;[7] the objective of shareholder voting;[8] and how and when shareholder voting creates value.[9] This Article is dedicated to filling in the gap in our collective understanding of shareholder voting. *Moreover, as discussed in greater detail in Part V, it also provides support for the SEC's recently proposed changes to Rule 14a-8.*

Shareholder voting provides a means by which shareholders can participate in corporate decision making. As stated by the famous law and economics scholars Robert Fischel and Frank Easterbrook, "The right to vote is the right to make all decisions not otherwise provided by contract – whether the contract is express or supplied by legal rule."[10] Yet, very few corporate decisions, especially in the type of corporations this essay is focused on, publicly traded companies that take the corporate form ("public companies"), involve this decision-making mechanism. Those decisions include major corporate actions such as the election of corporate directors,[11] merger agreements,[12] proxy contests,[13] changes to the articles of incorporation,[14] and the election of directors at the annual meeting.[15] However, while important, they are extremely few in number compared to the millions of decisions that are made annually in a public company.

Such limited use makes sense. Shareholder voting may be used for purposes other than shareholder wealth maximization, the presumed objective of corporate governance,[16] and is notoriously uninformed, even if the proxies are submitted by large institutional investors.[17] It may also lead the board of directors to make sub-optimal decisions in order preempt a shareholder vote on a shareholder proposal or proxy contest if it wants to avoid the risk of losing the vote.[18] If so, then why is its use, even though limited, so pervasive?[19] Why not just have the board of directors, chief executive officers, and company employees make all the decisions, keeping shareholders entirely out of the decision-making process?

While these questions may seem out of step with today's movement toward greater and greater shareholder democracy and control, the so-called "shareholder empowerment" movement,[20] this wasn't

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[7] *See infra*, Part II.
[8] *See infra*, Part III.
[9] *See infra*, Part IV.
[10] Frank H. Easterbrook and Daniel R. Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW at 66 (Harvard University Press, 1991).
[11] *See* DEL. CODE ANN. 8, § 216.
[12] *See id.* at 251(c).
[13] REGULATION 14A: SOLICITATION OF PROXIES, 17 C.F.R. 240.14a-1 *et seq*.
[14] *See id.* at § 242.
[15] *See id.* at § 211(b).
[16] See *infra*, Part III.
[17] See *infra*, Part I.
[18] See *infra*, Part V.
[19] Kosmas Papadopoulos, ISS Analytics, *An Overview of Vote Requirements at U.S. Meetings*, HARV. L. SCHOOL F. ON CORP. GOV. & FIN. REG. (July 6, 2019) https://corpgov.law.harvard.edu/2019/07/06/an-overview-of-vote-requirements-at-u-s-meetings/.
[20] Shareholder empowerment is strongly related to the concept of "shareholder democracy," a term coined in the 1940s that "carried the normative message that greater shareholder participation in corporate governance was both possible and desirable." Harwell Wells, *A Long View of Shareholder Power: From the Antebellum Corporation to the Twenty-First Century*, 67 FLA. L. REV. 1033, 1069 (2015). Shareholder democracy is currently associated with the idea of one-share, one-vote. *See* Usha Rodrigues, *The Seductive Comparison of Shareholder and Civic Democracy*, 63 WASH. & LEE L. REV. 1389, 1390 (2006).

always the case. In the 1950s and 60s, leading legal scholars including Adolph Berle, Bayless Manning, and Abram Chayes, and management guru Peter Drucker, thought the answer to these questions should lead to the end of shareholder voting.[21] According to Henry Manne: "Most of the critics of the school of corporate democracy have taken issue with the basic suppositions that it is appropriate for shareholders to make the decisions they do (including election of directors) and that they are capable' of making intelligent decisions."[22]

Nevertheless, this essay does not try to make the argument that shareholder voting must be eliminated in public companies simply because it is arguably uninformed. Instead, even though it finds the shareholder empowerment movement to be a hinderance to efficient corporate decision making and should be curtailed, this essay will argue that it needs to continue, inefficiencies and all.

The textual foundation for this Article comes from my December 20, 2019 comment letter to the Securities and Exchange Commission.[23] In the process of writing that letter, a letter that argued for the implementation of the SEC's proposed amendments to its proxy rules for proxy voting advice, it became clear to me that the letter was also an exploration of the pros and cons of shareholder voting. As such, Parts I, II, and IV of this Article share much of the same textual language as found in that comment letter. Therefore, I do not believe it is necessary to continuously footnote quotes and cites from that letter.

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 U.S. companies are incorporated,[24] and its corporate law often serves as the authority that other states look to when developing their own statutory and common law.[25] Therefore, the primary examples are from Delaware, but the thinking is meant to be global.

Part I will describe the collective action problem that is at the heart of shareholder voting and how it leads to uninformed voting. Part II will discuss how the use of proxy advisors does not solve the collective action problem of shareholder voting faced by institutional investors. Part III addresses the objective of shareholder voting and why shareholder wealth maximization may not necessarily be its only or even its primary objective. Part IV will discuss how and when shareholder voting creates value. Part V discusses two specific implications of shareholder voting for the corporate governance of public companies, including the SEC's recently proposed rule changes for shareholder proposals.

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[21] Henry A. Manne, *The "Higher Criticism" of the Modern Corporation*, 62 COLUM. L. REV. 399, 408-09 (1962).
[22] *Id.*
[23] Letter from Bernard S. Sharfman to Ms. Vanessa Countryman, Sec'y, Sec. & Exch. Comm'n, RE: Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice (December 20, 2019), https://www.sec.gov/comments/s7-22-19/s72219-6571096-201082.pdf.
[24] *See* LEWIS S. BLACK, JR., WHY CORPORATIONS CHOOSE DELAWARE 1 (2007) (stating that Delaware is the "favored state of incorporation for U.S. businesses."). According to the State of Delaware website, "More than 1,000,000 business entities have made Delaware their legal home. More than 66% of the Fortune 500 have chosen Delaware as their legal home." *About the Division of Corporations*, DEL. DIVISION CORPS., http://corp.delaware.gov/aboutagency.shtml (last visited Aug. 23, 2019).
[25] *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 COLLECTIVE ACTION PROBLEM IMBEDDED IN SHAREHOLDER VOTING

Shareholder voting is notoriously uninformed. This is because shareholder voting in a public company suffers from a significant "collective action" problem.[26] As a result, many voters are uninformed when they vote. According to Frank Easterbrook and Daniel Fischel, "When many are entitled to vote, none of the voters expects his votes to decide the contest. Consequently none of the voters has the appropriate incentive at the margin to study the firm's affairs and vote intelligently."[27] According to Paul Edelman, Randall Thomas, and Robert Thompson, "There is a serious collective action problem in shareholder voting: the benefits of a successful vote accrue to all shareholders *but the costs of voting* (for example, information acquisition, preparation and distribution of materials, mustering support) *are borne by each voter* separately so that shareholders may have inadequate incentives to vote."[28] As a result, when shareholders do not bother to become informed or don't even vote, they are not considered to be irresponsible but "rationally apathetic."[29]

A. The Impact

Empirically, this collective action problem results in a low percentage of retail investors casting their ballots at stockholder meetings. Based on recent research by Alon Brav, Matthew Cain, and Jonathon Zytnick, retail investors are not inclined to vote unless they own a significant percentage of the company's stock or the company has experienced a recent track record of poor financial performance.[30]

The collective action problem also exists at the institutional investor level, but is manifested in a different way. As a result of the previously discussed regulatory guidance from the SEC and the Department of Labor, making shareholder voting a fiduciary duty, institutional investors such as investment advisers and ERISA plan managers feel compelled to cast their ballots on almost all issues presented for a vote at a public company. This has resulted in many institutional investors being required to cast ballots by proxy on tens if not hundreds of thousands of votes per year.[31] However,

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

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

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

[29] *See generally* Robert C. Clark, CORPORATE LAW 390-92 (1986) (discussing rational apathy).

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

[31] *See*, e.g., VANGUARD, INVESTOR STEWARDSHIP 2018 ANNUAL REPORT 34 (2018), https://about.vanguard.com/investment-stewardship/perspectives-and-

because of the collective action problem, the amount of resources they are willing to spend on the acquiring of information internally or externally in order to be adequately informed on each and every vote is minimal, requiring them to seek the services of a low cost provider of voting recommendations. For example, engages the services of a proxy advisor, a third-party creator of voting recommendations for institutional investors.

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

Consider how the collective action problem and the regulatory pressure to vote encourages our largest investment advisers to index mutual funds (BlackRock, Vanguard, State Street Global Advisors, Fidelity, etc.) to adopt a low-cost approach to shareholder voting. The management of passive funds exists in a super competitive industry with extremely thin profit margins, providing investment advisers with very little room to spend resources on shareholder voting. Moreover, since the goal of an index fund is to meet, not beat the market, the adviser would not derive any competitive benefit from receiving highly informed and precise recommendations and therefore would have no incentive to spend the money that the creation of such recommendations would require.[32]

According to Lucian Bebchuk and Scott Hirst, when investor stewardship teams from the "Big Three" mutual fund families (Blackrock, Vanguard, and State Street Global Advisors) provide voting recommendations to their index fund clients: "Our analysis of the voting guidelines and stewardship reports of the Big Three indicates that their stewardship focuses on governance structures and processes and pays limited attention to financial underperformance."[33] This "mitigating governance risk" strategy results in a significant economization of an investment advisors' resources. It also results in a one-size-fits-all voting policy. As described by Sean Griffith:

> Stewardship groups develop and work from a set of guidelines laying out a standard approach to recurring governance issues. These voting guidelines of each of the Big Three, for example, announce voting positions against staggered boards, poison pills and dual class shares. These positions lack nuance. In spite of recent research showing that these provisions can create value for some firms, stewardship group guidelines announce a one-size-fits-all approach to governance.[34]

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

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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.).

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

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

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

This collective action problem also applies to actively managed funds. In general, it will always be more profitable for them to use their limited resources to invest in stock valuation, such as fundamental analysis provided by equity analysts, than to spend their resources on costly high-value voting recommendations.[35] While the benefits of fundamental analysis will be a private gain for that specific portfolio manager, the benefits of investing in high-value voting recommendations will be shared by its competitors.

Of course, there are always exceptions to the rule. Activist hedge funds, those unregulated hedge funds who take significant stock positions in a particular company in order to advocate for strategic change prior to selling their shares, will have strong financial motivations to vote on an informed basis.[36] But in general, as stated by Jill Fisch, Asaf Hamdani, and Steven Davidoff Solomon:

> This collective action problem, however, characterizes all institutional investor engagement in corporate governance - by both active and passive funds. Costly steps that investors may take to improve the performance of companies in their portfolio benefit all the investors that hold shares of these companies.[37]

In sum, rational investors are compelled not invest in being informed when voting because the expected payoff from making such an investment is simply not adequate.

II. PROXY ADVISORS DO NOT SOLVE THE COLLECTIVE ACTION PROBLEM

Institutional investors cannot solve their collective action problem through the use of proxy advisors. The reason is because the collective action problem necessarily impacts proxy advisors as well. Proxy advisors must exist in an environment where their institutional investor clients are only willing to pay a minimal fee for voting recommendations. This makes proxy advisors resource constrained. It also explains why institutional investors are not demanding proxy advisors to provide them with better informed and more precise voting recommendations. Or, "leading the charge for [regulatory] reform"[38] so that can happen. Institutional investors simply don't want them better recommendations if it means having to spend more money.

A. Evidence Pointing to Proxy Advisors Being Resource Constrained

As a result of these agency costs, it should be expected that proxy advisors are resource constrained. The evidence appears to bear this out:[39]

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[35] Bernard S. Sharfman, *Enhancing the Value of Shareholder Voting Recommendations*, 86 TENN. L. REV. 691, 713-715 (2019), at PART IV.
[36] Edelman, Thomas, and Thompson, *supra* note 28, at 1379.
[37] Jill E. Fisch, Asaf Hamdani, and Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, forthcoming, U. PENN. L. REV. (2020) at 14, https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=2985&context=faculty_scholarship.
[38] Michael T. Cappucci, Harvard Management Co., *The Proxy War Against Proxy Advisors*, HARV. L. SCHOOL F. ON CORP. GOV. & FIN. REG. (Nov. 27, 2019), https://corpgov.law.harvard.edu/2019/11/27/the-proxy-war-against-proxy-advisors/.
[39] Sharfman, *supra* note 35, at 713-715.

> There is strong evidence that the two major proxy advisor firms 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 advisor firms, ISS (61% market share) and Glass Lewis (37% market share), devote to the creation of recommendations.
>
> As of June 2017, the ISS Global Research team covered 40,000 shareholder meetings [approximately 250,000 votes] with approximately 270 research analysts [an estimated 800 plus votes per analyst during the proxy season] and 190 data analysts. However, it is not known how many research analysts are full-time, part-time or seasonal (proxy season only)….
>
> In 2018, Glass Lewis reported that it covers 20,000 meetings each year with approximately the same number of analysts it had in 2014 [200]. However, it is not known if this number included data as well as research analysts.
>
> Perhaps the most egregious example of where the lack of resources impacts the precision of a proxy advisor's voting recommendations is in the critically important areas of proxy contests and mergers and acquisitions (M&A). For example, to provide these recommendations the ISS has created a Special Situations Research Team ("Research Team"). Remarkably, the Research Team is made up of only *eight* analysts….
>
> It is extremely doubtful that the expertise required for any particular proxy contest could be found within the eight-member Research Team. That is because there are close to 4,000 public companies in the US alone and they exist in numerous of industries. For example, the Global Industry Classification Standard includes 11 sectors which are further subdivided into 24 industry groups, 69 industries and 158 sub-industries. In sum, it would be a rare occasion when the Research Team could find an analyst on staff that would have the expertise to do an adequate job in evaluating a proxy contest.
>
> This same lack of expertise would apply to M&A recommendations. On an average annual basis, "approximately 5% of U.S. public companies delist as a result of M&A activity." The delist percentage may vary, but we will assume that the Research Team has between 150 to 300 M&A per year. This assumption is several times larger than the number the Research Team actually deals with in terms of proxy contests. For an eight-person team lacking the proper expertise, doing an adequate job of providing voting recommendations is an impossible task.

This resource constrained business environment is further evidenced in a recent study by Ana Albuquerque, Mary Ellen Carter, and Susanna Gallani.[40] They find that the negative assessments provided by ISS on the executive compensation of public companies are significantly correlated with

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

poor future accounting performance. However, this only occurs when the assessments are provided during the time of year not associated with the proxy season:[41]

> We provide empirical evidence showing that ISS appears to identify poor compensation practices *mainly* for the subsample of observations that have a non-December fiscal year end (FYE). This result suggests that during the proxy season when ISS is busier (evaluating firms with December FYE, which represent the majority of ISS's coverage) and more constrained regarding resources needed to analyze firms' compensation packages, their recommendations are of lower quality.[42]

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

In sum, proxy advisors exist in an industry where there is a clear mandate to produce low cost, low value voting recommendations within a resource constrained business environment.[43] Combining this result with a proxy advisory industry that has developed into an oligopoly where there are only two primary providers of these low cost voting recommendations, ISS and Glass Lewis, an excessive amount of conformity in voting recommendations may also result.

B. How a Proxy Advisor Deals with Significant Resource Constraints

Proxy advisors have developed two primary cost minimizing strategies to deal with a resource constrained business environment. The first is creating voting recommendations based on "mitigating governance risk"[44] and the second is creating broad-based recommendations based on interested party

[41] *Id.*
[42] *Id.* In the sample used by Albuquerque, Carter, and Gallani, over 70% of the sample firms had a December FYE. *Id.* This is consistent with the Conference Board finding that approximately 85% of Russell 3000 companies hold their annual meetings during the first half of the year. *See* Matteo Tonello, *Proxy Voting Analytics, (2016‑2019)*, THE CONFERENCE BOARD, (2019), https://www.conference-board.org/press/pressdetail.cfm?pressid=9287.
[43] As observed by Chester Splatt, the former Chief Economist of the SEC, "During the SEC's roundtable on the proxy process held in November 2018, individual asset managers focused concern about greater regulation of proxy advisory firms upon the potential implications for the costs and resulting pricing of their services, rather than the equilibrium effects on the quality of governance." *See* Chester S. Splatt, *Proxy Advisory Firms, Governance, Market Failure, and Regulation*, MILKEN INSTITUTE at 6 (2019).
[44] Statement of Gary Retelny, President & CEO, Institutional S'holder Servs. Inc., to Subcomm. on Capital Mkts. & Gov't Sponsored Enters., Comm. on Fin. Servs., U.S. House of Representatives, Legislative Proposals to Enhance Capital Formation, Transparency and Regulatory Accountability (May 17, 2016), at A-14, https://www.issgovernance.com/file/duediligence/iss-statement-hfsc-17-may-2016.pdf[https://perma.cc/NC9Y-W6WT]; Letter from Gary Retelny, President & CEO, Institutional S'holder Servs. Inc., to Bill Huizenga, Chairman, Subcomm. on Capital Mkts., Sec., & Inv., Comm. on Fin. Servs., U.S. House of Representatives, & Carolyn B. Maloney, Ranking Member, Subcomm. on Capital Mkts., Sec., & Inv., Comm. on Fin. Servs., U.S. House of Representatives, Re: July 18, 2017, Hearing Entitled "The Cost of Being a Public Company in Light of Sarbanes-Oxley and the Federalization of Corporate Governance" (July 27, 2017), at 2, https://www.issgovernance.com/file/duediligence/20170727-iss-letter-to-hfsc-subcommitee-on-captal-markets-securities-and-investment.pdf[https://perma.cc/PMQ4-3XKH].

feedback, including feedback from clients.[45] In general, both strategies help avoid doing any real financial analysis regarding a particular shareholder vote, and, most importantly, spending the significant resources involved in doing such analysis.[46]

1. Creating Voting Recommendations Based on Mitigating Governance Risk

Instead of a proxy advisor investing the necessary resources to produce voting recommendations that are based on a thorough financial analysis of each vote; it creates voting recommendations based on corporate governance principles that are not fine-tuned to the circumstances of any individual company. Just like the approach taken by investor stewardship teams, this "mitigating governance risk" strategy results in a significant economization of a proxy advisor's resources. It also results in limited attention being paid to financial underperformance and results in a one-size-fits-all voting policy.

For example, every proxy season, ISS produces a benchmark report and five additional specialty voting reports on each public company.[47] These reports create a default voting policy for each public company held in a client's equity portfolio.[48] None of these reports have shareholder wealth maximization as the exclusive and sole objective of its voting recommendations.[49]

Regarding the benchmark report, Gary Retelny, President and Chief Executive Officer of ISS has made conflicting statements on its objective. He has alternatively stated that its objective is "focused solely on protecting shareholder value *and* mitigating governance risk"[50] while also stating that its objective is "focused solely on maximizing shareholder value *and* mitigating governance risk."[51] These

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

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

[47] ExxonMobil, Comment Letter on Roundtable on the U.S. Proxy Process (July 26, 2019), at 7, https://www.sec.gov/comments/4-725/4725-5879063-188728.pdf[https://perma.cc/5A9Y-8KNS].

[48] *Id.*

[49] *Id.* at 8 n.12.

[50] Institutional Shareholder Services, Inc., *supra* note 45, at 1; *see also* Statement of Gary Retelny, President & CEO, Institutional S'holder Servs. Inc., to Subcomm. on Capital Mkts. & Gov't Sponsored Enters., Comm. on Fin. Servs., U.S. House of Representatives, Legislative Proposals to Enhance Capital Formation, Transparency and Regulatory Accountability (May 17, 2016), at A-14, https://www.issgovernance.com/file/duediligence/iss-statement-hfsc-17-may-2016.pdf[https://perma.cc/NC9Y-W6WT].

[51] Letter from Gary Retelny, President & CEO, Institutional S'holder Servs. Inc., to Bill Huizenga, Chairman, Subcomm. on Capital Mkts., Sec., & Inv., Comm. on Fin. Servs., U.S. House of Representatives, & Carolyn B. Maloney, Ranking Member, Subcomm. on Capital Mkts., Sec., & Inv., Comm. on Fin. Servs., U.S. House of Representatives, Re: July 18, 2017, Hearing Entitled "The Cost of Being a Public Company in Light of Sarbanes-Oxley and the Federalization of Corporate Governance" (July 27, 2017), at 2, https://www.issgovernance.com/file/duediligence/20170727-iss-letter-to-hfsc-subcommitee-on-captal-markets-securities-and-investment.pdf[https://perma.cc/PMQ4-3XKH].

are similar sounding, but conflicting statements.[52] The first makes clear that a stated objective is not even the pursuit of shareholder wealth maximization, but something lesser, the protection of shareholder value.[53] However, it is likely that what Mr. Retelny meant to say is that the objective of protecting shareholder value or shareholder wealth maximization will be achieved through a strategy of "mitigating governance risk."[54] Such an approach to voting recommendations makes economic sense when a proxy advisor is resource constrained.[55] That is, instead of a proxy advisor investing the necessary resources to produce voting recommendations that are based on a thorough financial analysis of each issue as a means to pursue shareholder wealth maximization; it takes a short-cut approach by creating voting recommendations based on corporate governance principles.[56] This resource constrained strategy may also explain why ISS feels that an eight-person team of analysts is sufficient to review all the proxy contests and M&A transactions that come before it on an annual basis.[57]

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

2. Creating Voting Recommendations Based on Feedback

ISS makes public that in the development of its benchmark voting policy "it collects feedback from a diverse range of market participants through multiple channels: an annual Policy Survey of institutional investors and corporate issuers, roundtables with industry groups, and ongoing feedback during proxy season."[58] Glass Lewis is much more mysterious in how it goes about using feedback, saying only that it utilizes the advice of an independent body referred to as the Research Advisory Council.[59] The current composition of the Council is extremely impressive.[60] However, it is not known how they interact with Glass Lewis or what kind of inputs they use in developing their feedback or what kind of feedback they actually provide.

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[52] *See* Bernard S. Sharfman, *Now is the Time to Designate Proxy Advisors as Fiduciaries under ERISA*, forthcoming, STAN. J. L., BUS., & FIN. at 15-20, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3446291.
[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] *Id.*
[57] *Id.*
[58] Institutional Shareholder Services, *Policy Formulation Process* (accessed Dec. 12, 2019), https://www.issgovernance.com/policy-gateway/policy-formulation-application/. *See also*, Institutional Shareholder Services, *ISS Opens Global Policy Survey for 2020: Investors, Companies and Corporate Governance Organizations Encouraged to Participate in ISS' Annual Policy Development Process* (July 22, 2019), https://www.issgovernance.com/iss-opens-global-policy-survey-for-2020/ (noting the use of the survey for purposes of revising its benchmark voting policies).
[59] U.S. Government Accountability Office, CORPORATE SHAREHOLDER MEETINGS: PROXY ADVISORY FIRMS' ROLE IN VOTING AND CORPORATE GOVERNANCE PRACTICES, GAO-17-47 at 23 (Nov. 2016), https://www.gao.gov/assets/690/681050.pdf.
[60] Currently, David Nierenberg, Charles A. Bowsher, Jesse Fried, Bonnie Hill, Stéphanie Lachance, and Katherine Rabin sit on the Research Advisory Council. *See* Glass Lewis, *Leadership: Research Advisory Council* (accessed Dec. 12, 2019), https://www.glasslewis.com/leadership-2/.

A significant problem in taking this low-cost approach is that while the preferences of multiple stakeholders may potentially be revealed and taken into consideration, the preferences of beneficial investors and public pension fund beneficiaries may be ignored. Institutional investors should be the advocates of their own investors and pension fund beneficiaries, but this may not be the case. As already noted in Part I, Section B of this essay they may have their own preferences which they will treat as their first priority.

Moreover, relying on stakeholder preferences creates plenty of room for those with the most influence at a proxy advisor, e.g., their biggest and best clients, to overweight and therefore bias a proxy advisor's benchmark voting policy with their own preferences. For example, in its 2019 Global Policy Survey for US companies, Institutional Shareholder Services (ISS) "asked investors whether a time-based sunset requirement of no more than seven years was seen as appropriate" for dual class share structures."[61] According to ISS, of "those investors who provided a response to the question, 55 percent agreed that a maximum seven-year sunset is appropriate."[62] As a result, ISS changed its benchmark policy such that "no sunset period of more than seven years from the date of the IPO will be considered to be reasonable."[63]

Besides the problem of how the question was phrased (the question could have simply been opened ended without leading the investor to a predetermined maximum number of years), this policy change was based on the responses of only 89 unidentified institutional investors,[64] of which 49 (estimated) of them said yes.[65] With an institutional client base of approximately 2,000,[66] this seems to be an incredibly small sample size of institutional investors to use when making a very important policy change. In addition, the sample may have been significantly over-weighted with representatives of those who support shareholder empowerment, such as public pension and union-related funds. Moreover, it should be noted that the Council of Institutional Investors (CII), the trade organization that represents such funds, has strongly advocated for a seven-year sunset.[67] Based on these facts, a potential inference is that the phrasing of the question and the resulting policy change was simply meant to please those clients who espouse shareholder empowerment, such as the CII and its public pension and union-related fund members.

It should be noted that this is not the first time that the use of feedback and survey results has been criticized as being opaque and bias. A number of years ago David Larcker, Allan McCall, and Brian Tayan found that, "the ISS data collection process relies on a very small number of participants"; "the composition of the respondent pool that ISS does reach is not well disclosed"; "the survey suffers from

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[61] Subodh Mishra, Institutional Investor Services, Inc., *ISS Benchmark Policy Updated-Executive Summary*, HARV. L. SCHOOL F. ON CORP. GOV. & FIN. REG. (Dec. 2, 2019), HTTPS://CORPGOV.LAW.HARVARD.EDU/2019/12/02/ISS-BENCHMARK-POLICY-UPDATED-EXECUTIVE-SUMMARY/.
[62] *Id.*
[63] *Id.*
[64] Institutional Investor Services, Inc., 2019 GLOBAL POLICY SURVEY, SUMMARY OF RESULTS at 27 (Sept. 11, 2019), https://www.issgovernance.com/file/policy/2019-2020-iss-policy-survey-results-report.pdf.
[65] *Id.*
[66] ISS, *About* (accessed on Sept. 28, 2019), https://www.issgovernance.com/about/about-iss/.
[67] *Dual-Class Stock*, COUNCIL INSTITUTIONAL INV., https://www.cii.org/dualclass_stock (archived Dec. 2, 2019).

design errors that are likely to confuse and/or bias respondents"; and "it is unclear how ISS incorporates the feedback that it receives during the open comment period to finalize voting policies."[68]

In sum, this strategy of using stakeholder preferences, especially client preferences, may create significant bias in voting recommendations. It also leads to the conclusion that "proxy advisory firms are concerned that their voting recommendations reflect the opinions and prejudices of their clients, the institutional investors; it matters less to proxy firms whether the governance regime reflected in their voting guidelines is correct."[69]

C. A Market Failure in the Market for Voting Recommendations

In the market for voting recommendations, there are two parties that contract with each other, the providers of voting recommendations, proxy advisors, and their clients, institutional investors. Unfortunately, the two parties most impacted by the quality of the voting recommendations are not parties to the contract, the public companies whose shareholders are being asked to vote and the beneficial investors of the proxy advisor's clients.[70]

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

The first negative externality is the negative impact that uninformed and inadequately precise voting recommendations will have on the decision making of public companies.[71] For example, if an activist hedge fund is utilizing a proxy contest to change the strategic direction of the company and the shareholder vote is significantly influenced by inadequate voting recommendations. As a result, the company's market and financial performance will suffer as well as its ability to successfully compete against its' rivals.

The second externality is the negative impact that such voting recommendations will have on beneficial investors and public pension fund beneficiaries.[72] These investors will suffer economic losses because suboptimal voting recommendations will lead to value reducing decisions at public companies.[73] For example, if the result of a merger vote is significantly influenced by imprecise voting recommendations.

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[68] David F. Larcker, Allan L. McCall, and Brian Tayan, *And Then A Miracle Happens!: How Do Proxy Advisory Firms Develop Their Voting Recommendations?*, STANFORD CLOSER LOOK SERIES (2013), https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-closer-look-31-proxy-firms-voting-recommendations.pdf.

[69] Bryce C. Tingle, *Bad Company! The Assumptions behind Proxy Advisors' Voting Recommendations*, 37 DALHOUISE L. REV. 709, 723 (2014).

[70] Bryce C. Tingle, *The Agency Cost Case for Regulating Proxy Advisory Firms*, 49 U.B.C. L. REV. 725, 746-47 (2016), at 782.

[71] *Id.*

[72] *Id.*

[73] The empirical research on how voting recommendations impacts shareholder value is not extensive. *See* David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, *Outsourcing Shareholder Voting to Proxy Advisory Firms*,

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

> For example, I have heard that the Commission should not take any action related to proxy voting advice provided by proxy advisory firms because "... the investors themselves... the ones paying for proxy advice... are not asking for protection." To be clear, in this context, I do not consider asset managers to be the "investors" that the SEC is charged to protect. Rather, the investors that I believe today's recommendations aim to protect are the ultimate retail investors, who may have their life savings invested in our stock markets. These Main Street investors who invest their money in funds are the ones who will benefit from (or bear the cost of) these advisers' voting decisions.[74]

Without these negative externalities "market forces rather than regulation are the most appropriate and effective oversight mechanism for the proxy advisory industry."[75] However, that is not where we are. Even if the voting recommendations are tainted with significant errors in facts, conflicts, or methodological weaknesses, institutional investors are very happy to purchase and use them. This is another significant weakness in shareholder voting, especially when, as they do today, institutional investors dominate the voting of proxies.

III. SHAREHOLDER WEALTH MAXIMIZATION, THE ASPIRATIONAL OBJECTIVE OF SHAREHOLDER VOTING

According to Vice Chancellor Laster of the Delaware Chancery Court and quoted with approval by the Delaware Supreme Court, "What 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 [shareholder] wealth

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

[74] 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.

[75] Tingle, *supra* note 70, at 779 quoting Comment letter from Debra L Sisti, Vice President & Martha Carter, Managing Director of Institutional Shareholder Services, *Re: Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms* at 15 (Aug. 10, 2012), https://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120810_25-401_sistid_carterm.pdf.

maximization."[76] What this statement says is that the courts expect shareholder voting is to be done through the lens of shareholder wealth maximization.

As I have argued in other writings,[77] Laster's statement is consistent with the premise that the overwhelming majority of the 100 million-plus individual retail investors in the United States who invest in voting stock indirectly through the use of investment advisers, such as mutual fund advisers,[78] as well as the beneficiaries of public pension funds, "simply want to earn the highest risk adjusted financial return possible,"[79] including when they vote or have votes cast for them by their investment advisers or pension fund managers. That is, it is reasonable to presume that investors "have a uniform interest in maximizing their own wealth."[80]

In addition, this desire to earn the highest risk-adjusted financial return possible is also arguably shared by "the overwhelming number of socially motivated retail investors who align their investments based on their moral or social values,[81] even though they give up some risk-adjusted return in terms of portfolio diversification," have 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,[82] and may "pay higher management fees for this customization."[83] "That is, these investors are willing

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[76] Kurz v. Holbrook, 989 A.2d 140, 178 (Del. Ch. 2010), *aff'd in part, rev'd in part on other grounds sub nom.* Crown Emak Partners v. Kurz, 992 A.2d 377, 388–90 (Del. 2010) (quoting *Kurz*, 989 A.2d at 178 with approval).

[77] *See e.g.*, Sharfman, *Enhancing the Value of Shareholder Voting Recommendations*, supra note 35, at 700-03.

[78] INV. CO. INST., *2017 Facts at a Glance*, *in* 2018 INVESTMENT COMPANY FACT BOOK (58th ed. 2018), http://www.icifactbook.org/deployedfiles/FactBook/Site%20 Properties/pdf/2018/2018_factbook.pdf.

[79] George David Banks & Bernard Sharfman, *Standing Up for the Retail Investor*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (June 10, 2018), https://corpgov.law.harvard.edu/2018/06/10/standing-up-for-the-retail-investor/; *see* Paul Brest, Ronald J. Gilson, and Mark A. 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.

[80] Sean J. Griffith, *supra* note 34.

[81] According to Paul Brest, Ronald Gilson, and Mark 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.

Brest et al., *supra* note 79.

[82] *See* Hendrik Bessembinder, *Do Stocks Outperform Treasury Bills?*, 129 J. FIN. ECON. 440, 442 (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. *Id.* at 440–43. 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. Wealth creation "refers to 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." *Id.* at 454 tbl.5.

[83] Bernard S. Sharfman, *Commentary: Reforming a Broken System*, PENSIONS & INV. (Aug. 27, 2018, 1:00 AM), http://www.pionline.com/article/20180827/ONLINE/180829997/commentary-reforming-a-broken-system.

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."[84]

Finally, with the exception of a minority of funds that publicly disclose their willingness to sacrifice financial 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 representing the interests of tens, hundreds, thousands, or even millions[85] of investors, can come closest to representing the preferences of their retail investors or beneficiaries. As stated by Sean Griffith:

> [S]hareholder wealth maximization is often posited or assumed not because it is the highest and best thing for real life shareholders but because it is the most we can assume about shareholders as a class. It does not rest upon the results of a poll of shareholder passions but rather operates as a kind of lowest common denominator solution to their inability to coalesce around other objectives. Indeed, government failures to advance particular social objectives, frustrating to critics of wealth maximization, may reflect the divergent preferences of the political electorate, but these critics have supplied no reason to suppose that corporate electorates will not have similarly divergent preferences.[86]

Therefore, at the very least, with the exception of funds that specifically states in their disclosure documents that the fund is set up to pursue a non-wealth maximizing objective, an investor should expect that the objective of an investment fund will be shareholder wealth maximization.

A. Corporate Law

Corporate law, despite Vice Chancellor Laster's compelling dicta, provides no guidance on what the objective of shareholder voting must be. For example, statutory corporate law is silent on this issue. This should not be surprising as it is consistent with corporate law's private ordering approach to corporate governance arrangements. Under Delaware General Corporation Law, the law enables private ordering by providing default,[87] not mandatory, rules.[88]

1. Controlling Shareholders

Moreover, the courts application of corporate law's fiduciary duties, which are quite extensive when it comes to the activities of the board of directors, only applies to shareholders who have a controlling interest in the company and are transacting with the corporation. For example, it will

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[84] *Id.*
[85] Vanguard, a global investment company, reports that it has thirty million investors as of August 31, 2019. *See Fast Facts About Vanguard*, VANGUARD, https://about.vanguard.com/who-we-are/fast-facts/ (last visited Nov. 4, 2019).
[86] Griffith, *supra* note 34, at 25.
[87] Although default rules can be modified, "the default rule is tailored toward what the legislature believes most, but not all, of an organization's stakeholders would have agreed to if contracting were efficient." *See* James D. Cox, *Corporate Law and the Limits of Private Ordering* 7 (Duke Law Sch. Pub. L. & Legal Theory Series No. 2015-47, 2015), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2671850 [https://perma.cc/8Z2K-ZAEP].
[88] *See* Williams v. Geier, 671 A.2d 1368, 1381 (Del. 1996) ("At its core, the Delaware General Corporation Law is a broad enabling act which leaves latitude for substantial private ordering, provided the statutory parameters and judicially imposed principles of fiduciary duty are honored." (emphasis added)).

generally apply when a controlling shareholder has decided that it wants to buy out the minority shareholders in a self-dealing transaction that is referred to as a "freeze out" merger[89] or when a company is sold to a third party and the controller is alleged to have received special benefits relative to minority shareholders.[90] In both situations, shareholders must vote to approve the transaction. If the transaction is challenged, then the courts will normally apply an "entire fairness" standard of review.

Entire fairness is a court's most onerous standard of review.[91] Entire fairness requires a review of the result for "substantive fairness," with the burden of proof on the controlling shareholder and the board of which it controls.[92] According to Ezra (a.k.a. Lawrence) Mitchell, an "[entire] fairness [review] contemplates a range of values and fiduciary conduct that properly is analyzed within the totality of a transaction's circumstances."[93] When this standard of review applies, courts must "consider carefully how the board of directors discharged all of its fiduciary duties with regard to each aspect of the non-bifurcated components of entire fairness: fair dealing and fair price."[94] Moreover, "[n]ot even an honest belief that the transaction was entirely fair will be sufficient to establish entire fairness. Rather, the transaction itself must be *objectively* fair, independent of the board's beliefs."[95]

Fair *dealing* "embraces questions of when the transaction was timed, how it was initiated, structured, *negotiated*, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained."[96] Moreover, one possessing superior knowledge may not mislead any stockholder by use of corporate information to which the latter is not privy."[97] This point may be especially relevant when a controlling shareholder is entering into a transaction with the corporation. Fair *price* "relates to the economic and financial considerations of the proposed [transaction], including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock."[98]

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89 Recently, the Delaware courts have allowed relief from the entire fairness standard of review in freeze-out mergers if certain conditions are met. *See* Kahn v. M&F Worldwide Corp., 88 A.3d 635, 642 (Del. 2014). In a freeze-out transaction if the Board appoints a special independent committee to negotiate the transaction on behalf of the minority stockholders and the transaction is approved by an informed majority of minority stockholders, then the transaction will be given the benefit of the much more lenient business judgment rule. *Id.* at 645.

90 Amy L. Simmerman and Katherine A. Martin, *Controlling-Stockholder Conflicts and How to Handle Them*, 2 PLI CURRENT 593, 597(No. 4; Autumn 2018) citing Frank v. Elgamal, 2014 WL 957550 (Del. Ch. Mar. 10, 2014); SEPTA v. Volgenau, 2013 WL 400919 (Del. Ch. Aug. 5, 2013), *aff'd*, 91 A.3d 563 (Del. 2014); *In re* John Q. Hammons Hotels, Inc. S'holders Litig., 2009 WL 3165613 (Del. Ch. Oct. 2, 2009); In re Martha Stewart Living Omnimedia, Inc. S'holder Litig., 2017 WL 3568089 (Del. Ch. Aug. 18, 2017).

91 Reis v. Hazelett Strip-Casting Corp., 28 A.3d 442, 459 (Del. Ch. 2011). For a general discussion of the entire fairness standard of review, *see* Bernard S. Sharfman, *The Importance of the Business Judgment Rule*, 14 N.Y.U. J.L. & BUS. 27, 39–42 (2017).

92 Solomon v. Armstrong, 747 A.2d 1098, 1112 (Del. Ch. 1999).

93 Lawrence E. Mitchell, *Fairness and Trust in Corporate* Law, 43 DUKE L. J. 425, 427 (1993).

94 *Emerald Partners*, 787 A.2d at 97.

95 Gesoff v. IIC Indus., Inc., 902 A.2d 1130, 1145 (Del. Ch. 2006) (emphasis added).

96 Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983) (emphasis added).

97 *Id.*

98 *Id.*; *see also* Encite LLC v. Soni, No. 2476-VCG, 2011 Del. Ch. LEXIS 177 at *75 (Del. Ch. 2011). Memorandum opinion.

The entire fairness standard of review, while not demanding the highest price possible, is clearly seeking to make sure that the focus is on getting at least a fair deal, especially in terms of price,[99] for the corporation and its minority shareholders. As a result, there is a better chance for shareholder wealth maximization to be achieved. However, because there are so few fact patterns where the entire fairness standard of review will apply to a shareholder vote, since it only applies to a controlling shareholder transacting with the corporation and a shareholder vote is required, its ability to encourage shareholders to vote with the objective of shareholder wealth maximization must be considered negligible.

2. Non-Controlling Shareholders

Unlike controlling shareholders, non-controlling shareholders never owe fiduciary duties to the company's other shareholders and can vote with whatever objective they feel appropriate or simply desire, no matter the impact on their fellow shareholders. For example, if an investor's objective in shareholder voting is minimizing carbon emissions of the company, not shareholder wealth maximization, then so be it. This lack of fiduciary duty supports the fundamental principle that shareholders have only limited financial liability when they interact with the corporation.[100] That is, they are only liable up to the dollar amount of their investment in company stock and nothing more.

In sum, even if shareholder wealth maximization were to be a consideration in fiduciary duty analysis, it would be irrelevant in the context of shareholder voting by non-controlling shareholders. This is a critically important in the United States where "controlled companies make up only 3.6 percent of S&P 500 and 8.4 percent of the entire Russell 3000."[101] This means that for the overwhelming majority of U.S. public companies, corporate law does not provide any guidance to shareholders on what should be the corporate objective when voting their proxies.

B. Fiduciary Duties Under Federal Law

According to the publication *Pensions & Investments*, institutional investors currently own up to eighty percent of the market value of U.S. publicly traded equities.[102] This compares to approximately six percent in 1950.[103] These types of stockholders are susceptible to many different types of

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[99] According to the Chancery Court, "at least in non-fraudulent transactions, price may be the preponderant consideration. That is, although evidence of fair dealing may help demonstrate the fairness of the price obtained, what ultimately matters most is that the price was a fair one." *See Encite*, 2011 Del. Ch. LEXIS 177 at *24.

[100] According to Robert J. Flanagan,

> Shareholders do not, as a matter of status, owe fiduciary obligations to each other or to their corporations. As discussed earlier, the interposition of the corporate entity between the shareholders and the business had fundamental consequences. The corporation now carried on the business as a principal. For shareholders, that produced their limited liability, but also negated the mutual fiduciary obligations they would otherwise have if they had carried on the business together without incorporating.

Robert J. Flanagan, *Fiduciary Duties of Shareholders and Directors*, 2004 J. OF BUS. L. 277, 285 (2004).

[101] Kosmas Papadopoulos, Institutional Shareholder Services, Inc., *CEO Ownership, Corporate Governance, and Company Performance*, HARV. L. SCHOOL F. ON CORP. GOV. & FIN. REG. (May 13, 2019), https://corpgov.law.harvard.edu/2019/05/13/ceo-ownership-corporate-governance-and-company-performance/.

[102] 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.

[103] MATTEO TONELLO & STEPHAN RABIMOV, THE 2010 INSTITUTIONAL INVESTMENT REPORT: TRENDS IN ASSET ALLOCATION AND PORTFOLIO COMPOSITION 22 TBL.10 (2010).

opportunistic behavior and conflicts of interest that may benefit the investment managers or third parties but do not conform to the interests of their beneficial investors or pension fund beneficiaries. For example, a company that set up a pension plan for their employees will be run by trustees who are selected by the company's management. If the plan includes company stock, then it is not too far-fetched to believe that the trustees will vote their shares so as to be in compliance with management's wishes.[104] Also, mutual funds who successfully market their investment management services to an employer and have delegated voting authority will be reluctant to vote against the interests of company management for fear of losing their business.[105] In addition, a pension fund sponsored by a labor union may vote its' shares based on the how it financially impacts its members instead of trying to maximizing the value of its pension assets.[106] That is, "in situations where they are voting on issues that affect their [members] jobs or future as workers in a company, they may well vote in their interests as workers at the expense of shareholders [beneficial investors and/or pension fund beneficiaries]."[107] For example, an institutional investor with a strong preference for shareholder empowerment or some component of ESG may prioritize that preference over the default objective of shareholder wealth maximization.[108] Finally, public pension funds trustees, who are often politicians or political appointees, may vote to maximize their own political ambitions instead of the value of the pension fund.[109]

The potential for opportunistic behavior means that the fiduciary duties of investment managers should play a very important role to play in making sure they do not use their shareholder voting authority to benefit themselves at the expense of their beneficial investors and/or pension fund beneficiaries. However, this has not been the case, let alone guiding investment managers to vote their proxies based on the objective of shareholder wealth maximization.

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[104] James D. Cox, Tomas J. Mondino & Randall S. Thomas, *Understanding the (Ir)relevance of Shareholder Votes on M&A Deals*, 69 DUKE L. J. 503, 535 (2019).

[105] *Id.* at 535-36. *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, ….."); 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.

[106] Cox, Mondino, and Thomas, *supra* note 104, at 536.

[107] *Id.*

[108] Sharfman, *Now is the Time to Designate Proxy Advisors as Fiduciaries under ERISA*, *supra* note 52. *See also*, Bernard S. Sharfman, *How the SEC Can Help Mitigate the 'Proactive' Agency Costs of Agency Capitalism*, 8 AM. U. BUS. L. REV. 1, 15-16 (2019). As stated in that writing:

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

Id.

[109] Cox, Mondino, and Thomas, *supra* note 104, at 536.

1. The Objective of Shareholder Voting Under the Advisers Act

In the United States, investment managers are primarily regulated by the Securities and Exchange Commission (SEC) under the authority of the Investment Advisers Act of 1940 ("Advisers Act").[110] Investment advisers[111] to mutual funds, exchange-traded funds, and separately managed accounts are typically delegated the authority to vote their clients securities. They manage 30% of all U.S. publicly traded equity securities,[112] approximately $10.2 trillion of total U.S. equity value.[113] Most significantly, based on projecting the historical trends in the growth of index funds, Lucian Bebchuk and Scott Hirst estimate that the Big Three investment advisers to mutual funds, BlackRock, Vanguard, and State Street Global Advisors, alone will control 34.3% of S&P 500 (an index made up of the 500 largest companies listed on U.S. stock exchanges) votes by 2028 and 40.8% by 2038.[114] In regard to the Russell 3000 (an index made up of the 3,000 largest publicly held companies incorporated in the U.S.), they estimate that the Big Three will control 29.8% of votes in 2028 and 36.7% of votes in 2038.[115]

In 2003, with the implementation of the Proxy Voting Rule, [116] as promulgated under Section 206 of the Advisers Act, 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."[117] 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*."[118] In these situations, a fund's adviser may have an incentive to support management recommendations to further its business interests.[119]

Yet, the SEC has done little to enforce these fiduciary duties. There has been only one SEC enforcement action under the Proxy Voting Rule, the action against INTECH.[120] Here, the registered investment adviser, INTECH Investment Management LLC, had initially voted its proxies based on an

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[110] 15 U.S.C. 80b-1 *et seq*.
[111] 15 U.S.C. 80b-2(a)(11) (2018) (defining investment advisor).
[112] INV. CO. INST., *2018 Facts at a Glance*, *in* 2019 INVESTMENT COMPANY FACT BOOK (59th ed. 2018), https://www.ici.org/pdf/2019_factbook.pdf.
[113] GuruFocus, *Buffett Indicator: Where Are We with Market Valuations?* (accessed Feb. 17, 2020), https://www.gurufocus.com/stock-market-valuations.php.
[114] Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 BOS. U. L. REV. 721, 739–40 (2019).
[115] *Id.*
[116] Proxy Voting by Investment Advisers, *supra* note 105.
[117] *Id.* The fiduciary duties of an investment adviser were formally recognized by the U.S. Supreme Court in *SEC v. Capital Gains Research Bureau, Inc.*[117] 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.

375 U.S. 180, 194 (1963). *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 doubt that Congress intended to impose enforceable fiduciary obligations.").
[118] Proxy Voting by Investment Advisers, *supra* note 105.
[119] *Id.*
[120] 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.

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.[121] 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."[122] 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."[123] Soon after, some of INTECH's original clients started making inquiries regarding the higher number of votes against management on shareholder proposals.[124]

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.[125] 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.[126]

What was conspicuously absent from the INTECH enforcement action or in any other guidance or regulations proposed or implemented by the SEC, is any explicit acknowledgment that shareholder wealth maximization should be a consideration when an investment adviser votes its proxies. This lack of acknowledgement by the SEC is extremely important since in *Transamerica Mortg. Advisors v. Lewis*,[127] 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.[128] By extension, no private right of action exists under the Proxy Voting Rule.[129] With the SEC being the sole enforcer of the Proxy Voting Rule, its approach of not taking a position on the objective of shareholder voting means that fiduciary duties under the Advisers Act are essentially irrelevant in keeping investment advisers focused on their respective objectives, including the default objective of shareholder wealth maximization.

2. The Objective of Shareholder Voting Under ERISA

The Department of Labor (DOL), through its administration of the Employee Retirement Income Security Act of 1974 (ERISA),[130] also has an important role to play as a securities regulator, especially

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[121] *Id.* at 2.
[122] *Id.* at 4 n.3.
[123] *Id.* at 2.
[124] *Id.* at 4.
[125] *Id.* at 4–5.
[126] *Id.* at 7.
[127] 444 U.S. 11 (1979).
[128] Bernard S. Sharfman, *How the SEC Can Help Mitigate the 'Proactive' Agency Costs of Agency Capitalism*, 8 AM. U. BUS. L. REV. 1, 21 (2019).
[129] *Id.*
[130] Pub. L. No. 93-406, 88 Stat. 829 (29 U.S.C. 1001 *et seq.*).

in the area of investment management.[131] This importance is evidenced by the over $11 trillion worth of assets[132] held in ERISA "employee pension benefit plans."[133]

Plan managers under ERISA have a fiduciary duty to vote the shares over which they have voting authority. This began with the infamous 1988 U.S. Department of Labor (DOL) letter that is commonly referred to as the "Avon letter."[134] In the letter, the DOL stated that "[i]n 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."[135] 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 DOL policy has been affirmed by the DOL in 1990,[136] 1994,[137] 2008,[138] 2016,[139] and 2018.[140]

The fiduciary duty under ERISA is very similar to what is found under the common law of trusts. Under ERISA, those who manage plan assets owe the strictest duties of loyalty and care to their

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[131] *See* Anita K. Krug, *The Other Securities Regulator: A Case Study in Regulatory Damage*, 92 TUL. L. REV. 339, 340-41 (2017).

[132] Marlene Satter, *Retirement Assets Hit $29.2T: ICI Report*, THINKADVISOR (Dec. 27, 2018), https://www.thinkadvisor.com/2018/12/27/retirement-assets-hit-29-2t-ici-report/[https://perma.cc/4YXH-TJH3] (noting that there is $8.1 trillion in employer-sponsored Defined Contribution plans and $3.2 trillion in private-sector Defined Benefit plans).

[133] 29 U.S.C. § 1002(2) (2017) ("The terms 'employee pension benefit plan' and 'pension plan' mean any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund, or program − (i) provides retirement income to employees, or (ii) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond . . . .").

[134] Letter from Alan D. Lebowitz, Deputy Assistant Sec'y, U.S. Dep't of Labor to Helmuth Fandl, Chairman of Ret. Bd., Avon Prods., Inc. (Feb. 23, 1988), *in* 15 Pens. Rep. (BNA) 391–92 (Feb. 29, 1988). [hereinafter Avon Letter]

[135] *Id.* at 392.

[136] U.S. Dep't of Labor, Pension & Welfare Benefit Programs, Opinion Letter on Responsibilities of Plan Fiduciaries under ERISA with Respect to Voting Proxies (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.").

[137] Interpretive Bulletins Relating to the Employee Retirement Income Security Act of 1974, 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.").

[138] Interpretive Bulletin Relating to Exercise of Shareholder Rights, 73 FED. REG. 61732 (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.").

[139] 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 . . . .").

[140] U.S. DEP'T OF LABOR, EMP. BENEFITS SEC. ADMIN., FIELD ASSISTANCE BULLETIN NO. 2018-01, INTERPRETIVE BULLETINS 2016-01 AND 2015-01 (2018), https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-01[https://perma.cc/M9XZ-T8NL].

beneficiaries[141] and participants.[142] These duties are comparable to what is found under the common law of trusts.[143]

Under ERISA's duty of loyalty, a plan fiduciary shall discharge his duties with respect to a plan "'*solely* in the interest of the participants and beneficiaries' and for the '*exclusive* purpose' of benefitting them."[144] The duty of loyalty also requires an exclusive focus on the "pursuit of '*financial* benefits' for the plan beneficiaries."[145] The latter constrains plan managers to focus solely on rates of return to help ensure that beneficiaries and participants ultimately receive what they are due, expect or hope for in terms of private pension benefits. In terms of investing in equity securities, this is very much a shareholder wealth maximization approach.[146]

Given these fiduciary duties, how shareholder voting is to be approached by a plan manager was long ago summarized in footnote four of the Avon letter:

> Section 404(a)(1) requires, among other things, that a fiduciary of a plan act prudently, solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits to participants and beneficiaries. To act prudently in the voting of proxies (as well as in all other fiduciary matters), a plan fiduciary must consider those factors which would affect the value of the plan's investment. Similarly, the Department [of Labor] has construed the requirements that a fiduciary act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives.[147]

This guidance sounds very much like a shareholder wealth maximization approach to shareholder voting. Yet, there has been no case law to enforce this approach.

C. Public Pension Funds

According to the U.S. Census Bureau's 2018 Annual Survey of Public Pensions, over 5,000 public state and local pension funds held approximately $4.3 trillion worth of assets, of which $1.4 trillion

[141] 29 U.S.C. § 1002(8) ("The term 'beneficiary' means a person designated by a participant, or by the terms of an employee benefit plan, who is or may become entitled to a benefit thereunder.").
[142] *Id.* at § 1002(7) ("The term 'participant' means any employee or former employee of an employer, or any member or former member of an employee organization, who is or may become eligible to receive a benefit of any type from an employee benefit plan which covers employees of such employer or members of such organization, or whose beneficiaries may be eligible to receive any such benefit.").
[143] *See infra*, Part II.
[144] Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. (forthcoming 2020) (manuscript at 15), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3244665[https://perma.cc/LF5K-PMR5] (citing 29 U.S.C. § 1104(a)(1)(A)(i)).
[145] *Id.* at 15 (citing Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409, 421 (2014)).
[146] For a more thorough discussion of this point, Sharfman, *Now is the Time to Designate Proxy Advisors as Fiduciaries Under ERISA*, *supra* note 52.
[147] U.S. Dep't of Labor, Avon Letter, *supra* note 134, at 11 n.4.

were equity securities.[148] The assets of public pension funds are not evenly distributed. The twenty largest funds held approximately $2.5 trillion in assets.[149]

Even though there is significant diversity between states, trustees of public pension funds have fiduciary duties that closely track what is required under the common law of trusts. This means that their fiduciary duties are the same or very close to what is required of ERISA plan managers. Somewhat amazingly, even though ERISA is not applicable to state and local public pension funds, "many states share, or have even copied, ERISA's fiduciary duties to govern their own pension funds," including the states of California, Florida, and New York.[150]

Therefore, an argument can be made that this would require a shareholder wealth maximization approach to shareholder voting. But again, there has been no case law to enforce such an approach.

D. Summary of Part I

There is a strong argument to be made that shareholder wealth maximization should be the default objective of shareholder voting in a public company. Yet, this is not what the law requires. Even though there is a general consensus that investment advisers and plan managers have a fiduciary duty to vote all of its proxies unless it has a good reason not to do so,[151] neither the state courts when applying the common law of trusts or corporate law, the SEC, or the Department of Labor have provided institutional investors with little enforceable guidance on the fiduciary objective of shareholder voting, let alone requiring it to be shareholder wealth maximization. This means that institutional investors may be tempted to utilize shareholder voting for their own purposes (enhancing the welfare of the institutional investor or its managers) and not for maximizing the wealth of its beneficial investors or public pension fund beneficiaries.

IV. HOW SHAREHOLDER VOTING PROVIDES VALUE

So far, this essay has painted a very dismal picture of shareholder voting. Perhaps those scholars of the 50s and 60s who wanted to get rid of shareholder voting were on to something.[152] Obviously, shareholder voting is not a very efficient way to make decisions at a public company. This problem is something that the marketplace for corporate governance arrangements appear to already reflect. Shareholder voting is rarely used when it comes to decision-making at a public company. The default rule under corporate law, whether or not a public company, is that corporate decision making is to be

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[148] U.S. Census Bureau, 2018 Annual Survey of Public Pensions: State & Local Tables (accessed Feb. 22, 2020), https://www.census.gov/data/tables/2018/econ/aspp/aspp-historical-tables.html.

[149] Wikipedia, *List of largest pension schemes in the United States* (accessed Feb. 22, 2020), https://en.wikipedia.org/wiki/List_of_largest_pension_schemes_in_the_United_States#cite_note-1.

[150] David Webber, *The Use and Abuse of Labor's Capital*, 89 N.Y.U. L. REV. 2106, 2120 (2014).

[151] *See* Luca Enriques & Alessandro Romano, *Institutional Investor Voting Behavior: A Network Theory Perspective* 15 (European Corp. Governance Inst., Working Paper No. 393, 2018) ("These requirements [DOL's Avon Letter and the 2003 SEC Proxy Voting Rule], while stopping short of mandating voting, are a powerful nudge in that direction for all institutions to which they apply.").

[152] *See supra*, at INTRODUCTION.

left in the hands of those who are the most informed about the affairs of the company, the board of directors and its executive management. [153]

As so well stated by James Cox, Tomas Mondino, and Randall Thomas:

> Corporations are not democratic institutions. In a democracy, power flows from the voting populace, and it is this body that is then governed. The populace governs the procedures for selecting candidates for office so that continued service as its elected representative depends heavily on popular support to be the nominee in the election. This is not the case with the corporation. By statute, power over corporate affairs is lodged in the corporation's "governor"—the board of directors. Importantly, the source of the board's power and its legitimacy is derived from the statute and not the shareholders. In addition, the power is exercised over interested parties, such as nonvoting security holders and labor, who do not vote in the election of directors. Indeed, the spheres within which shareholders have authority are limited in number and deeply circumscribed…. To be sure, stockholder approval is required for so-called fundamental transactions, such as mergers and the sale of substantially all of the company's assets. However, these transactions must be initiated by the board of directors, which controls their timing as well as the information upon which shareholders rely in deciding whether to approve the matter.[154]

Moreover, they go on to say:

> The genius of business organizations is their efficiency, which in large measure flows from enabling individuals with very different skills, experiences, and other endowments to combine with resulting synergies. Business organization law facilitates specialization and, in doing so, accommodates the unique limitations of owners whose personal endowment and circumstances justify their status as owners but not managers of the enterprise.[155]

Finally, in contrast to the efficiency issues faced by shareholders when they try to involve themselves in the decision-making of a public company, the value of authority, as represented by the board of directors and executive management, is of major benefit to public companies. This value of authority is what Michael Dooley and Stephen Bainbridge consider to be the crowning jewel of corporate governance.[156] They have persuasively made their arguments based on Kenneth Arrow's theory of large organizations: [157]

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[153] *See* DEL. CODE ANN. tit. 8, § 141(a) and § 142(a).
[154] James D. Cox, Tomas J. Mondino & Randall S. Thomas, *supra* note 105, at 515-16.
[155] *Id.* at 517.
[156] *See, e.g.*, Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 487 (1992); Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 547–48 (2003).
[157] Kenneth J. Arrow, THE LIMITS OF ORGANIZATION 68–70 (1974). Michael Dooley was the first to make the connection between the work of Kenneth Arrow and the structure of Delaware corporate law. Dooley, *supra* note 156, at 467. Professor Bainbridge has adopted Professor Dooley's application of Arrow's theory and readily acknowledges the contribution Professor Dooley has made in the development of his director primacy model. *See* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 85 n.11 (2004) ("I should acknowledge the debt director primacy owes to Professor Dooley's so-called 'Authority Model,' . . . .").

> Arrow's [theory] starts out with the basic proposition that "authority is needed to achieve a coordination of the activities of the members of the organization." But, more importantly, centralized authority enhances organizational efficiency. According to Arrow, efficiency is created in a large organization because "the centralization of decision-making serves to economize on the transmission and handling of information."[158]

That is, information scattered throughout a large organization must be both filtered and transmitted to a centralized authority in order for a large organization to make informed decisions and minimize error in decision-making.[159] Obviously, the centralized authority does need to be held accountable to some degree. However, the fear is that in the process of trying to correct errors resulting from irresponsible decisions, "the genuine values of authority" will be destroyed.[160] When that occurs, "accountability can be understood to cross over the line to where a new and competing locus of authority is created—a locus of authority, such as uninformed shareholders, that does not benefit from the informational advantages of the original authority."[161] This understanding is why Bainbridge has been able to make the bold statement that the "[p]reservation of managerial discretion should always be the null hypothesis."[162] In sum, you do not want to trample on the value of authority, as represented by the board and executive management, with too much shareholder decision-making.

A. Shining the Light on Shareholder Interests

Nevertheless, even with its defects, it can be argued that there is significant value in shareholder voting *if it is used sparingly and wisely*. This is acceptable not only because one does not want to diminish the value of authority by implementing too much accountability through shareholder participation, but also because "[t]he necessary conditions for accountability are supplied by competitive forces in the product market, in the internal and external markets for managers, … in the market for corporate control,"[163] and, most recently, through hedge fund activism.

Moreover, as I have previously stated:

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

[158] Arrow, *supra* note 157, at 68-70.
[159] *Id.*
[160] *Id.* at 77-78.
[161] Bernard S. Sharfman, *Shareholder Wealth Maximization and Its Implementation Under Corporate Law*, 66 Fla. L. Rev. 389, 406 (2014).
[162] *See* Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, *supra* note 150, at 109.
[163] Dooley, *supra* note 158, at 465.

> for why shareholders are given limited opportunities to weigh in and participate in corporate decision-making.[164]

The reference to decision-making being made "through the lens of shareholder interests" is the key point being made in quote above. According to former Delaware Chief Justice 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. 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.[165]

The ability of shareholders and only shareholders to "sue to enforce the corporation's compliance with the corporate law and the directors' compliance with their fiduciary duties" require directors to focus on shareholder interests or else be the subject of a shareholder suit for breach of those duties.[166] According to the Delaware Supreme Court in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*:

> 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.[167]

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[164] Sharfman, *supra* note 35, at PART I.
[165] 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, 453–55 (2014) (emphasis added) (internal citations omitted). 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 (Aug. 25, 2015), https://www.professorbainbridge.com/professorbainbridgecom/2015/08 /directors-are-fiduciaries-but-they-are-not-agents.html; *see also* United States 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." (quoting Restatement (First) of Agency § 14(c) (Am. Law Inst. 1933))); Arnold v. Soc'y for Sav. Bancorp, Inc., 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*."); Restatement (Second) of Agency § 14C (Am. Law Inst. 1958) ("[n]either the board of directors nor an individual director of a business is, as such, an agent of the corporation or of its members.").
[166] *See* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007).
[167] *Id.* at 101 (quoting Malone v. Brincat, 722 A.2d 5, 9 (Del. 1998)).

These fiduciary duties of care and loyalty (good faith is subsumed under the duty of loyalty under Delaware law[168]), enforced under corporate law, direct a board to make decisions that promote shareholder interests.[169]

In a similar manner corporate law utilizes a limited amount of shareholder voting as another tool to shine light on shareholder interests and help realize its shareholder-centric objective. But when voting does occur, it has significant ramifications for corporate decision-making:

> [S]hareholder voting in a public company cannot be looked at as simply another tool of accountability, i.e., a device to minimize agency costs[170] or enhance efficiency, such as when shareholders file a direct or derivative lawsuit [seeking compensatory or injunctive relief from an alleged breach in a board's fiduciary duties], initiate a proxy contest, attempt a hostile takeover, or take significant positions in the company and then advocate for change (hedge fund activism). When shareholders vote they are also participating, alongside the board, in corporate decision-making. That is, they are temporarily transformed into a locus of corporate authority that rivals the authority of the board. As co-decision makers, it is critical that shareholders and those with delegated voting authority, such as mutual fund advisers, have informed and sufficiently precise voting recommendations at their disposal, ...[171]

While this co-decision-making function is what distinguishes shareholder voting from the other tools used by corporate law to make sure the board of directors is focused on the interests of shareholders, its ability to support this objective, like the other tools, is what gives shareholder voting its value. The value provided by shareholder voting applies to a controlled company as well. Without shareholder voting a controlling shareholder would have no recourse but to file a lawsuit based on a breach of fiduciary duty in order to get the board to take into consideration its interests as the controller. Therefore, shareholders in both types of public companies can use this tool, no matter how limited its use and imperfections, to make sure that the decision-making approach of a board of directors is aligned with their interests.

V. THE IMPLICATIONS OF SHAREHOLDER VOTING

The following discussion focuses on two specific implications of shareholder voting for the corporate governance of public companies:

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[168] *See* Stone v. Ritter, 911 A.2d 362, 369–70 (Del. 2006).
[169] *See generally* Bernard S. Sharfman, *The Importance of the Business Judgment Rule*, 14 N.Y.U. J.L. & Bus. 27, 63–67 (2017) (discussing how fiduciary duties are directed toward satisfying shareholder interests).
[170] According to Andrew Schwartz, "Agency costs is the idea that, left to their own devices, corporate managers might pay themselves extravagantly, work as little as possible, or even steal from the company, all to the detriment of investors." *See* Andrew A. Schwartz, *Mandatory Disclosure in Primary Markets*, 2019 UTAH L. REV. 1069, 1071 (2019).
[171] Sharfman, *supra* note 35, at INTRODUCTION.

A. The SEC's Proposed Rules

The SEC's recently proposed rule changes for shareholder proposals,[172] which according to the SEC's own analysis will most likely have the effect of significantly reducing the annual number of shareholder proposals submitted to public companies,[173] is a reasonable reaction to the risks of shareholder voting. Unfortunately, the more shareholder proposals that are submitted to a public company the greater the likelihood that there will be more corporate decision-making being done through the inefficient corporate governance mechanism of shareholder voting. Therefore, keeping shareholder proposals and the potential voting on them to a minimum must be considered desirable. Consistent with this argument, Matsusaka, Ozbas, and Yi found that the stock market reacted positively when the SEC permitted shareholder proposals to be excluded.[174]

Perhaps most importantly, the interjection of shareholder voting into the decision-making of a public company, when the voting is uninformed and where the objectives of that voting are difficult to appraise, creates significant uncertainty for a board of directors when planning corporate strategy. If a shareholder presents a proposal for a shareholder vote, management may try to persuade the shareholder to withdraw the proposal by agreeing to a sub-optimal, non-wealth maximizing alternative in order to avoid risking a vote that it might lose. This is the argument that Matsusaka and Ozbas persuasively make in a recent paper,

> Managers have an incentive to deter proposals from activist shareholders by adjusting corporate policy; one might conjecture that external pressure leads them to choose policies more appealing to other shareholders in order to reduce the electoral prospects of activist proposals. However, we show that when deterrence occurs, it is always by moving policy toward the position favored by the activist, even if this reduces shareholder wealth. Our analysis stresses the central role of *voting uncertainty* in determining the value consequences of shareholder rights and proxy access.[175]

The recent work of Nickolay Gantchev and Mariassunta Giannetti supports the implementation of this approach. They found that value-destroying shareholder proposals, typically submitted by high-volume submitters of proposals, may actually go to a vote, receive majority support, and be

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[172] SEC, *Procedural Requirements and Resubmission Thresholds Under Exchange Act Rule 14a-8*, Release No. 34-87458 (Nov. 5, 2019), https://www.sec.gov/rules/proposed/2019/34-87458.pdf. *See also*, SEC, *Procedural Requirements and Resubmission Thresholds Under Exchange Act Rule 14a-8*, 84 Fed. Reg. 66458 (Dec. 4, 2019). For a good summary of the proposed changes, *see* SEC, *SEC Proposes Amendments to Modernize Shareholder Proposal Rule*, Press Release 2019-232 (Nov. 5, 2019), https://www.sec.gov/news/press-release/2019-232.

[173] *See* SEC, *Procedural Requirements and Resubmission Thresholds Under Exchange Act Rule 14a-8*, 84 Fed. Reg. 66458, 66496-66502.

[174] 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.*

[175] John G. Matsusaka and Oguzhan Ozbas, *A Theory of Shareholder Approval and Proposal Rights*, 33 J. L. ECON. & ORG. 377, 377 (2017).

implemented by management.[176] According to Gantchev and Giannetti, "We show that at least some of the proposals submitted by the most active individual sponsors seem to be ill-conceived. Not only do these proposals receive less support and produce negative abnormal returns if they pass with a majority in the shareholder meeting, but they are also less likely to be implemented by management, and if implemented, produce negative long-term abnormal returns."[177] The fact that some ill-conceived proposals may actually get majority support and be implemented by management supports the implementation of a risk adverse strategy as described above.

Moreover, such a desire on the part of management to avoid a shareholder vote is most likely heightened when certain shareholders find it desirable to use shareholder proposals as bargaining chips in their negotiations with management. For example, Matsusaka, Ozbas, and Yi found that labor unions used shareholder proposals as bargaining chips to extract side payments from management.[178]

Finally, without new, up-to-date rules to limit the use of shareholder proposals, there is also the risk that the current, more lenient rules will allow the use of shareholder proposals to proliferate. If so, then companies will be compelled to become increasingly reliant on shareholder voting as a mechanism for corporate decision-making, even though it would be much more efficient for management to continue to make those decisions. As a result, we should expect more sub-optimal corporate decision-making both as a result of shareholder voting and as a tool to avoid such voting. Therefore, in order to avoid these outcomes, it is desirable that the SEC's proposed changes to Rule 14a-8 be implemented.

B. Composition of Shareholders and its Impact on Share Price

A second implication, and one that is admittedly speculative, is that the greater the composition of shareholders with voting objectives that do not match shareholder wealth maximization or are indifferent to that objective, the more an equity analyst may penalize the company in terms of valuation, putting downward pressure on the value of the company's stock price. For example, an equity analyst may mark down her estimated value of a firm's stock when institutional investors are relatively overrepresented and retail investors are underrepresented. This type of result can be inferred from the recent research of Alon Brav, Matthew Cain, and Steven Davidoff Solomon who found that "Retail shareholders and institutional investors vote substantially differently. Retail shareholder support for management proposals is strongly related to lagged firm stock price performance, even with account-firm fixed effects, consistent with a focus on disciplining poorly-performing firms, whereas the voting of the Big Three institutional investors [Blackrock, Vanguard, and State Street Global Advisors] is not statistically significantly correlated with recent stock performance."[179] Or, perhaps when public pension

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[176] Nickolay Gantchev and Mariassunta Giannetti, *The Costs and Benefits of Shareholder Democracy* (Nov. 2019), http://ssrn.com/abstract_id=3269378.
[177] *Id.*
[178] 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.*

[179] Brav, Cain, and Zytnick, *supra* note 30.

funds with a focus on shareholder empowerment, not shareholder wealth maximization are overrepresented in a public company's investor base.[180]

CONCLUSION

Shareholder voting is a necessary component of corporate governance. However, it does have many risks which cannot be ignored. As we have discussed, shareholder voting, because of shareholders being generally uniformed and the potential for institutional investors to vote opportunistically with uncertain objectives, is an inefficient way to make decisions at a public company. As argued in this Article, such decision-making is the kind that needs to be kept at a minimum. Therefore, from a global perspective, regulators, shareholders, and managers should always be extremely wary of any proposal to increase the use of shareholder voting as a decision-making tool.

[180] *See* Tracie Woidtke, *Public Pension Fund Activism and Firm Value*, Legal Policy Report, The Manhattan Institute (2015) (This writing found that public pension fund ownership is associated with lower firm value.), available at https://www.manhattan-institute.org/html/public-pension-fund-activism-and-firm-value-7871.html.