ENHANCING THE VALUE OF SHAREHOLDER VOTING RECOMMENDATIONS

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

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

INTRODUCTION

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

1. Letter from Bernard S. Sharfman to Brent J. Fields, Sec'y, Sec. & Exch. Comm'n (Oct. 8, 2018) [hereinafter Comment Letter No. 1], https://www.sec.gov/comments/4-725/4725-4555147-176184.pdf; Letter from Bernard S. Sharfman to Brent J. Fields, Sec'y, Sec. & Exch. Comm'n (Oct. 12, 2018) [hereinafter Comment Letter No. 2], https://www.sec.gov/comments/4-725/4725-4513625-175932.pdf, *in* Bernard S. Sharfman, *Comment Letter in Advance of SEC Staff Roundtable on the Proxy Process*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Nov. 2, 2018),

of an entity that is defined as an investment adviser under the authority of the Investment Advisers Act of 1940 (Advisers Act).[2] The first comment letter targeted the fiduciary duties of investment advisers to mutual funds (mutual fund advisers), such as Vanguard, State Street Global Advisors, and Blackrock (the Big Three), when voting client securities.[3] The second and third comment letters concentrated on the fiduciary duties of proxy advisors, such as Institutional Shareholder Services and Glass Lewis.[4] As put forth in a 2010 SEC Concept Release, proxy advisors come under the definition of investment adviser and therefore have fiduciary duties under the Advisers Act.[5] The fourth comment letter was directed at the value of board voting recommendations and how they can be used to fulfill an investment adviser's fiduciary duties when voting client securities.[6]

When writing my fourth comment letter I realized that I was actually addressing a fundamental issue in corporate governance. That is, how can investment advisers become informed voters without requiring them to read massive amounts of information on the hundreds or thousands of companies they have invested in (SEC required documents, other publicly available information, and privately generated information) for the thousands, tens of thousands, or even hundreds of thousands of shareholder votes they are confronted with each year, which is impossible to do, and then come to conclusions that none of them can adequately make?

This issue has major significance for corporate governance because investment advisers to mutual funds, exchange-traded funds, and professional money managers of separately managed accounts are typically delegated the authority to vote their clients' securities. This most commonly includes the voting rights associated with a company's common stock. Investment advisers manage well over 30%

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https://corpgov.law.harvard.edu/2018/11/02/comment-letter-in-advance-of-sec-staff-roundtable-on-the-proxy-process/; Letter from Bernard S. Sharfman to Brent J. Fields, Sec'y, Sec. & Exch. Comm'n (Nov. 27, 2018) [hereinafter Comment Letter No. 3], https://www.sec.gov/comments/4-725/4725-4684881-176574.pdf; Letter from Bernard S. Sharfman to Brent J. Fields, Sec'y, Sec. & Exch. Comm'n (Dec. 17, 2018) [hereinafter Comment Letter No. 4], https://www.sec.gov/comments/4-725/4725-4780983-176889.pdf.

2. 15 U.S.C. § 80b-2(a)(11) (2012).

3. Comment Letter No. 1, *supra* note 1.

4. Comment Letter No. 2, *supra* note 1; Comment Letter No. 3, *supra* note 1.

5. *See* Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42,981, 43,010 (July 22, 2010); *infra* Part VI.

6. Comment Letter No. 4, *supra* note 1.

of all U.S. publicly traded equity securities[7] and have a fiduciary duty to vote their proxies[8] in their clients' best interest.[9] Most significantly, based on projecting the historical trends in the growth of index funds, Lucian Bebchuk and Scott Hirst estimate that the Big Three 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.[10] In regard to the Russell 3000 (an index made up of the 3000 largest publicly held companies incorporated in the United States), they estimate that the Big Three will control 29.8% of votes in 2028 and 36.7% of votes in 2038.[11]

A critical step in resolving this issue is maximizing the ability of investment advisers to avail themselves of "voting recommendations that are made on an informed basis and with the expectation that they will lead to shareholder wealth maximization."[12] One way to achieve this maximization is to recognize the value of board voting recommendations. As argued in my December 17, 2018 comment letter to the SEC, the most precise voting recommendations are not provided by a proxy advisor but by the board of directors.[13] Moreover, shareholders can easily find the board's voting recommendations, without charge, "in a public company's proxy statement."[14]

The recognition of the value of board voting recommendations would have significant policy implications. For example, it would change "a long-standing SEC policy where the value of proxy advisor recommendations is recognized but the value of board voting recommendations is not."[15] Such a paradigm shift will allow investment advisers to be less inhibited in using these informed and precise voting recommendations as a means to meet their fiduciary voting obligations. One way for the SEC to implement this new policy is to "provide investment advisers with a liability safe harbor under the Advisers Act when using board voting recommendations in voting

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7. 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.

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

9. *See infra* Part VI.

10. Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 BOS. U. L. REV. 721, 739–40 (2019).

11. *Id.*

12. Comment Letter No. 4, *supra* note 1, at 3–4.

13. *Id.* at 4.

14. *Id.*

15. *Id*. at 1.

their proxies as long as their clients do not prohibit their use and no significant business relationship exists between the investment adviser and the company whose shares are being voted."[16]

A ready argument against this recommendation is that shareholders would be giving up their role of keeping the board accountable if they simply followed the voting recommendations of the board. But this argument ignores the fact that shareholder voting in a public company cannot be looked at as simply another tool of accountability, i.e., a device to minimize agency costs or enhance efficiency, such as when shareholders file a direct or derivative lawsuit, initiate a proxy contest, attempt a hostile takeover, or take significant positions in the company and then advocate for change (hedge fund activism). When shareholders vote they are also participating, alongside the board, in corporate decision-making. That is, they are temporarily transformed into a locus of corporate authority that rivals the authority of the board. As co-decision makers, it is critical that shareholders and those with delegated voting authority, such as mutual fund advisers, have informed and sufficiently precise voting recommendations at their disposal, no matter the source, including the board of directors. If shareholders and investment advisers with delegated voting authority feel that the board can provide them with the most precise voting recommendations, then those are the recommendations that they should use.

Another way to achieve shareholder wealth maximization is to make sure that the voting recommendations provided by proxy advisors are truly informed ones. This leads to the recommendation that "the proxy advisor should be held to the standard of an *information trader*."[17] Moreover,

> If a proxy advisor cannot attest to the use of that standard when generating a voting recommendation, then the proxy advisor must abstain from making that recommendation to its clients. Making a recommendation that does not meet this standard would be a breach of a proxy advisor's fiduciary duty under the Advisers Act.[18]

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16. *Id*.

17. Comment Letter No. 2, *supra* note 1, at 14; *see infra* Section IV.C for the definition of an information trader.

18. Comment Letter No. 2, *supra* note 1, at 14.

Rather, the proxy advisor should defer to the voting recommendations provided by the board of directors of the company where voting is to take place.

In addition, a voting recommendation provided by a proxy advisor that is based on a board's voting recommendation should be disclosed as such. If not, then the investment adviser will be misled into believing that the proxy advisor is providing an independently-created voting recommendation. Given such disclosure, the client may want to go somewhere else for an independent third-party recommendation.

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

The foundation for this Article can be found in my comment letters of October 12, 2018[19] and December 17, 2018.[20] As such, this Article shares much of the same textual language as found in those two letters. Therefore, I do not believe it is necessary to continuously footnote quotes and cites from the two letters.

Also, the discussion that follows—when it references state corporate law—has been pragmatically framed in the context of Delaware corporate law. Delaware is the state where the vast majority of the largest U.S. companies are incorporated,[21] and its corporate law often serves as the authority that other states look to when developing their own statutory and common law.[22] Therefore,

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19. Comment Letter No. 2, *supra* note 1.

20. Comment Letter No. 4, *supra* note 1.

21. *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).

22. *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).

the primary examples are from Delaware, but the thinking is meant to be global.

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

I. THE LEGAL FOUNDATION FOR SHAREHOLDING VOTING

Shareholder voting is a creation of corporate law and is only required for a very small number of corporate decisions. For example, major corporate actions, such as merger agreements,[23] changes to the articles of incorporation,[24] and the election of directors at the annual meeting[25] require shareholder voting.

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.[26] However, at the same time, shareholder voting makes

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23. *See* DEL. CODE ANN. tit. 8, § 251(c) (2019).

24. *See id.* § 242.

25. *See id.* § 211(b).

26. *See* 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); *infra* Section III.C.

corporate decision-making much more unwieldy and potentially subject to the whims of uninformed and/or opportunistic shareholders.[27] Hence, a good rationale for why shareholders are given limited opportunities to weigh in and participate in corporate decision-making.

Shareholder voting also makes the company vulnerable to a potential change of control, either through hedge fund activism, where the activist is seeking to persuade the board to put the company, or a good part of it, up for sale;[28] or through a hostile takeover,[29] even though various takeover protections have muted most of this type of activity over the last thirty years.[30]

Corporate law requires a minimum level of shareholder participation by having quorum requirements for shareholder meetings. Under the default rules of Delaware corporate law, "[a] majority of the shares *entitled* to vote, present in person or represented by proxy, shall constitute a quorum at a meeting of stockholders."[31] While this percentage can be modified in a corporation's certificate of incorporation or bylaws, it cannot go below one-third of the shares entitled to vote.[32] In sum, corporate law requires a certain level of shareholder participation to implement certain actions but does not require any particular shareholder to participate.

However, this does not end the story of shareholder voting, at least for investment advisers with delegated voting authority. The voting

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27. *See* Bernard S. Sharfman, *How the SEC Can Help Mitigate the "Proactive" Agency Costs of Agency Capitalism*, 8 AM. U. BUS. L. REV. 1, 18–20 (2019) (discussing the risks of shareholder votes on shareholder proposals).

28. *See* Bernard S. Sharfman, *A Simple Plan to Liberate the Market for Corporate Control*, CLS BLUE SKY BLOG (Aug. 15, 2017), http://clsbluesky.law.columbia.edu/2017/08/15/a-simple-plan-to-liberate-the-market-for-corporate-control/; *see also* Bernard S. Sharfman, *A Theory of Shareholder Activism and Its Place in Corporate Law*, 82 TENN. L. REV. 791, 810 (2015) (discussing how a hedge fund activist was able to persuade the board of Timken Inc. to spin off its steel division).

29. *See generally* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965) (discussing various methods of takeovers, including proxy fights, direct purchases of shares, and mergers); Henry G. Manne, *Some Theoretical Aspects of Share Voting: An Essay in Honor of Adolf A. Berle*, 64 COLUM. L. REV. 1427 (1964) (discussing various forms of takeovers).

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

31. DEL. CODE ANN. tit. 8, § 216(1) (2019) (emphasis added).

32. *See id.* § 216.

requirements of corporate law have been significantly modified by federal regulation over the last thirty years. This began with the infamous 1988 U.S. Department of Labor (DOL) letter that is commonly referred to as the "Avon letter."[33] 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."[34] That is, the parties responsible for managing voting stock in pension plans governed by Title I of the Employee Retirement Income Security Act of 1974 (ERISA) have a fiduciary duty to vote their proxies.

The DOL letter was followed a year later by the DOL's first Proxy Project Report.[35] According to the Report, "Properly designated investment managers may not be passive on the issue of exercising proxy votes, even if plan and trust documents are silent to this effect. For example, investment managers may not, as a general policy, decline to vote proxies, or vote only non-controversial proxies."[36]

The DOL affirmed the Avon Letter in 1990,[37] 1994,[38] 2008,[39] and 2016.[40]

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33. 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).

34. *Id.* at 392.

35. PENSION & WELFARE BENEFITS ADMIN., U.S. DEP'T OF LABOR, PROXY PROJECT REPORT (1989). The date the report was issued on was March 2, 1989. *Id.*

36. *Id.* at 8.

37. *See* Letter from U.S. Dep't of Labor to Robert A.G. Monks, Institutional S'holder Servs., Inc. (Jan. 23, 1990), *in* 17 Pens. Rep. (BNA), No. 5, at 244, 245–46 (Jan. 29, 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.").

38. *See* Interpretive Bulletins Relating to the Employee Retirement Income Security Act of 1974, 59 Fed. Reg. 38,863, 38,863 (July 29, 1994) ("[A] statement of proxy voting policy would be an important part of any comprehensive statement of investment policy.").

39. *See* Interpretive Bulletins Relating to the Employee Retirement Income Security Act of 1974, 73 Fed. Reg. 61,732, 61,732 (Oct. 17, 2008) ("The fiduciary act of managing plan assets that are shares of corporate stock includes the management of voting rights appurtenant to those shares of stock.").

40. *See* Interpretive Bulletin Relating to the Exercise of Shareholder Rights and Written Statements of Investment Policy, Including Proxy Voting Policies or Guidelines, 81 Fed. Reg. 95,879, 95,880 (Dec. 29, 2016) (to be codified at 29 C.F.R. pt. 2509) ("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 . . . .").

In 2003, with the implementation of the Proxy Voting Rule,[41] the SEC formally recognized the fiduciary duties of registered investment advisers[42] when voting proxies:[43]

> The duty of care requires an adviser with voting authority to monitor corporate actions and vote client proxies. . . . We do not suggest that an adviser that fails to vote every proxy would necessarily violate its fiduciary obligations. There may even be times when refraining from voting a proxy is in the client's best interest, such as when the adviser determines that the cost of voting the proxy exceeds the expected benefit to the client. An adviser may not, however, ignore or be negligent in fulfilling the obligation it has assumed to vote client proxies.[44]

Absent an agreement with the client to the contrary,[45] there is a general consensus that in order for an investment adviser to meet its fiduciary obligations, it must vote all its proxies unless it has a good reason not to.[46]

II. SHAREHOLDER WEALTH MAXIMIZATION AS THE OBJECTIVE OF SHAREHOLDER VOTING

This Article is based on the premise that the default objective of shareholder voting is shareholder wealth maximization. This view is consistent with Delaware courts' understanding of why shareholder voting adds value to corporate governance: "What legitimizes the

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41. 17 C.F.R. § 275.206(4)-6 (2018).

42. *See* 15 U.S.C. §§ 80b-3, 80b-3(a) (2012) (discussing the registration of investment advisers).

43. Proxy Voting by Investment Advisers, Release No. IA-2106 (Jan. 31, 2003) [hereinafter Release, Proxy Voting Rule], https://www.sec.gov/rules/final/ia-2106.htm.

44. *Id.*

45. *See* SEC Staff Legal Bulletin No. 20 (IM/CF) (June 30, 2014) [hereinafter SEC Staff Legal Bulletin No. 20], https://www.sec.gov/interps/legal/cfslb20.htm ("An investment adviser and its client may agree that the investment adviser will abstain from voting any proxies at all, regardless of whether the client undertakes to vote the proxies itself.").

46. *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.").

stockholder vote as a decision-making mechanism is the premise that stockholders with economic ownership are expressing their collective view as to whether a particular course of action serves the corporate goal of stockholder wealth maximization."[47]

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

> The hunt for profit drives companies to strive to identify and meet people's needs using as few resources as possible. Companies communicate with their customers and suppliers through the price system. People tell companies what they value when they pay for the products and services those companies offer. Suppliers, by raising or lowering prices, tell companies how valuable the resources are that the companies use. Companies respond to what their customers and suppliers tell them. In this way, companies help to ensure that people spend their time wisely and that resources are used for the things society values most. Companies combine the diverse and complementary talents of their employees to research, develop, explore, produce, sell, and provide services to willing customers. In these activities, corporations play an important role in expanding scientific and technological knowledge, enabling people to profit from their hard work, and ensuring that society's resources are allocated to the uses we most value.[48]

Moreover, shareholder wealth maximization is also 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,[49] as well as the beneficiaries of public

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47. 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).

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

49. INV. CO. INST., *supra* note 7, at Facts at a Glance.

pension funds,[50] "simply want to earn the highest risk adjusted financial return possible,"[51] including when they vote or have votes cast for them by their investment advisers.

In addition, this desire to earn the highest risk-adjusted financial return possible is also shared by "the overwhelming number of socially motivated retail investors who align their investments based on their moral or social values,[52] 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,[53] and may "pay higher management fees for this

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50. A discussion of public pension funds is outside the scope of this Article.

51. 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 et al., *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.

52. 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 51.

53. *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

customization."[54] "That is, these investors are willing to exclude certain stocks from their portfolios because they find them to be socially undesirable, but are still looking for the highest risk-adjusted return possible given their investment constraints."[55]

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[56] of investors, can come closest to representing the preferences of their retail investors or beneficiaries.

III. THE BOARD AS A PROVIDER OF SUPERIOR VOTING RECOMMENDATIONS

According to Michael Schouten, "shareholders need to have at least some information to ensure that they are more likely to be right than wrong."[57] That is, shareholder voting needs to be more than just a flip of the coin.

Where does this informed source of voting recommendations come from if not from proxy advisors? Fortunately, the board of a public company already provides this foundational level of information in their own recommendations on how shareholders should vote.

A. The Role of Corporate Law

Corporate law, by establishing the board of directors as the most important locus of decision-making authority in the corporation,[58] allows the board access to information from all corners of the corporation. The reason why corporate law takes such an approach is that channeling information into a centralized, hierarchical authority

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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.

54. 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.

55. *Id.*

56. 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).

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

58. *See* DEL. CODE ANN. tit. 8, § 141(a) (2019).

allows for the efficient management of for-profit corporations. As a company grows in size, this becomes even more apparent. According to Kenneth Arrow, efficiency is created in a large organization because "the centralization of decision-making serves to economize on the transmission and handling of information."[59] Thus, the board is the source for the most precise voting recommendations because it has a large informational advantage over all other sources, including proxy advisors. For example, when it comes to nominating directors,

> The board nominating committee has an informational advantage over even the most informed shareholders because of the inside information it has on how the current board interacts with each other and executive officers, expectations on how a particular nominee will meld with other board members and executive officers, and the needs of the corporation in terms of directors, based on both public and confidential information.[60]

Hence, the board is in the best position to nominate a director that can enhance shareholder wealth.

Directors, as well as executive management, are often referred to as "insiders." According to Zohar Goshen and Gideon Parchomovsky, "[*i*]*nsiders* have access to inside information due to their proximity to the firm; they also have the knowledge and ability to price and evaluate this information."[61]

B. The Formulation of Board Voting Recommendations

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

> [D]etermining whether a business decision is shareholder wealth-maximizing is not just about plugging in a formula and calculating the result, which any computer or calculator can do. Rather, it refers to the specific formula that will be

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59. KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 68–70 (1974).

60. Bernard S. Sharfman, *Why Proxy Access Is Harmful to Corporate Governance*, 37 J. CORP. L. 387, 402 (2012).

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

> utilized by management to determine if a particular decision maximizes shareholder wealth. One can think of this in terms of a mathematical formula where the decision maker is given the responsibility of choosing the variables and estimating the coefficients of those variables. This requires many sources of knowledge and expertise . . . [which proxy advisors as well as the overwhelming majority of shareholders may lack], including experience in the particular business that the company may be in, product and company knowledge, management skills, financial skills, creative and analytical thinking pertinent to a company's business, confidential information, and so on. For example, who has the knowledge and expertise to decide whether a distinctive corporate culture enhances or detracts from shareholder value? The clear answer is that the board and its executive management are the proper locus of authority for making this decision.[62]

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

C. The Problem of Bias

However, even with their significant informational and analytical advantages, it is not guaranteed that the board will be able to deliver the maximum precision in its voting recommendations. Bias may have a significant negative impact on the precision of the board's recommendations. First, the board, being so close in proximity to the firm, may have, at times, difficulty in being objective in its voting recommendations.[63] According to Goshen and Parchomovsky: "Insiders' narrow focus on their own corporation, however, prevents them from exploiting economies of scale and scope in gathering, evaluating and pricing general market information. Moreover, due to their proximity to the firm, insiders cannot objectively assess the value of their own business decisions."[64] That is, the insider problem of narrow focus may create bias in the board's voting recommendations, reducing their precision. Perhaps the poor

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62. Bernard S. Sharfman, *Shareholder Wealth Maximization and Its Implementation Under Corporate Law*, 66 FLA. L. REV. 389, 408 (2014).

63. *See* Goshen & Parchomovsky, *supra* note 61, at 722.

64. *Id.*

performance of the company's stock price is the best indicator of when board bias is significant and therefore may also have a significant impact on the precision of a board's voting recommendations.[65] Another indicator of significant bias is when an activist hedge fund has taken a significant position in the company and is trying to encourage the board to change its business strategy or prepare the company for sale.[66] However, the occurrence of these two events is a signal, not an affirmation, that poor board decision-making is occurring.[67] A determination of whether board voting recommendations of any particular company are insufficiently precise because of a narrow focus, and therefore, a third-party source of "informed" voting recommendations is required, can only be made based on the independent judgment of each investment adviser.

Second, there is also the issue of agency costs ("the economic losses resulting from managers' natural incentive to advance their personal interests even when those interests conflict with the goal of maximizing their firm's value"[68]). As explained by Professor Paul Rose:

> Under a classic theory of the firm, agency costs in the corporate context increase as ownership is separated from control. As the manager's ownership of shares in the firm decreases as a percentage of the total, the manager will bear a diminishing fraction of the costs of any nonpecuniary benefits he takes out in maximizing his own utility. To prevent the manager from maximizing his utility at the expense of the shareholders, shareholders will seek to constrain the manager's behavior by aligning the manager's interests with the shareholders' interests.[69]

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65. *See* Bernard S. Sharfman, *Activist Hedge Funds in a World of Board Independence: Creators or Destroyers of Long-Term Value?*, 2015 COLUM. BUS. L. REV. 813, 842–47 (2015).

66. *See id.* at 844–47.

67. *See id.* at 842–47.

68. Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 775 (2017); *see also* Paul Rose, *Common Agency and the Public Corporation*, 63 VAND. L. REV. 1355, 1361 (2010) (citing Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976)) (discussing common agency theory on agency costs).

69. Rose, *supra* note 68, at 1361.

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

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

> In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible *while conforming to their basic rules of the society, both those embodied in law and those embodied in ethical custom*.[70]

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

Moreover, shareholder desires are what must guide the board of directors.[71] For example, while shareholders are not generally involved in the governance of a public company, this being delegated to the board under corporate law,[72] the governance role that shareholders do play signals to board members that the interests of shareholders must be their primary concern. In that way, corporate law establishes the foundation for a shareholder wealth maximization norm. According to Leo Strine:

> In American corporate law, only stockholders get to *elect directors*, *vote on corporate transactions and charter*

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70. Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970, at 17 (emphasis added).

71. *See* Christopher Conas, *Does Milton Friedman Support a Vigorous Business Ethics?*, 87 J. BUS. ETHICS 391, 392 (2009) (citing Friedman, *supra* note 70). Conas interprets Friedman's quote to mean that "[p]rofits are not ends-in-themselves; the only reason why executives are obligated to increase profits is because that is what the stockholders desire." *Id.*

72. *See* DEL. CODE ANN. tit. 8, §141(a) (2019).

> *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.[73]

In addition to the norm of shareholder primacy that these shareholder rights create, the board of directors also owes fiduciary duties to the corporation for the benefit of shareholders.[74] These duties, enforced by the courts by applying equitable principles, require directors to focus on shareholder interests or else be the subject of a shareholder suit for breach of those duties. According to the Delaware Supreme Court in *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

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73. 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.").

74. *See* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007).

> "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.[75]

Also, the *Gheewalla* court stated that even when a corporation is in the zone of insolvency, a board still owes fiduciary duties to stockholders and not to creditors because the "focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its stockholders by exercising their business judgment in the best interests of the corporation for the benefit of its stockholder owners."[76]

These fiduciary duties of care and loyalty (good faith is subsumed under the duty of loyalty under Delaware law[77]), enforced under corporate law, direct a board to make decisions, including voting recommendations, that enhance shareholder value.[78] Moreover, Strine has argued that "the corporate law *requires* directors, as a matter of their duty of loyalty, to pursue a good faith strategy to maximize profits for the stockholders,"[79] and that directors should only receive the benefit of the business judgment rule if their decision was motivated by a desire to enhance shareholder value.[80]

But the signals provided by corporate law that direct boards to focus on shareholder primacy and corporate law's fiduciary duties are not the only means by which agency costs are mitigated in favor of shareholders. Federal securities laws covering insider trading and securities fraud (as found under Section 10(b) of the Securities Exchange Act of 1934[81] and Rule 10b-5 as promulgated thereunder[82]), laws that may lead to civil penalties, criminal penalties, or both, keep shareholder interests clearly at the fore in board decision-making.

In addition, the listing requirements of U.S. stock exchanges make sure that boards are composed of a majority of independent

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75. *Id.* at 101 (quoting Malone v. Brincat, 722 A.2d 5, 9 (Del. 1998)).

76. *Id.*

77. *See* Stone v. Ritter, 911 A.2d 362, 369–70 (Del. 2006).

78. *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).

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

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

81. 15 U.S.C. § 78j(b) (2012).

82. 17 C.F.R. § 240.10b-5 (2017).

directors.[83] These requirements are to ensure that directors have ties to the corporation that are not so significant as to influence their judgment in corporate matters. That is, they help keep the board independent of management and focused on the interests of shareholders. The listing requirements also demand that a board's audit, compensation, and nominating committees be composed entirely of independent members.[84] According to Spencer Stuart, 85% of S&P 500 directors were independent in 2017.[85]

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

IV. THE VOTING RECOMMENDATIONS OF A PROXY ADVISOR

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

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

It should not be surprising that a proxy advisor's voting recommendations can have a significant impact on the results of a

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83. *See, e.g.*, NYSE, Listed Company Manual §§ 303A.01–.02 (2009), https://nyseguide.srorules.com/listed-company-manual (setting forth the New York Stock Exchange's independent director requirement).

84. *See, e.g.*, *id.* §§ 303A.04–.06.

85. SPENCER STUART, SPENCER STUART U.S. BOARD INDEX 16 (2017), https://www.spencerstuart.com/~/media/ssbi2017/ssbi_2017_final.pdf.

shareholder vote.[86] For example, Nadya Malenko and Yao Shen report that a negative Institutional Shareholder Services (ISS) recommendation on say-on-pay proposals led, on average, to a twenty-five percentage point reduction in voting support by shareholders during the sample period of 2010 to 2011.[87] In a general review of the empirical research on proxy advisor recommendations, James Copland, David Larcker, and Brian Tayan conclude that "[t]he evidence suggests that proxy advisors have a material, if unspecified, influence over institutional voting behavior and therefore also voting outcomes."[88] Moreover, they also conclude that an "against" recommendation from a proxy advisor "is associated with a reduction in the favorable vote count by 15%–30%."[89]

Given the potential for a proxy advisor's voting recommendations to have a significant impact on voting outcomes, it is critical that these recommendations be targeted toward enhancing shareholder value. However, many critics of proxy advisors argue that a significant number of their voting recommendations incorporate various types of data, analytic, and methodological errors.[90] If implemented, such voting recommendations will lead to sub-optimal corporate decision-making and a reduction in shareholder value. Such *imprecision* cannot be tolerated in a proxy advisor's recommendations.

B. The Limitations of Proxy Advisor Recommendations

As observed by Andrey Malenko and Nadya Malenko, "the presence of the proxy advisor increases firm value (the probability of a correct decision being made) only if the *precision* of its recommendations is sufficiently high."[91] However, based on the

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86. *See* JAMES R. COPLAND ET AL., PROXY ADVISORY FIRMS, EMPIRICAL EVIDENCE AND THE CASE FOR REFORM 11–13 (2018), https://www.manhattan-institute.org/sites/default/files/R-JC-0518-v2.pdf. *See generally* Andrey Malenko & Nadya Malenko, *Proxy Advisory Firms: The Economics of Selling Information to Voters*, 74 J. FIN. 2441, 2441 (2019) ("Extant research provides strong empirical evidence that proxy advisors recommendations have a large influence on voting outcomes.").

87. Nadya Malenko & Yao Shen, *The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design*, 29 REV. FIN. STUD. 3394, 3397 (2016).

88. COPLAND ET AL., *supra* note 86, at 13.

89. *Id.*

90. *See id.* at 11; LATHAM & WATKINS LLP, CORPORATE GOVERNANCE COMMENTARY: PROXY ADVISORY BUSINESS: APOTHEOSIS OR APOGEE? 5 (2011) [hereinafter PROXY ADVISORY], https://www.lw.com/upload/pubContent/_pdf/pub4042_1.pdf.

91. Malenko & Malenko, *supra* note 86, at 4 (emphasis added).

subsequent discussion in this Part, it is doubtful that a proxy advisor can provide the same level of precision as a board of directors in the creation of most voting recommendations. Even if the biases found in proxy advisors' voting recommendations are significantly less than found in board recommendations, their recommendations, on average, are so less informed that it makes the potential bias differential irrelevant. That is, voting recommendations that are made on an uninformed basis have little or no value.

C. Being Informed

As a foundational matter, for a proxy advisor to generate a recommendation that is sufficiently precise, the proxy advisor must be *truly* informed. For a proxy advisor to be truly informed, they need to be held to the standard of an informed investor, or what Goshen and Parchomovsky would call an "information trader."[92] According to Goshen and Parchomovsky, an information trader, even though they lack access to the information possessed by the board of directors, is identified by their willingness and ability "to devote resources to gathering and analyzing information as a basis for their investment decisions,"[93] including the gathering of private information.[94] Moreover, "information traders have the ability and knowledge to collect, evaluate and price firm-specific and general market information."[95] Furthermore, "[s]earching for, verifying, analyzing, and pricing general market and firm-specific information are costly tasks . . . ."[96]

D. The Low-Cost, Low-Value Approach

Yet, this high-cost, informed approach is not what proxy advisors appear to be providing. As observed by Luca Enriques and Alessandro Romano, "[t]he core function of proxy advisors is to offer institutional investors relatively cheap suggestions on how to vote portfolio

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92. Goshen & Parchomovsky, *supra* note 61, at 723.

93. *Id.*

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

95. Goshen & Parchomovsky, *supra* note 61, at 723.

96. *Id.* at 731.

companies' shares."[97] According to a corporate governance commentary, due to "the large number of voting recommendations that must be made in a short time period, it is inconceivable that proxy advisors' recommendations can or will be based on a thorough analysis of the facts and circumstances of each company in the context of each voting decision."[98] Moreover, David Larcker and Brian Tayan observe that "robust evidence does not exist that the recommendations of advisory firms are correct."[99]

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)[100] and Glass Lewis (37% market share),[101] devote to the creation of recommendations. In 2014, ISS had a global staff of 250 research analysts to provide recommendations on 250,000 shareholder votes.[102] Based on this information, the U.S. Chamber of Commerce stated that "it is clear that, on average, each ISS analyst is responsible for researching and preparing reports on 1,000 issues in the truncated period of the *usual* 'proxy season,'" which is primarily between March and June.[103] As of June 2017, the ISS Global Research team covered 40,000 shareholder meetings with approximately 270 research analysts and 190 data

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97. Enriques & Romano, *supra* note 46, at 14.

98. PROXY ADVISORY, *supra* note 90, at 4.

99. David F. Larcker & Brian Tayan, *Seven Myths of Corporate Governance*, STAN. CLOSER LOOK SERIES, June 2011, at 1, 3.

100. *See ISS*, CTR. ON EXEC. COMPENSATION, http://www.execcomp.org/Issues/Issue/proxy-advisory-firms/iss (last visited Sept. 6, 2019).

101. *See Glass Lewis*, CTR. ON EXEC. COMPENSATION, http://www.execcomp.org/Issues/Issue/proxy-advisory-firms/glass-lewis (last visited Sept. 6, 2019). Besides ISS and Glass Lewis, the U.S. proxy advisory industry is made up of only three other firms: Egan-Jones Proxy Services (Egan-Jones), Marco Consulting Group (Marco Consulting), and ProxyVote Plus. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-17-47, CORPORATE SHAREHOLDER MEETINGS: PROXY ADVISORY FIRMS' ROLE IN VOTING AND CORPORATE GOVERNANCE PRACTICES 6 (2016), http://www.gao.gov/assets/690/681050.pdf.

102. CTR. FOR CAPITAL MKT. COMPETITIVENESS, U.S. CHAMBER OF COMMERCE CORPORATE GOVERNANCE UPDATE: PUBLIC COMPANY INITIATIVES IN RESPONSE TO THE SEC STAFF'S GUIDANCE ON PROXY ADVISORY FIRMS 5 n.7 (2015), http://www.centerforcapitalmarkets.com/wp-content/uploads/2015/01/021874_ProxyAdvisory_final.pdf.

103. *Id.* (emphasis added).

analysts.[104] However, it is not known how many research analysts are full-time, part-time, or seasonal (proxy season only).[105]

According to the U.S. Chamber of Commerce, "Glass Lewis purports to analyze fewer issues, but has fewer analysts [approximately 200 in 2014] available to do so, ensuring that its analysts are equally overwhelmed with their responsibilities in a very short period of time."[106] In 2018, Glass Lewis reported that it covers 20,000 meetings each year with approximately the same number of analysts it had in 2014.[107] However, it is not known if this number includes 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).[108] For example, to provide these voting recommendations, ISS has created a Special Situations Research Team (Research Team).[109] Remarkably, the Research Team is made up of only eight analysts.[110] As discussed below, this is simply not enough.

To begin, in 2018, there was an estimated fifty-one proxy contests in the United States.[111] Informed voting on these types of decisions, which "will determine whether there is going to be a significant

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104. *See* INSTITUTIONAL S'HOLDER SERVS. INC., DUE DILIGENCE COMPLIANCE PACKAGE 5–6 (2017), https://www.issgovernance.com/file/duediligence/Due-Diligence-Package-November-2017.pdf.

105. *See id.* at 6 n.3.

106. CTR. FOR CAPITAL MKT. COMPETITIVENESS, *supra* note 102.

107. *See Company Overview*, GLASS LEWIS, http://www.glasslewis.com/company-overview/ (last visited Sept. 6, 2019) (stating that Glass Lewis has "more than 360 employees worldwide, more than half of whom are dedicated to research").

108. *See* Bernard S. Sharfman, *Beware a Proxy Advisor's M&A and Proxy Contest Advice*, REAL CLEAR MKTS. (May 28, 2019), https://www.realclearmarkets.com/articles/2019/05/28/beware_a_proxy_advisors_ma_and_proxy_contest_advice_103753.html ("If proxy advisors such as ISS are to provide informed and precise voting recommendations on proxy contests and M&A, then they must invest vastly greater resources into generating their voting recommendations.").

109. *See id.*

110. *See* Michelle Celarier, *The Mysterious Private Company Controlling Corporate America*, INSTITUTIONAL INV. (Jan. 29, 2018), https://www.institutionalinvestor.com/article/b16pv90bf0zbj8/the-mysterious-private-company-controlling-corporate-america.

111. SULLIVAN & CROMWELL LLP, REVIEW AND ANALYSIS OF 2018 U.S. SHAREHOLDER ACTIVISM 26 (2019), https://www.sullcrom.com/files/upload/SC-Publication-SandC-MnA-2018-US-Shareholder-Activism-Analysis.pdf; *see* Sharfman, *supra* note 108.

change in business strategy or if the company should be preparing itself for sale," requires a significant amount of both industry and company specific knowledge.[112] "Most likely, acquiring such expertise entails years of experience analyzing not just a specific industry but also the fine points of the specific company being targeted. Such expertise would require being at the level of a seasoned equity analyst who has both industry and company specific expertise."[113]

It is extremely doubtful that the expertise required for any particular proxy contest could be found within the eight-member Research Team.[114] This is because there are nearly 4000 public companies in the United States alone, and they exist in numerous industries.[115] For example, the Global Industry Classification Standard includes 11 sectors that are further subdivided into 24 industry groups, 69 industries, and 158 sub-industries.[116] 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."[117]

This lack of expertise would also apply to M&A voting recommendations.[118] Moreover, there are many more voting recommendations to deal with.[119] On an average annual basis, "approximately 5% of U.S. public companies delist as a result of M&A activity."[120] The delist percentage may vary, but we will assume that the Research Team has between 150 to 300 M&A per year.[121] This assumption is several times larger than the number the Research Team actually deals with in terms of proxy contests.[122] For an eight-person team lacking the proper expertise, doing an adequate job of providing voting recommendations is an impossible task.[123]

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112. Sharfman, *supra* note 108.

113. *Id.*

114. *See id.*

115. *See id.*

116. S&P GLOB. MKT. INTELLIGENCE & MSCI, GLOBAL INDUSTRY CLASSIFICATION STANDARD (GICS) 3 (2018), https://www.spglobal.com/marketintelligence/en/documents/112727-gics-mapbook_2018_v3_letter_digitalspreads.pdf.

117. Sharfman, *supra* note 108.

118. *Id.*

119. *Id.*

120. *Id.*; *see* Benjamin Bennett & Robert A. Dam, Merger Activity, Stock Prices, and Measuring Gains from M&A 9 (Aug. 1, 2019) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3000574.

121. *See* Sharfman, *supra* note 108.

122. *See id.*

123. *See id.*

Given the low level of resources devoted to analysis, it should not be surprising that a lack of resources may create the situation where a company claims one or more significant errors in a proxy advisor's adverse voting recommendation (recommending a vote against management) but then is not given a reasonable amount of time to contest the error prior to its release.[124] According to a recent study commissioned by the American Council for Capital Formation (ACCF), nearly 37% of sampled companies reported that ISS did not allow them an opportunity to respond, while 84% of companies said the same about Glass Lewis.[125]

Perhaps even more frustrating, "[w]hen a company did receive notice, it was often not enough time to generate a response."[126] In the sample's dealings with ISS, "[n]early 85% of companies that were given notice . . . indicated they received less than 72 hours to respond . . . , with roughly 36% of these companies indicating they received less than 12 hours-notice."[127]

The primary option for dealing with this problem is for the company to provide a supplemental proxy filing pointing out the errors in the proxy advisor's analysis.[128] Unfortunately, this is not a satisfactory solution. Based on a review of supplemental proxy filings during the 2016, 2017, and 2018 (through September 30, 2018) proxy seasons, an ACCF study found that "there were 107 filings from 94 different companies citing 139 significant problems including 90 factual or analytical errors."[129] While this number appears large, it likely represents just a small percentage of voting recommendations that could have been disputed as "many companies with objections to an advisor's recommendations decide not to make supplemental filings either because default electronic voting [robo-voting] or other timing issues limit their impact on voting, or because they know they

124. *See* FRANK M. PLACENTI, AM. COUNCIL FOR CAPITAL FORMATION, ARE PROXY ADVISORS REALLY A PROBLEM? 10 (2018), http://accfcorpgov.org/wp-content/uploads/2018/10/ACCF_ProxyProblemReport_FINAL.pdf.

125. *Id.* at 7.

126. *Id.*

127. *Id.* at 7–8.

128. *See id.* at 3.

129. *Id.* at 11. For a summary of each of the 139 proxy advisor errors, see FRANK M. PLACENTI, AM. COUNCIL FOR CAPITAL FORMATION, ANALYSIS OF PROXY ADVISOR FACTUAL AND ANALYTICAL ERRORS IN 2016, 2017, AND 2018 (2018), http://accfcorpgov.org/wp-content/uploads/Analysis-of-Proxy-Advisor-Factual-and-Analytical-Errors_October-2018.pdf.

have to face the recommendations of the proxy advisor in future years."[130]

In a 2015 survey by NASDAQ and the U.S. Chamber of Commerce, the responding companies reported that proxy advisors commonly gave them only twenty-four to forty-eight hours to respond to recommendations, and sometimes only one hour was provided.[131] Perhaps most telling, "[o]nly 25% of companies believed the proxy advisory firm carefully researched and took into account all relevant aspects of the particular issue on which it provided advice."[132] Confirming this belief, responding companies asked advisory firms to allow their input about 47% of the time, but that input was only allowed about 53% of the time.[133] In addition, when responding companies formally requested previews of advisor recommendations, that request was granted only about half the time.[134]

E. The One-Size-Fits-All Approach

A one-size-fits-all approach to voting recommendations is the inevitable result of proxy advisor firms that have significant resource constraints. Both ISS and Glass Lewis provide annually updated and extensively detailed voting policies that provide public companies and institutional investors with a roadmap on what the advisors recommendations will be even before an issue is raised at a specific company.[135] A one-size-fits-all approach in these policies are found everywhere, including when discussing hot button topics, such as dual class shares,[136] proxy access,[137] and staggered boards.[138] According to Albert Choi, Andrew Lund, and Robert Schonlau, "[t]o the extent that their institutional shareholder clients care less about the issue, proxy

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130. PLACENTI, *supra* note 124, at 11.

131. U.S. CHAMBER CTR. FOR CAPITAL MKTS. COMPETITIVENESS & NASDAQ, 2015 PROXY SEASON SURVEY: PUBLIC COMPANY EXPERIENCE DURING THE CURRENT PROXY SEASON 1 (2015), https://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/2015-Proxy-Season-Survey-Summary.pdf.

132. *Id.*

133. *See id.*

134. *See id.* at 2.

135. *See Current Voting Policies 2019*, ISS, https://www.issgovernance.com/policy-gateway/voting-policies/ (last visited Sept. 15, 2019); *Policy Guidelines*, GLASS LEWIS, http://www.glasslewis.com/guidelines/ (last visited Sept. 15, 2019).

136. *See* INSTITUTIONAL S'HOLDER SERVS., UNITED STATES: PROXY VOTING GUIDELINES, BENCHMARK POLICY RECOMMENDATIONS 30 (2019), https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf.

137. *Id.* at 16.

138. *Id.* at 17.

advisor recommendations may be more likely to rely on simple, one-size-fits-all criteria so as to economize their resources."[139]

Perhaps more to the point:

> [A]s everyone connected with the institutional shareholder voting process knows or should know, proxy advisors' voting recommendations are driven by inflexible, one-size-fits all *voting policies* and *simplistic analytic models* designed to utilize standard and easily accessible inputs that can be derived from readily available data and to avoid any need for particularized research or the application of meaningful judgment.[140]

Moreover,

> While proxy advisors may claim that each company and each vote is arrived at individually and reflects the particulars of the situation, this is true only in the most *superficial* sense. The analyses, in fact, are driven by checking boxes or inputting readily obtainable and relatively simple-to-find data, running this data through simplistic models and sticking inflexibly to whatever outcome is "spit out" of the process.[141]

The undesirability of this short-cut approach, at least to the extent it is currently used, is reflected in the following statement by current SEC Chairman Jay Clayton:

> We also need clarity regarding the analytical and decision-making processes advisers employ, including the extent to which those analytics are company or industry specific. *On this last point, it is clear to me that some matters put to a shareholder vote can only be analyzed effectively on a company-specific basis, as opposed to applying a more general market or industry-wide policy*.[142]

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139. Albert H. Choi et al., *Shareholder Voting on Golden Parachutes: Determinants and Consequences*, VAND. L. REV. (forthcoming) (manuscript at 5), https://ssrn.com/abstract=3229962.

140. PROXY ADVISORY, *supra* note 90, at 4 (emphasis added).

141. *Id.* (emphasis added).

142. *Oversight of the U.S. Securities and Exchange Commission: Hearing Before U.S. S. Comm. on Banking, Hous., & Urban Affairs*, 115th Cong. 10 (statement of Jay

F. The Undisclosed Following of Board Recommendations

Alternatively, a proxy advisor may be economizing on resources by simply accepting a board's voting recommendations as its own. This may explain why proxy advisors vote in support of management's recommendations about 89% of the time.[143] While this is not necessarily an undesirable approach, especially if you believe in the value of board recommendations, such an approach needs to be disclosed when it is used. If not, then the investment adviser will be misled into believing that the proxy advisor is providing an independent source of voting recommendations. Given such disclosure, the client may want to go elsewhere for an independent third-party recommendation. However, once disclosed, it would not be necessary for the proxy advisor to attest to the use of the information trader standard for that particular voting recommendation.

G. Conflicts of Interest

There is much concern that the recommendations of a proxy advisor may be tainted with conflicts of interest.[144] Such conflicts of interest would create bias in their voting recommendations, leading to something less than shareholder wealth maximization if their recommendations are implemented. There are two primary sources of these potential conflicts. First, the conflicts that may arise when a proxy advisor, such as ISS, sells not only voting recommendations but consulting services to a public company (Glass Lewis does not provide consulting services).[145] The concern is that providing consulting

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Clayton, Chairman, U.S. Securities & Exchange Commission) (2018) (emphasis added), https://www.banking.senate.gov/imo/media/doc/Clayton%20Testimony%2012-11-18.pdf.

143. Press Release, Council of Institutional Inv'rs, Investor Group Responds to Wall Street Journal Editorial: Proxy Advisory Firms Do Not Dictate Voting Outcomes (Aug. 13, 2018), https://www.cii.org/files/about_us/press_releases/2018/08-13-18_cii_press_release_WSJ_editorial.pdf (discussing proxy advisor recommendations for Russell 3000 companies).

144. *See* TIMOTHY M. DOYLE, AM. COUNCIL FOR CAP. FORMATION, THE CONFLICTED ROLE OF PROXY ADVISORS 7 (2018), http://accfcorpgov.org/wp-content/uploads/2018/05/ACCF_The-Conflicted-Role-of-Proxy-Advisors.pdf.

145. *See id.* at 7 ("In recent years, these institutions have drawn increased scrutiny for the conflicts of interest inherent in rating and providing voting recommendations concerning public companies while simultaneously offering consulting services to those same companies, including how they can improve their ratings and voting recommendations.").

services may encourage a proxy advisor to recommend a vote for management due to fear of losing business. Or, a possible quid pro quo may result if the proxy advisor offers to provide support for board recommendations in exchange for the purchase of its consulting services.[146]

Another source of possible conflict arises when clients, who are not totally focused on maximizing the wealth of investors or beneficiaries, try to influence a proxy advisor's voting recommendations. For example, according to James Copland of the Manhattan Institute, "ISS receives a substantial amount of income from labor-union pension funds and 'socially responsible' investing funds, which gives the company an incentive to favor proposals that are backed by these clients."[147] That is, pressure from these clients may lead to non-wealth maximizing proxy voting recommendations.

Given this long-standing understanding of how conflicts may arise, it was surprising to see ISS publicly enter into a new alliance with the Council of Institutional Investors (CII),[148] a powerful trade organization that represents the interests of public pension and labor union related funds and is a prominent leader in the shareholder empowerment movement.[149] The members of CII hold assets totaling over $4 trillion.[150] According to the website formed by the two entities (which has since been taken down), *Protect the Voice of Shareholders*:[151]

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146. *See id.* at 8.

147. James R. Copland, *Politicized Proxy Advisers vs. Individual Investors*, WALL ST. J. (Oct. 7, 2012, 7:06 PM), http://online.wsj.com/article/SB10000872396390444620104578012252125632908.html.

148. *See* Comment Letter No. 3, *supra* note 1, at 1 (discussing a fact pattern based on this alliance).

149. Both ISS and Glass Lewis are associate members of CII. *See* Alicia McElhaney, *Council of Institutional Investors Questions Wall Street Journal Over Proxy Advisory Firms*, INSTITUTIONAL INV. (Aug. 14, 2018), https://www.institutionalinvestor.com/article/b19j0gf9vscx87/Council-of-Institutional-Investors-Questions-Wall-Street-Journal-Over-Proxy-Advisory-Firms; *see also* *Associate Members*, COUNCIL INSTITUTIONAL INV., https://www.cii.org/associate_members (last visited Nov. 17, 2019). According to CII's associate member application form, the annual fee for being an associate member, for firms with between 26 and 2500 employees, is $12,000. *Application for Associate Membership*, COUNCIL INSTITUTIONAL INV. 1, 1, https://www.cii.org/files/about_us/members/Application%20for%20 Associate%20Membership.pdf (last visited Nov. 17, 2019).

150. *See About Us*, COUNCIL INSTITUTIONAL INV., https://www.cii.org/about_us (last visited Sept. 15, 2019).

151. As a matter of full disclosure, the Protect the Voice of Shareholders website has promoted several articles and posts that are critical of my association with the

> Protect the Voice of Shareholders is a joint project of the Institutional Shareholder Services (ISS), a leading provider of corporate governance and responsible investment solutions and the Council of Institutional Investors (CII), on behalf of its members. This site was developed and is managed through ISS funding. ISS is responsible for the site's editorial and content approval, with input and consent rights from CII.
>
> The work and goals of the Protect the Voice of Shareholders project are aligned with the concerns, public policy positions, and opposition to H.R. 4015 expressed by investment companies, state and municipal public retirement plans, consumer advocate organizations, labor union funds, and others capital market stakeholders.[152]

House Resolution 4015 is a piece of legislation that has passed the House but is stalled in the Senate.[153] The legislation would have the effect of increasing the regulatory authority of the SEC over a proxy advisor with the intent of reducing both a proxy advisor's conflicts of interest and errors in its voting recommendations.[154]

More pertinent to this discussion, such an alliance immediately raises a suspicion that whatever the trade organization can provide in terms of political support is being exchanged for voting recommendations that move further in the direction of shareholder empowerment. That is, the alliance may represent a quid pro quo. If so, then this would be a breach in the proxy advisor's fiduciary duties to its clients and a major source of bias in their voting recommendations.

Main Street Investors Coalition as well as my writings on proxy advisors, including my comment letter dated October 12, 2018, Comment Letter No. 2.

152. The website was previously available at the following link, https://www.protectshareholders.org/about-us. For additional information, see Ning Chiu, *CII and ISS Team Up to Oppose House Legislation on Proxy Advisory Firms, Speak for "Real Main Street" Investors*, BRIEFING:GOVERNANCE (Oct. 4, 2018), https://www.briefinggovernance.com/2018/10/cii-and-iss-team-up-to-oppose-house-legislation-on-proxy-advisory-firms-speak-for-real-main-street-investors/; James McRitchie, *Protect the Voice of Shareholders*, CORP. GOVERNANCE (Oct. 3, 2018), https://www.corpgov.net/2018/10/protect-the-voice-of-shareholders/.

153. Corporate Governance Reform and Transparency Act of 2017, H.R. 4015, 115th Cong. (2017), https://www.congress.gov/bill/115th-congress/house-bill/4015/text (as passed by the House of Representatives, Dec. 20, 2017).

154. *See id.*

V. THE PREFERENCE FOR LOW-COST, LOW-VALUE RECOMMENDATIONS

As previously discussed, the Avon letter[155] began the process of U.S. regulators putting pressure on institutional investors to vote all their proxies, whether or not their votes were informed. This pressure was given a big boost fifteen years later when the SEC implemented the Proxy Voting Rule[156] and formally recognized the fiduciary duties of registered investment advisers when voting proxies.[157]

This has been a boon for proxy advisors. Institutional investors, who do not find value in voting, have responded by seeking out low-cost, low-value recommendations from proxy advisors to meet their fiduciary duties at the lowest cost possible.[158] As subsequently discussed, this approach simply makes good economic sense for almost all institutional investors except for perhaps activist hedge funds who over-weight their portfolios with a small number of stocks and seek as much voting power as possible.[159]

Moreover, with the implementation of the Proxy Voting Rule, the SEC stated that the investment adviser could use an independent third party, such as a proxy advisor, to demonstrate that it was voting absent a conflict of interest.[160] This SEC endorsement of the use of a proxy advisor was reinforced in the SEC's 2014 Staff Bulletin, *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms*.[161] This was another boon for proxy advisors. However, this SEC endorsement was recently weakened when the SEC withdrew two long-standing no-action letters that supported this approach.[162]

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155. 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., *supra* note 33.

156. 17 C.F.R. § 275.206(4)-6 (2018).

157. *See* Release, Proxy Voting Rule, *supra* note 43.

158. *See* Enriques & Romano, *supra* note 46, at 14.

159. The activist hedge fund is a special type of information trader. They are distinguished from the most common type of information trader, the value investor, by their willingness to take a significant position in a company as a means to implement strategic changes, to spend resources to identify such changes, and to spend additional resources to try to get a company to implement those changes. *See* Sharfman, *supra* note 65, at 827–28.

160. Release, Proxy Voting Rule, *supra* note 43.

161. SEC Staff Legal Bulletin No. 20, *supra* note 45.

162. *See Statement Regarding Staff Proxy Advisory Letters*, U.S. SEC. & EXCHANGE COMMISSION (Sept. 13, 2018), https://www.sec.gov/news/public-statement/statement-regarding-staff-proxy-advisory-letters ("[T]he staff of the Division of Investment Management has recently re-examined the letters that the

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

A. The Preferences of Index Fund Managers

Low-cost, low-value recommendations are extremely appealing to the largest investment advisers of mutual funds, especially those who specialize in managing index funds. BlackRock, Vanguard, State Street Global Advisors, Fidelity, etc., investment advisers who are responsible for managing trillions of dollars' worth of equity securities, face tens if not hundreds of thousands of shareholder votes each year.[163] This would be an extremely costly undertaking if they were seeking precise voting recommendations. However, according to Lucian Bebchuk, Alma Cohen, and Scott Hirst, since the goal of an index fund is to meet, not beat the market, the adviser would not derive any competitive benefit from receiving precise recommendations and therefore would have no incentive to spend the money that such recommendations would require. They found:

> If the investment manager of a certain mutual fund that invests according to a given index increases its spending on stewardship at a particular portfolio company and thereby increases the value of its investment in that company, it will also increase the value of the index, so its expenditure would not lead to any increase in the performance of the mutual fund relative to the index. Nor would it lead to any increase relative to the investment manager's rivals that follow the same index, as any increase in the value of the corporation would also be captured by all other mutual funds investing according to the index, even though they had not made any additional expenditure on stewardship.

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staff issued in 2004 to Egan-Jones Proxy Services (May 27, 2004) and Institutional Shareholder Services, Inc. (Sept. 15, 2004). Taking into account developments since 2004, the staff has determined to withdraw these letters, effective today.").

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

> Thus, if the investment manager were to take actions that increase the value of the portfolio company, and therefore also the portfolio that tracks the index, doing so would not result in a superior performance that could enable the manager to attract funds currently invested with rival investment managers.[164]

Moreover,

> [I]f the index fund were to raise its fees and improve its stewardship, each individual investor in the fund would have an incentive to switch to rival index funds. That is, a move by any given index fund manager to improve stewardship and raise fees would unravel, because its investors would prefer to free-ride on the investment manager's efforts by switching to another investment fund that offers the same indexed portfolio but without stewardship or higher fees.[165]

Finally, in this current cut-throat fee environment that index fund advisors now face,[166] they must be extremely pleased to have the low-cost, low-value option available.

B. Actively Managed Funds

Investment managers who actively manage their portfolios will also prefer the low-cost, low-value option. It will always be more profitable for them to use their limited resources to invest in stock valuation (e.g., fundamental analysis used by information traders) than to spend their money on high-value voting recommendations.[167] While the benefits of fundamental analysis will be a private gain for that specific portfolio manager, the benefits of investing in high-value voting recommendations will be shared by its competitors. This

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164. Lucian A. Bebchuk et al., *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 98 (2017).

165. *Id.*

166. *See* Charles Stein & Annie Massa, *The Age of Zero*, BLOOMBERG BUSINESSWEEK, Aug. 13, 2018, at 25, 26.

167. *See* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 890 (2013). I substitute high-value voting recommendations for shareholder intervention in Gilson's and Gordon's argument. This is an appropriate substitution as both are costly but are expected to enhance the corporate governance of a targeted firm.

applies to the time and resources spent by a portfolio manager and their securities analysts in determining how to vote. Moreover, Bebchuk, Cohen, and Hirst argue that many actively managed funds are in reality "closet indexers."[168] As such, they gain very little from more precise voting except perhaps the stock of companies that are over-weighted in their portfolios relative to the appropriate benchmark index.[169] For those stocks that are under-weighted, the benchmark index would benefit more from the more precise voting, giving investment managers of actively managed funds a disincentive to make such an investment.[170]

VI. FIDUCIARY DUTIES UNDER THE ADVISERS ACT

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

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

According to the SEC in its 2010 Concept Release on the Proxy Process System (Concept Release),[171] the voting advice provided by a proxy advisor comes under the Advisers Act's definition of an investment adviser:[172]

> We understand that typically proxy advisory firms represent that they provide their clients with advice designed to enable institutional clients to *maximize* the value of their investments. In other words, proxy advisory firms provide analyses of shareholder proposals, director candidacies or corporate actions and provide advice concerning particular votes in a manner that is intended to assist their institutional clients in achieving their investment goals with respect to the voting securities they hold. In that way, *proxy advisory firms*

168. Bebchuk et al., *supra* note 164, at 98.

169. *See id.* at 98–99 (explaining if resources were devoted to more precise voting at underweighted stocks, then the benchmark would benefit more than the investment manager's portfolio, harming the investment manager's competitive position).

170. *See id.* at 99–100.

171. Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42,981 (July 22, 2010).

172. 15 U.S.C. § 80b-2(a)(11) (2012).

> *meet the definition of investment adviser* because they, for compensation, engage in the business of issuing reports or analyses concerning securities and providing advice to others as to the value of securities.[173]

The fiduciary duties of an investment adviser were formally recognized by the U.S. Supreme Court in *SEC v. Capital Gains Research Bureau, Inc.*[174] 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.[175]

As an investment adviser, a proxy advisor owes fiduciary duties to its clients.[176] Moreover, Section 206 of the Investors Act of 1940 applies to all persons that come within the definition of "investment adviser,"[177] including unregistered advisers. Therefore, the proxy advisor is a fiduciary under Section 206 of the Investment Advisers Act of 1940 even when, like Glass Lewis, it is not registered as an investment adviser with the SEC.

B. The Conflict

The Concept Release further stated that, "as a fiduciary, the proxy advisory firm has a duty of care requiring it to make a reasonable investigation to determine that it is not basing its recommendations

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173. Concept Release on the U.S. Proxy System, 75 Fed. Reg. at 43,010 (emphasis added).

174. 375 U.S. 180, 194 (1963); *see also* Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979) ("As we have previously recognized, Section 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." (quoting Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 471 n.11 (1977)) (internal citations omitted)).

175. *Capital Gains Research Bureau, Inc.*, 375 U.S. at 194 (internal citations omitted).

176. *See* Concept Release on the U.S. Proxy System, 75 Fed. Reg. at 43,010.

177. *See id*.

on materially inaccurate or incomplete information."[178] If a proxy advisor provides voting recommendations "based on materially inaccurate or incomplete data," then we have a potential breach in the proxy advisor's duty of care.[179] Consistent with this approach, if the proxy advisor provides voting recommendations that are uninformed and therefore of insufficient precision, wouldn't this also be considered a breach of fiduciary duty? In such a situation wouldn't the proxy advisor have a fiduciary duty to abstain from providing a recommendation and instead simply defer to the informed recommendation provided by the board of directors?

The harm caused by uninformed voting recommendations is aggravated when institutional investors take a herd mentality in following the advice of a dominant proxy advisor who provides low-cost, low-value voting recommendations. According to Malenko and Malenko, "when shareholders follow the same signal (the advisor's recommendation), their mistakes are perfectly correlated, which increases the probability that an incorrect decision will be made."[180] Therefore, "[t]he collective action problem may lead to excessive overreliance on the advisor's recommendations and crowd out too much private information production."[181] Moreover, "[i]f the quality of the advisor's information is low, there is overreliance on its recommendations and insufficient private information production."[182]

In a similar vein, the voting recommendations provided by the board of directors (high-cost, high-value), the most informed locus of authority in a corporation, are also crowded out by a proxy advisor's low-cost, low-value recommendations. This reduces the amount of informed voting that can take place. Why does the SEC prefer low-cost, low-value voting recommendations over more informed ones? This makes no sense as "the advisor's presence leads to more informative voting *only if* its information is sufficiently precise."[183] The fiduciary duties of a proxy advisor should be used to make sure this crowding out of board recommendations does not occur.

178. *Id.* at 43,012.
179. *Id.*
180. Malenko & Malenko, *supra* note 86, at 3.
181. *Id.*
182. *Id.* at 1.
183. *Id*. at 1 (emphasis added).

VII. CURRENT SEC POLICY ON BOARD VOTING RECOMMENDATIONS

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

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

> An investment adviser and its client *may agree* that the investment adviser should exercise voting authority as recommended by management of the company . . . absent a contrary instruction from the client or a determination by the investment adviser that a particular proposal should be voted in a different way if, for example, it would further the investment strategy being pursued by the investment adviser on behalf of the client.[184]

This statement provides that the investment adviser can use the voting recommendations of the board as long as it has permission from the client. Therefore, such use of voting recommendations would not be a breach of its fiduciary duties under the Advisers Act. The statement also implies that board voting recommendations have value. However, the SEC has yet to explicitly opine on the value of such voting recommendations. This has been the case even though the SEC has periodically acknowledged the value of a proxy advisor's recommendations in shareholder voting. For example, the Release implementing the Proxy Voting Rule stated that an investment adviser could avail itself of voting recommendations generated by an independent third party, such as a proxy advisor, to demonstrate that it was voting absent a conflict of interest.[185]

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184. SEC Staff Legal Bulletin No. 20, *supra* note 45; *see* SEC, Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Release Nos. IA-5325, IC-33605 (Aug. 21, 2019) (affirming that an investment adviser and its client may agree to different voting arrangements).

185. Release, Proxy Voting Rule, *supra* note 43; *see* Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42,981, 43,009 n.240 (July 22, 2010).

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

VIII. WHAT CAN BE DONE?

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

A. Recommendation #1

Investment advisers should not be in fear of breaching their fiduciary duties if they use board voting recommendations.[186] The

186. An argument has been made that following the voting recommendations of the board without more may violate an investment manager's fiduciary duties. Nevertheless, this argument does not appear to have any basis in the law. In the recent past, the ISS has mistakenly asserted that the Department of Labor's Proxy Project Report of 1989 provided the guidance that "blindly voting all proxies with management are inconsistent with the fiduciary responsibility provisions of ERISA." Letter from Gary Retelny, President, Institutional S'holder Servs., Inc. to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n 2 (Mar. 5, 2014), https://www.sec.gov/comments/4-670/4670-13.pdf; *see also* Statement of Gary Retelny, President & CEO Institutional S'holder Servs., Inc. to the Subcomm. on Capital Mkts. & Gov't Sponsored Enters. Comm. on Fin. Servs. U.S. House of Representatives A-14 (May 17, 2016), https://www.issgovernance.com/file/duediligence/iss-statement-hfsc-17-may-2016.pdf (discussing the treatment of proxy voting under the Advisers Act). The ISS cites the Proxy Project Report as its source for this assertion, but there is no such guidance in the report. *See* PENSION & WELFARE BENEFITS ADMIN., U.S. DEP'T OF LABOR, PROXY PROJECT REPORT (1989). This mistaken understanding of an investment manager's fiduciary duties most likely originated in an article written many years ago by David George Ball, a former Assistant Secretary of Labor for the Pension and Welfare Benefits Administration. In that article Secretary Ball stated, "A fiduciary who fails to vote, or casts a vote without considering the impact of the question, or votes *blindly* with management would appear to violate his duty to manage plan assets solely in the

superior precision of board voting recommendations, being based on inside information and enhanced by the expertise of executive management, should give investment advisers the right to use them without fear of liability. The SEC needs to go further than just approving the use of board voting recommendations as long as the investment adviser has an agreement with the client to use them. By contrast, an investment adviser does not need to receive the permission of the client when using the recommendations of a proxy advisor. Therefore, "[t]he SEC . . . should [explicitly state] that an institutional investor, as an alternative to using the voting recommendations of a proxy advisor, can meet its fiduciary voting duties by utilizing the voting recommendations provided by the board of directors."[187] Moreover,

> To implement such a policy, . . . the SEC [needs] to provide investment advisers with a liability safe harbor under the Advisers Act when using board voting recommendations in voting their proxies as long as their clients do not prohibit their use and no significant business relationship exists between the investment adviser and the company whose shares are being voted. This will help ensure that the value inherent in board voting recommendations is reflected in the voting of proxies by investment advisers.[188]

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

B. Recommendation #2

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

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interests of the participants and beneficiaries of the plan." David George Ball, *Where the Government Stands on Proxy Voting*, 6 FIN. EXECUTIVE 31, 35 (1990) (emphasis added).

187. Comment Letter No. 2, *supra* note 1, at 1.

188. Comment Letter No. 4, *supra* note 1, at 11.

> When making a voting recommendation, the proxy advisor should be held to the standard of an *information trader* (as previously defined[189]). If a proxy advisor cannot attest to the use of that standard when generating a voting recommendation, then the proxy advisor must abstain from making that recommendation to its clients. Making a recommendation that does not meet this standard would be a breach of a proxy advisor's fiduciary duty under the Advisers Act.[190]

Proxy advisors need to disclose how they are going to meet this standard when making their voting recommendations.

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

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

C. Recommendation #3

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

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189. *See supra* notes 92–96 and accompanying text for the definition of an information trader.

190. Comment Letter No. 2, *supra* note 1, at 1.

D. Summary

All three recommendations, if implemented, would encourage a shift from the use of proxy advisor recommendations to board voting recommendations. However, this does mean that a proxy advisor or another type of third-party advisor would have no role to play in shareholder voting. Investment advisers and other institutional investors should always have the option of using the voting recommendations of a proxy advisor if those recommendations meet the information trader standard. Moreover, there will be times when it will be of significant value to an investment adviser or any institutional investor to a have an "informed" third-party voting recommendation.

For example, an informed third-party voting recommendation may be desired when the investment adviser determines that the board's voting recommendations are so biased that they are insufficiently precise; when the company is engaged in a proxy contest where an activist hedge fund seeks a change in operating strategy or to have the board put the company up for sale; a merger or acquisition agreement that is subject to a shareholder vote; or when the investment adviser has a conflict of interest as discussed in the Release to the Proxy Voting Rule,[191] assuming the third party does not have a similar conflict of interest. This is when an informed proxy advisor or another third party can significantly help enhance the value of voting recommendations. However,

> If proxy advisors such as ISS are to provide informed and precise voting recommendations on proxy contests and M&A, then they must invest vastly greater resources into generating their voting recommendations. This means either hiring the hundreds of seasoned equity analysts required to cover the broad swath of industries and companies that may be the subject of such transactions or spending the large sums of money required in obtaining outside recommendations from seasoned professions with both industry and company specific expertise.[192]

191. Release, Proxy Voting Rule, *supra* note 43, at 4.
192. Sharfman, *supra* note 108.

CONCLUSION

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