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THE RISKS AND REWARDS OF SHAREHOLDER VOTING

*Bernard S. Sharfman**

ABSTRACT

The SEC's recent staff roundtable on the proxy process and its resulting guidance, interpretation, and proposed rules has made shareholder voting the most prominently debated corporate governance issue of recent times. The number of comment letters submitted to the SEC has been voluminous and includes eight submitted by this Article's author. Yet, the author doubts many of the writers of these letters, except in the context of their political agendas, have really thought deeply about the role shareholder voting plays in the governance of corporations, the collective action problem imbedded in such voting (and how it needs to be managed), the inability of proxy advisors to solve the collective action problem, the objective of shareholder voting, and how and when shareholder voting creates value. This Article is dedicated to filling the gap in the collective understanding of shareholder voting.

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* Bernard S. Sharfman is a Senior Corporate Governance Fellow at the RealClearFoundation, a member of the editorial advisory board of the Journal of Corporation Law, the former Chairman of the Main Street Investors Coalition Advisory Council, and a former visiting assistant professor of law at Case Western Reserve University School of Law and the University of Maryland Francis King Carey School of Law. Mr. Sharfman would like to thank Andrew Tuch, Amitai Aviram, Robert Rhee, Lawrence A. Cunningham, Marc Moore, Bobby Reddy, Alexander Platt, Michael Cappucci, Brett McDonnell, and Leon Anidjar for their extremely helpful comments. The opinions expressed here are the author's alone and do not represent the official position of any organization with which he was previously affiliated. Mr. Sharfman is dedicating this Article to his wife, Susan Thea David, his daughter, Amy David Beltchatovski, and his son-in-law, Elliot Beltchatovski.

I. INTRODUCTION

THE Securities and Exchange Commission's (SEC) recent staff roundtable on the proxy process[1] has made shareholder voting the most prominently debated corporate governance issue of recent times for three reasons: (1) the roundtable's resulting guidance, interpre-

1. Public Statement, Jay Clayton, Chairman, U.S. Sec. & Exch. Comm'n, Statement Announcing SEC Staff Roundtable on the Proxy Process (July 30, 2018), https://www.sec.gov/news/public-statement/statement-announcing-sec-staff-roundtable-proxy-process [https://perma.cc/2EMP-G8ZH].

tation, and proposed rules on limiting shareholder proposals,[2] (2) its issuance of a final rule on regulating proxy advisors (and the creation of shareholder voting recommendations for investment advisers),[3] and (3) its guidance, which increased the fiduciary burden on investment advisers to make sure that the voting recommendations provided by proxy advisors are adequately informed and nonconflicted.[4] The number of comment letters submitted to the SEC has been voluminous and includes eight submitted by this Article's author.[5] Yet, the author doubts that many of the writers of these letters, except in the context of their political agendas, have really thought deeply about the role played by shareholder voting in the governance of corporations, the collective action problem that is imbedded in such voting (and how it needs to be managed),[6] the inability of proxy advisors to solve the collective action problem,[7] the actual objective of shareholder voting,[8] and how and when shareholder voting creates value.[9] This Article is dedicated to filling the gap in the understanding of shareholder voting.

Shareholder voting provides a means by which shareholders can participate in corporate decision making. As stated by Frank Easterbrook and Daniel Fischel, "The right to vote is the right to make all decisions not otherwise provided by contract—whether the contract is express or supplied by legal rule."[10] Yet very few corporate decisions, especially in the type of corporations this Article is focused on (publicly traded companies taking the corporate form (public companies)), involve this decision-making mechanism. Shareholders do vote on major corporate

2. Procedural Requirements and Resubmission Thresholds Under Exchange Act Rule 14a-8, Exchange Act Release No. 34-87458, 84 Fed. Reg. 66,458 (proposed Dec. 4, 2019) (to be codified at 17 C.F.R. pt. 240).

3. 17 C.F.R. §§ 240.14a-1(1), a-2, a-9 (2020).

4. Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Investment Company Act Release No. IC-33605 (Sept. 10, 2019) (codified at 17 C.F.R. § 271 (2020)); Commission Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice, Exchange Act Release No. 34-86721(Sept. 10, 2019) (codified at 17 C.F.R. § 241 (2020)); Supplement to Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Investment Advisers Act Release No. 5547 (July 22, 2020) (codified at 17 C.F.R. § 276 (2020)).

5. U.S. SEC. & EXCH. COMM'N, COMMENTS ON STATEMENT ANNOUNCING SEC STAFF ROUNDTABLE ON THE PROXY PROCESS, https://www.sec.gov/comments/4-725/4-725.htm [https://perma.cc/QS8F-HZQB]; U.S. SEC. & EXCH. COMM'N, COMMENTS ON PROPOSED RULE: PROCEDURAL REQUIREMENTS AND RESUBMISSION THRESHOLDS UNDER EXCHANGE ACT RULE 14A-8, https://www.sec.gov/comments/s7-23-19/s72319.htm [https://perma.cc/TP7Y-8KZP]; U.S. SEC. & EXCH. COMM'N, COMMENTS ON PROPOSED RULE: AMENDMENTS TO EXEMPTIONS FROM THE PROXY RULES FOR PROXY VOTING ADVICE, https://www.sec.gov/comments/s7-22-19/s72219.htm [https://perma.cc/EW7A-UY5Y]; *see also* Jens Frankenreiter, *Mapping the Landscape of Comments to the SECs New Proxy Rules,* CLS BLUE SKY BLOG (Mar. 4, 2020), https://clsbluesky.law.columbia.edu/2020/03/04/mapping-the-landscape-of-comments-to-the-secs-new-proxy-rules/ [https://perma.cc/8SDU-45HF] (identifying the submission of over 500 comment letters).

6. *See infra* Part II.

7. *See infra* Part III.

8. *See infra* Part IV.

9. *See infra* Part V.

10. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 66 (1991).

actions such as the election of corporate directors,[11] merger agreements,[12] proxy contests,[13] changes to the articles of incorporation,[14] and the election of directors at the annual meeting.[15] However, while important, these actions are extremely limited compared to the millions of decisions made annually in a public company.

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

While these questions may seem out of step with today's so-called shareholder empowerment movement[20] toward greater shareholder democracy and control, this was not always the case. In the 1950s and '60s, leading legal scholars including Adolph Berle, Bayless Manning, and Abram Chayes, along with management guru Peter Drucker, thought the answer to these questions should lead to the end of shareholder voting.[21] According to Henry Manne, "Most of the critics of the school of corporate democracy have taken issue with the basic suppositions that it is appropriate for shareholders to make the decisions they do (including

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11. DEL. CODE ANN. tit. 8, § 216(3) (2020).
12. *Id.* § 251(c).
13. 17 C.F.R. §§ 240.14a-1 to -104 (2020).
14. tit. 8, § 242(b)(1).
15. *Id.* § 211(b).
16. *See infra* Part IV.
17. *See infra* Part II.
18. *See infra* Part VI.
19. Kosmas Papadopoulos, *An Overview of Vote Requirements at U.S. Meetings*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 6, 2019), https://corpgov.law.harvard.edu/2019/07/06/an-overview-of-vote-requirements-at-u-s-meetings/ [https://perma.cc/67BG-8BE7].
20. Shareholder empowerment is strongly related to the concept of "shareholder democracy," a term coined in the mid-1900s that "carried the normative message that greater shareholder participation in corporate governance was both possible and desirable." Harwell Wells, *A Long View of Shareholder Power: From the Antebellum Corporation to the Twenty-First Century*, 67 FLA. L. REV. 1033, 1069 (2015). Shareholder democracy is currently associated with the idea of one-share, one-vote. *See* Usha Rodrigues, *The Seductive Comparison of Shareholder and Civic Democracy*, 63 WASH. & LEE L. REV. 1389, 1390 (2006); *see also* Bernard Sharfman, *BlackRock, Larry Fink, and a New Form of Shareholder Empowerment*, REALCLEARMARKETS (May 8, 2020), https://www.realclearmarkets.com/articles/2020/05/08/blackrock_larry_fink_and_a_new_form_of_shareholder_empowerment_491105.html [https://perma.cc/T6RG-7CL3] (noting that "shareholder empowerment" is "the desire of certain shareholders for greater participation in corporate governance").
21. Henry G. Manne, *The "Higher Criticism" of the Modern Corporation*, 62 COLUM. L. REV. 399, 409 (1962).

election of directors) and that they are capable of making intelligent decisions."[22]

This view persisted into at least the early 1980s. Easterbrook and Fischel summarized the viewpoint of some academic scholars of that time:

> Shareholders' interests are protected not by voting but by the market for stock (and the managers' need to raise new capital), the market for goods, and the market for managers' services. It would make little difference if shareholders, like bondholders, could not vote at all. Funds spent providing shareholders with a more effective voice are wasted at best and harmful beyond their costs if they hamper the firms' effective pursuit of profits. On this view it is a puzzle that shareholders have, or exercise, votes.[23]

Nevertheless, this Article has no interest in resurrecting the argument that shareholder voting must be eliminated in public companies simply because it is arguably uninformed. Instead, even though it finds the shareholder empowerment movement to be a hindrance to efficient corporate decision making, and believes it should be curtailed, this Article will argue that it needs to continue—inefficiencies and all.

The textual foundation for this Article comes from the author's December 20, 2019 comment letter to the SEC.[24] In the process of writing that letter, a letter that argued for the implementation of the SEC's proposed amendments to its rules for proxy voting advice, it became clear that the letter was also an exploration of the pros and cons of shareholder voting. This Article continues that exploration but in a much more comprehensive way.

References to state corporate law in the discussion that follows has been pragmatically framed in the context of Delaware corporate law. The vast majority of the largest U.S. companies are incorporated in Delaware,[25] and Delaware's corporate law often serves as the authority that other states look to when developing their own statutory and common law.[26] Therefore, the primary examples are from Delaware, but the thinking is meant to be global.

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22. *Id.*

23. Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & Econ. 395, 397 (1983).

24. Letter from Bernard S. Sharfman to Vanessa Countryman, Sec'y, U.S. Sec. & Exch. Comm'n (Dec. 20, 2019), https://www.sec.gov/comments/s7-22-19/s72219-6571096-201082.pdf [https://perma.cc/4EJS-7TGR]. This comment letter was cited six times in the final rule and discussed a fair amount in the text. *See* 17 C.F.R. §§ 240.14a-1(1), a-2, a-9 (2020).

25. 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. Div. Corps., http://corp.delaware.gov/aboutagency.shtml [https://perma.cc/3MQG-P67L].

26. Nadelle Grossman, *Director Compliance with Elusive Fiduciary Duties in a Climate of Corporate Governance Reform*, 12 Fordham J. Corp. & Fin. L. 393, 397 (2007).

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

II. THE COLLECTIVE ACTION PROBLEM IMBEDDED IN SHAREHOLDER VOTING

"Shareholder voting suffers from a significant 'collective action' problem."[27] As a result, many voters are uninformed when they vote. According to Easterbrook and Fischel, "When many are entitled to vote, none of the voters expects his votes to decide the contest. Consequently none of the voters has the appropriate incentive at the margin to study the firm's affairs and vote intelligently."[28] Similarly, Paul Edelman, Randall Thomas, and Robert Thompson found the following:

> There is a serious collective action problem in shareholder voting: the benefits of a successful vote accrue to all shareholders *but the costs of voting* (for example, information acquisition, preparation and distribution of materials, mustering support) *are borne by each voter* separately so that shareholders may have inadequate incentives to vote.[29]

As a result, when shareholders do not bother to become informed, or don't even vote, they are not considered irresponsible but rather "rationally apathetic."[30]

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27. Letter from Bernard S. Sharfman to Vanessa Countryman, Sec'y, U.S. Sec. & Exch. Comm'n, *supra* note 24. This collective action problem was noted in the proposed amendments. Amendments to Exemptions From the Proxy Rules for Proxy Voting Advice, Exchange Act Release No. 3235-AM50, 84 Fed. Reg. 66,518, 66,541–42 (Dec. 4, 2019) (to be codified at 17 C.F.R. pt. 240) (citing Andrey Malenko & Nadya Malenko, *Proxy Advisory Firms: The Economics of Selling Information to Voters*, 74 J. FIN. 2441, 2442 (2019) ("In this paper, we emphasize that the market efficiency view does not take into account the *collective action* problem among shareholders. We show that because shareholders do not internalize the effect of their actions on other shareholders, there may be excessive overreliance on proxy advisors' recommendations and, as a result, excessive conformity in shareholders' votes." (emphasis added))).

28. Easterbrook & Fischel, *supra* note 23, at 402.

29. Paul H. Edelman, Randall S. Thomas & Robert B. Thompson, *Shareholder Voting in an Age of Intermediary Capitalism*, 87 S. CAL. L. REV. 1359, 1379 (2014) (emphasis added).

30. *See generally* ROBERT CHARLES CLARK, CORPORATE LAW § 9.5.1, at 390–92 (1986) (discussing the rational apathy problem).

A. The Impact

Empirically, this collective action problem results in a low percentage of retail investors casting their ballots at shareholder meetings. Based on recent research by Alon Brav, Matthew Cain, and Jonathon Zytnick, retail investors are not inclined to vote unless they own a significant percentage of the company's stock or the company has experienced a recent track record of poor financial performance. [31]

The collective action problem also exists at the institutional investor level but is manifested in a different way. As a result of SEC and Department of Labor (DOL) regulatory guidance that makes shareholder voting a fiduciary duty, institutional investors such as investment advisers and Employment Retirement Income Security Act of 1974 (ERISA) plan managers now feel compelled to cast their ballots on almost all issues presented for a vote at a public company.[32] This has resulted in many institutional investors being required to cast ballots by proxy on tens, if not hundreds, of thousands of votes per year.[33] However, because of the collective action problem, the amount of resources they are willing to spend on acquiring information, internally or externally, in order to be adequately informed on each and every vote is minimal. This requires them to seek the services of a low-cost proxy advisor for voting recommendations such as Institutional Shareholder Services (ISS) or Glass Lewis.

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

Consider how the collective action problem, and the regulatory pressure to vote, encourages our largest investment advisers to index mutual funds and exchange traded funds (BlackRock, Vanguard, State Street Global Advisors, Fidelity, etc.) to adopt a low-cost approach to shareholder voting. The management of passive funds exists in a supercompetitive industry with extremely thin profit margins, providing investment advisers with very little room to spend resources on shareholder voting. Moreover, since the goal of an index fund is to meet, not beat, the mar-

31. Alon Brav, Matthew D. Cain & Jonathan Zytnick, *Retail Shareholder Participation in the Proxy Process: Monitoring, Engagement, and Voting*, Harv. L. Sch. F. on Corp. Governance & Fin. Reg. (Nov. 19, 2019), https://corpgov.law.harvard.edu/2019/11/19/retail-shareholder-participation/ [https://perma.cc/6K25-ST8H] ("On the decision whether to cast a ballot, we find that retail shareholders cast 32% of their shares, on average, which is significantly lower than the 80% rate of participation by the entire shareholder base. In total, 12% of the average firm's retail accounts choose to vote. Retail voter participation is higher among smaller firms. The decision to cast a ballot varies predictably with anticipated costs and benefits. It increases with stake size, when the company's return on assets is poor, and when there are ISS-opposed proposals on the ballot.").

32. *See infra* Part IV.

33. *See, e.g.*, Vanguard, 2018 Investment Stewardship Annual Report 34 (2018), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2018_investment_stewardship_annual_report.pdf [https://perma.cc/WBH2-YPCD] (On a global basis, Vanguard's Investor Stewardship team "cast nearly 169,000 individual votes in the 2018 proxy year.").

ket, the adviser would not derive any competitive benefit from receiving highly informed and precise recommendations and, therefore, would have no incentive to spend the money that the creation of such recommendations would require.[34]

According to Lucian Bebchuk and Scott Hirst, when investor stewardship teams from the "Big Three" mutual fund families (Blackrock, Vanguard, and State Street Global Advisors) provide voting recommendations to their index fund clients, "their stewardship focuses on governance structures and processes and pays limited attention to financial underperformance."[35] This "mitigating governance risk" strategy results in a significant economization of an investment advisors' resources. For example, BlackRock only has forty-five global professionals in its investment stewardship team.[36] This small group of professionals manages tens of thousands of votes on an annual basis and all of BlackRock's engagement with its portfolio companies on various matters.[37] A BlackRock manager's description of her workload epitomizes how resource constrained its investment stewardship team is: "I cover industrials and materials in the US and Canada. I cover approximately 800 companies in those sectors and am responsible for the engagement and proxy voting with those firms."[38]

Besides uninformed voting, it also results in a one-size-fits-all voting policy. As described by Sean Griffith:

> Stewardship groups develop and work from a set of guidelines laying out a standard approach to recurring governance issues. The voting guidelines of each of the Big Three, for example, announce voting positions *against* staggered boards, poison pills and dual class shares. These positions lack nuance. In spite of recent research showing that [these provisions] can create value for some firms, stewardship group guidelines apply a one-size-fits-all approach to governance . . . .[39]

Hence, the strategy of mitigating governance risk in the creation of voting recommendations, whether used by investor stewardship teams or proxy advisors, is an approach that leads to voting recommendations that are

34. *See* Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, J. ECON. PERSPS., Summer 2017, at 89, 98.

35. Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2039 (2019). Bebchuk and Hirst provide the following example: "We reviewed all of the examples of behind-the-scenes engagements described in the Big Three Stewardship Reports. We found *zero* cases where engagement was described as being motivated by financial underperformance." *Id.* at 2096.

36. BLACKROCK, INVESTMENT STEWARDSHIP ANNUAL REPORT 25 (2020), https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2020.pdf [https://perma.cc/H856-QL24].

37. *Id.* at 13–14.

38. Ben Ashwell, *How BlackRock Connects the Dots on ESG*, CORPORATE SECRETARY (Oct. 12, 2020), https://www.corporatesecretary.com/articles/esg/32296/how-blackrock-connects-dots-esg [https://perma.cc/6CSS-865D].

39. Sean J. Griffith, *Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority*, 98 TEX. L. REV. 983, 1001–02 (2020) (citations omitted).

not very informed or precise, at least in terms of enhancing shareholder value. [40]

This collective action problem also applies to actively managed funds. In general, it will always be more profitable for them to use their limited resources to invest in stock valuation, such as fundamental analysis provided by equity analysts, than to spend their resources on costly high-value voting recommendations.[41] While the benefits of fundamental analysis will be a private gain for that specific portfolio manager, the benefits of investing in high-value voting recommendations will be shared by its competitors.

Of course, there are always exceptions to the rule. For example, "quality shareholders"[42] like Berkshire Hathaway perform detailed up-front research using fundamental analysis to determine which companies to invest in, and then hold these companies in a relatively concentrated portfolio for perhaps decades at a time.[43] However, their strategy of buy-and-hold means that they lack incentives for continually making additional investments in staying informed. Therefore, while informed at purchase, they may not be so informed as time passes. Also, activist hedge funds—unregulated hedge funds that take significant stock positions in a particular company in order to advocate for strategic change prior to selling their shares—will have strong financial motivations to vote on an informed basis.[44] However, similar to quality shareholders, activist hedge funds only hold a small number of company stocks in their portfolios.

While both quality shareholders and activist hedge funds have roles to play in the stock market, their respective roles appear small and can be viewed as forms of arbitrage: one focusing on the short-term[45] and the other on the long-term.[46] Therefore, as stated by Jill Fisch, Asaf Hamdani, and Steven Solomon, "The collective action problem . . . char-

40. *But see* Jill E. Fisch, Asaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17, 47 (2020) (arguing that investment advisers to passive index funds have incentives to be informed when voting).

41. *See* Bernard S. Sharfman, *Enhancing the Value of Shareholder Voting Recommendations*, 86 TENN. L. REV. 691, 713–14 (2019).

42. Lawrence Cunningham includes Warren Buffett and his company Berkshire Hathaway as "quality shareholders." Lawrence A. Cunningham, *The Case for Empowering Quality Shareholders*, 2020 BYU L. REV. (forthcoming 2020) (manuscript at 6), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3547482 [https://perma.cc/6HWZ-LN4L].

43. *Id.*

44. Edelman et al., *supra* note 29, at 1379.

45. Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1774 (2008).

46. Samuel Lee refers to the investment strategy utilized by quality shareholders as "time-horizon arbitrage"—that is, "buying assets with long-term value underappreciated by the market." Samuel Lee, *Warren Buffett and Time-Horizon Arbitrage*, MORNINGSTAR (Nov. 27, 2013), https://www.morningstar.com/articles/620888/warren-buffett-and-timehorizon-arbitrage [https://perma.cc/2XVH-UUTN]; *see also* Michael W. Roberge, Joseph C. Flaherty, Robert M. Almeida, Jr. & Andrew C. Boyd, *Lengthening the Investment Time Horizon*, MSF (May 2014), http://shareholderforum.com/access/Library/20140500_MFS.pdf [https://perma.cc/ZF7Z-VVRU] (identifying the increasing dispersion of equity returns over time as a time horizon arbitrage opportunity).

acterizes all institutional investor engagement in corporate governance—by both active and passive funds. Costly steps that investors may take to improve the performance of companies in their portfolio benefit all the investors that hold shares of these companies."[47]

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

III. PROXY ADVISORS DO NOT SOLVE THE COLLECTIVE ACTION PROBLEM

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

A. Evidence Pointing to Proxy Advisors Being Resource Constrained

As a result of the collective action problem faced by institutional investors, it should be expected that proxy advisors are resource constrained. The evidence appears to bear this out:

> There is strong evidence that the two major proxy advisor firms utilize a low-cost, low-value (not truly informed) approach to the creation of voting recommendations, leading to imprecise recommendations. This evidence is found in the resources that the two major proxy advisor firms, ISS (61% market share) and Glass Lewis (37% market share), devote to the creation of recommendations. . . . As of June 2017, the ISS Global Research team covered 40,000 shareholder meetings [approximately 250,000 votes] with approximately 270 research analysts [an estimated 800 plus votes per analyst during the proxy season] and 190 data analysts. However, it is not known how many research analysts are full-time, part-time, or seasonal (proxy season only). . . .
>
> . . . In 2018, Glass Lewis reported that it covers 20,000 meetings each year with approximately the same number of analysts it had in 2014 [200]. However, it is not known if this number included data as well as research analysts.
>
> Perhaps the most egregious example of where the lack of resources impacts the precision of a proxy advisor's voting recommendations is in the critically important areas of proxy contests and

47. Fisch et al., *supra* note 40, at 35 (citations omitted).

> mergers and acquisitions (M&A). For example, to provide these voting recommendations, ISS has created a Special Situations Research Team (Research Team). Remarkably, the Research Team is made up of only *eight* analysts. . . .
>
> . . . .
>
> It is extremely doubtful that the expertise required for any particular proxy contest could be found within the eight-member Research Team. This is because there are nearly 4000 public companies in the United States alone, and they exist in numerous industries. For example, the Global Industry Classification Standard includes 11 sectors that are further subdivided into 24 industry groups, 69 industries, and 158 sub-industries. In sum, "it would be a rare occasion when the Research Team could find an analyst on staff that would have the expertise to do an adequate job in evaluating a proxy contest."
>
> This lack of expertise would also apply to M&A voting recommendations. . . . On an average annual basis, "approximately 5% of U.S. public companies delist as a result of M&A activity." The delist percentage may vary, but we will assume that the Research Team has between 150 to 300 M&A per year. This assumption is several times larger than the number the Research Team actually deals with in terms of proxy contests. For an eight-person team lacking the proper expertise, doing an adequate job of providing voting recommendations is an impossible task.[48]

This resource-constrained business environment is further evidenced in a recent study by Ana Albuquerque, Mary Carter, and Susanna Gallani. They find that the negative assessments provided by ISS on the executive compensation of public companies are significantly correlated with poor future accounting performance.[49] However, this only occurs when the assessments are provided during the time of year not associated with the proxy season:

> [E]mpirical evidence show[s] that ISS appears to identify poor compensation practices *mainly* for the subsample of observations that have a non-December fiscal year end (FYE). This result suggests that during the proxy season when ISS is busier (evaluating firms with December FYE, which represent the majority of ISS's coverage) and more constrained regarding resources needed to analyze firms' compensation packages, their recommendations are of lower quality.[50]

48. Sharfman, *supra* note 41, at 713–15 (emphasis added) (footnotes omitted).

49. Ana Albuquerque, Mary Ellen Carter & Susanna Gallani, Are ISS Recommendations Informative? Evidence from Assessments of Compensation Practices 30 (Dec. 2019) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3590216 [https://perma.cc/934L-VJXL].

50. *Id.* at 4 (emphasis added). In the sample used by Albuquerque, Carter, and Gallani, over 70% of the sample firms had a December FYE. *Id.* This is consistent with the Conference Board finding that approximately eighty-five of Russell 3000 companies hold their annual meetings during the first half of the year. MATTEO TONELLO, CONF. BOARD, PROXY VOTING ANALYTICS (2016–2019) AND 2020 SEASON PREVIEW 14 (2019), https://

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

In sum, proxy advisors exist in an industry where there is a clear mandate to produce low-cost, low-value voting recommendations within a resource-constrained business environment.[51] Combining this result with a proxy advisory industry that has developed into an oligopoly where there are only two primary providers of these low-cost voting recommendations, ISS and Glass Lewis, may result in an excessive amount of conformity in voting recommendations.

B. How a Proxy Advisor Deals with Significant Resource Constraints

Proxy advisors have developed two primary cost-minimizing strategies to deal with a resource-constrained business environment. The first is creating voting recommendations based on "mitigating governance risk,"[52] and the second is creating broad-based recommendations based on interested party feedback, including feedback from clients.[53] In general, both strategies help proxy advisors avoid doing any real financial analysis regarding a particular shareholder vote and, most importantly, spending the

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cclg.rutgers.edu/news/proxy-voting-analytics-2016-2019-and-2020-season-preview/ [https://perma.cc/HF7K-D632].

51. As observed by Chester Splatt, former Chief Economist of the SEC: "During the SEC's roundtable on the proxy process held in November 2018, individual asset managers focused concern about greater regulation of proxy advisory firms upon the potential implications for the costs and resulting pricing of their services, rather than the equilibrium effects on the quality of governance." Chester S. Splatt, Milken Inst., Proxy Advisory Firms, Governance, Market Failure, and Regulation 6 (2019), https://milkeninstitute.org/sites/default/files/reports-pdf/Proxy%20Advisory%20Firms%20FINAL.pdf [https://perma.cc/822B-62XV].

52. Statement of Gary Retelny, President & CEO, Institutional S'holder Servs. Inc., to Subcomm. on Capital Mkts. & Gov't Sponsored Enters., Comm. on Fin. Servs., U.S. House of Representatives, Legislative Proposals to Enhance Capital Formation, Transparency and Regulatory Accountability A-14 (May 17, 2016), https://www.issgovernance.com/file/duediligence/iss-statement-hfsc-17-may-2016.pdf [https://perma.cc/MT2K-YYNK] [hereinafter Retelny House Statement]; Letter from Gary Retelny, President & CEO, Institutional S'holder Servs. Inc., to Bill Huizenga, Chairman, Subcomm. on Capital Mkts., Sec., & Inv., Comm. on Fin. Servs., U.S. House of Representatives & Carolyn B. Maloney, Ranking Member, Subcomm. on Capital Mkts., Sec., & Inv., Comm. On Fin. Servs., U.S. House of Representatives, Re: July 18, 2017, Hearing Entitled "The Cost of Being a Public Company in Light of Sarbanes-Oxley and the Federalization of Corporate Governance" (July 27, 2017), https://www.issgovernance.com/file/duediligence/20170727-iss-letter-to-hfsc-subcommitee-on-captal-markets-securities-and-investment.pdf [https://perma.cc/C8U8-XEEZ].

53. For example, ISS reports that it provides "more than 400 customized voting [reports]." Letter from Gary Retelny, President & CEO, Institutional S'holder Servs. Inc., to Brent J. Fields, Sec'y U.S. Sec. & Exch. Comm'n 1 (Aug. 7, 2018), https://www.sec.gov/comments/s7-09-18/s70918-4184213-172552.pdf [https://perma.cc/P4JW-P9V6]. Glass Lewis reports that it provides customized reports to a "supermajority" of its clients. Glass Lewis, Best Practice Principles for Providers of Shareholder Voting Research & Analysis: Glass Lewis Statement of Compliance for the Period of 1 January 2018 through 31 December 2018 at 9 (2019).

significant resources involved in doing such analysis.[54]

1. Creating Voting Recommendations Based on Mitigating Governance Risk

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

For example, every proxy season ISS produces a benchmark report, and five additional specialty voting reports, on each public company.[55] These reports create a default voting policy for each public company held in a client's equity portfolio.[56] None of these reports have shareholder wealth maximization as the exclusive objective of their voting recommendations.[57]

Regarding the benchmark report, Gary Retelny, President and Chief Executive Officer of ISS, has made conflicting statements about its objective. He has alternatively stated that its objective is "focused solely on protecting shareholder value *and* mitigating governance risk"[58] while also stating that its objective is "focused solely on maximizing shareholder value *and* mitigating governance risk."[59] These statements sound similar but actually conflict.[60] The first makes clear that a stated objective is not even the pursuit of shareholder wealth maximization but something lesser, the protection of shareholder value.[61] However, it is likely that what Mr. Retelny meant to say is that the objective of protecting share-

54. These cost-minimizing strategies do not work where some sort of financial analysis must be applied in a voting recommendation and research report, such as addressing the desirability of a merger or acquisition. There, as already discussed in this Part, the issue is the quality of the financial analysis in a resource-constrained environment. *See* discussion *supra* Section III.A.

55. Letter from Neil A. Hansen, Vice President, Inv. Rels. & Corp. Sec'y, Exxon Mobil Corp., to Vanessa Countryman, Acting Sec'y, U.S. Sec. & Exch. Comm'n 7 (July 26, 2019), https://www.sec.gov/comments/4-725/4725-5879063-188728.pdf [https://perma.cc/QG3V-LG4K].

56. *Id.*

57. *Id.* at 8 n.12.

58. Letter from Gary Retelny, President & CEO, Instutional S'holder Servs. Inc., to Brent J. Fields, Sec'y U.S. Sec. & Exch. Comm'n, *supra* note 53, at 1 (emphasis added); Retelny House Statement, *supra* note 52, at A-2.

59. Letter from Gary Retelny, President & CEO, Institutional S'holder Servs. Inc., to Bill Huizenga, Chairman, Subcomm. on Capital Mkts., Sec., & Inv., Comm. on Fin. Servs., U.S. House of Representatives & Carolyn B. Maloney, Ranking Member, Subcomm. on Capital Mkts., Sec., & Inv., Comm. On Fin. Servs., U.S. House of Representatives, *supra* note 52 (emphasis added).

60. *See* Bernard S. Sharfman, *Now is the Time to Designate Proxy Advisors as Fiduciaries under ERISA*, 25 STAN. J.L. BUS. & FIN. 1, 32 (2020).

61. *Id.*

holder value, or shareholder wealth maximization, will be achieved through a strategy of "mitigating governance risk."[62] Such an approach to voting recommendations makes economic sense when a proxy advisor is resource constrained.[63] That is, instead of a proxy advisor investing the necessary resources to produce voting recommendations that are based on a thorough financial analysis of each issue as a means to pursue shareholder wealth maximization, it takes a short-cut approach by creating voting recommendations based on corporate governance principles.[64] This resource-constrained strategy may also explain why ISS feels that an eight-person team of analysts is sufficient to review all the proxy contests and M&A transactions that come before it on an annual basis.[65]

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

2. *Creating Voting Recommendations Based on Feedback*

ISS makes public that, in the development of its benchmark voting policy, it "collects feedback from a diverse range of market participants through multiple channels: an annual Policy Survey of institutional investors and corporate issuers, roundtables with industry groups, and ongoing feedback during proxy season."[66] Glass Lewis is much more mysterious in how it goes about using feedback, saying only that it utilizes the advice of an independent body referred to as the Research Advisory Council.[67] The current composition of the Research Advisory Council is extremely impressive.[68] However, it is unknown how the council interacts with Glass Lewis, what kind of inputs it uses in developing its feedback, or what kind of feedback it actually provides.

A significant problem with taking a low-cost approach is that, while the preferences of proxy advisor stakeholders may potentially be revealed and taken into consideration, the preferences of beneficial investors and

62. *Id.* at 33.
63. *Id.*
64. *Id.*
65. *Id.*
66. *Policy Formulation Process*, Institutional S'holder Servs., https://www.issgovernance.com/policy-gateway/policy-formulation-application/ [https://perma.cc/9FG9-LULR]; *see also* Press Release, Institutional S'holder Servs., ISS Opens Global Policy Survey for 2020 (July 22, 2019), https://www.issgovernance.com/iss-opens-global-policy-survey-for-2020/ [https://perma.cc/F6JD-ZSYV] (noting the use of the survey for purposes of revising its benchmark voting policies).
67. U.S. Gov't Accountability Off., GAO-17-47, Corporate Shareholder Meetings: Proxy Advisory Firms' Role in Voting and Corporate Governance Practices 23 (Nov. 2016).
68. Currently, David Nierenberg, Charles A. Bowsher, Jesse Fried, Bonnie Hill, Stéphanie Lachance, and Katherine Rabin sit on the Research Advisory Council. *Leadership: Research Advisory Council*, Glass Lewis, https://www.glasslewis.com/leadership-2/ [https://perma.cc/2BTL-9ZKB].

public pension fund beneficiaries may be ignored. Institutional investors should be the advocates for their own investors and pension fund beneficiaries, but this may not be the case. For example, investment advisers to mutual funds and exchange traded funds may want to skew their voting patterns away from the preferences of baby boomers, the demographic group still providing the bulk of investment funds, and more toward the preferences of millennials. Millennials will increasingly be the generation holding most of the wealth in the U.S., making it essential for investment advisers to start catering to their needs and developing their loyalty now, not later.[69] As a result, this may mean that these investment advisers will vote their shares based on a currently perceived preference for less financial returns and more social activism.[70]

Moreover, relying on the preferences of proxy advisor stakeholders will create plenty of room for those with the most influence at a proxy advisor (i.e. its biggest and best clients) to outweigh others and, therefore, bias a proxy advisor's benchmark voting policy with their own preferences. For example, in its 2019 Global Policy Survey for U.S. companies ISS "asked investors whether a time-based sunset requirement of no more than seven years was seen as appropriate" for dual-class share structures.[71] According to ISS, of "those investors who provided a response to the question, 55 percent agreed that a maximum seven-year sunset is appropriate."[72] As a result, ISS changed its benchmark policy such that "[n]o sunset period of more than seven years from the date of the IPO will be considered to be reasonable."[73]

Besides the problem of how the question was phrased (the question should have simply been open-ended without leading the investor to a predetermined maximum number of years), this policy change was based on the responses of only eighty-nine unidentified institutional investors,[74] of which an estimated forty-nine responded yes.[75] With an institutional client base of approximately 2,000,[76] this seems to be an incredibly small sample size to use when making a very important policy change. In addition, the sample may have been significantly overweighted with representatives of investors who support shareholder empowerment, such as

69. Michal Barzuza, Quinn Curtis & David H. Webber, *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, 93 S. CAL. L. REV. (forthcoming 2020) (manuscript at 106), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3439516 [https://perma.cc/BDW8-EZZT].

70. *See id.*

71. Subodh Mishra, *ISS Benchmark Policy Updated—Executive Summary*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Dec. 2, 2019), https://corpgov.law.harvard.edu/2019/12/02/iss-benchmark-policy-updated-executive-summary/ [https://perma.cc/8H77-LLXM].

72. *Id.*

73. *Id.*

74. INSTITUTIONAL S'HOLDER SERVS., 2019 GLOBAL POLICY SURVEY: SUMMARY OF RESULTS 27 (2019), https://www.issgovernance.com/file/policy/2019-2020-iss-policy-survey-results-report.pdf [https://perma.cc/B2V8-F27F].

75. *Id.* (estimated).

76. *Proxy Voting Services*, INSTITUTIONAL S'HOLDER SERVS., https://www.issgovernance.com/solutions/proxy-voting-services/ [https://perma.cc/LZ7T-ZYU7].

public pension and union-related funds. Moreover, it should be noted that the Council of Institutional Investors (CII), the trade organization that represents such funds, has strongly advocated for a seven-year sunset period.[77] Based on these facts, a potential inference is that the question's phrasing, and the resulting policy change, was simply meant to please those clients who espouse shareholder empowerment, such as the CII and its public pension and union-related fund members.

It should be noted that this is not the first time that the use of feedback and survey results has been criticized as being opaque and biased. A number of years ago, David Larcker, Allan McCall, and Brian Tayan found that (1) "the ISS data collection process relies on a very small number of participants"; (2) "the composition of the respondent pool that ISS does reach is not well disclosed"; (3) "the survey suffers from design errors that are likely to confuse and/or bias respondents"; and (4) "it is unclear how ISS incorporates the feedback that it receives during the open comment period to finalize voting policies."[78]

Finally, it is important to ask why proxy advisors go to such great lengths to get institutional investor input for their default voting recommendations and why some institutional investors bother to provide it. One reason may be that it identifies investors who are willing to pay up for non-wealth maximizing voting recommendations.[79] Those who really care about certain issues want voting recommendations that are consistent with their interests.[80] More importantly, for these investors, there is great value in having a proxy advisor's one-size-fits-all recommendations represent their preferences. In that way, their voting power becomes amplified.[81] Perhaps that is why proxy advisors are so indulgent of institutional investors who advocate for shareholder empowerment by endorsing proxy access or restricting the use of dual-class shares. It may also explain why both the CII and public pension funds have, individually, strongly advocated for maintaining the status quo in the SEC's ongoing proxy process review.[82]

In sum, this strategy of using stakeholder preferences, especially client preferences, may create significant bias in voting recommendations. It

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77. *Dual-Class Stock*, Council Institutional Invs., https://www.cii.org/dualclass_stock [https://perma.cc/2W75-LHGG].

78. David F. Larcker, Allan L. McCall & Brian Tayan, *And Then a Miracle Happens!: How Do Proxy Advisory Firms Develop Their Voting Recommendations?*, Stan. Closer Look Series 2–3 (Feb. 25, 2013), https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-closer-look-31-proxy-firms-voting-recommendations.pdf [https://perma.cc/8KQ5-BNTW].

79. John G. Matsusaka & Chong Shu, A Theory of the Proxy Advice Market When Investors Have Social Goals 14 (Mar. 27, 2020) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3547880 [https://perma.cc/KEQ7-92LY].

80. *See id.*

81. *Id.* at 16.

82. *See, e.g.*, Letter from Kenneth A. Bertsch, Exec. Dir., and Jeffrey P. Mahoney, Gen. Couns., Council Institutional Invs., to Brent J. Fields, Sec'y, U.S. Sec. & Exch. Comm'n 15 (Nov. 8, 2018), https://www.sec.gov/comments/4-725/4725-4630831-176413.pdf [https://perma.cc/34SL-XW54].

also leads to the conclusion that "proxy advisory firms are concerned that their voting recommendations reflect the opinions and prejudices of their clients, the institutional investors; it matters less to proxy firms whether the governance regime reflected in their voting guidelines is correct."[83]

C. A Market Failure in the Market for Voting Recommendations

In the market for voting recommendations there are two parties that contract with each other: the providers of voting recommendations (proxy advisors) and their clients (institutional investors). Unfortunately, the two parties most impacted by the quality of the voting recommendations—the public companies whose shareholders are being asked to vote and the beneficial investors of the proxy advisors' clients––are not parties to the contract.[84]

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

The first negative externality is the negative impact that uninformed and inadequately precise voting recommendations will have on the decision-making of public companies.[85] For example, assume an activist hedge fund is initiating a proxy contest to change the strategic direction of a company and that the shareholder vote is significantly influenced by inadequate voting recommendations. As a result, the company's market and financial performance will suffer, as well as its ability to successfully compete against its rivals.

The second externality is the negative impact that such voting recommendations will have on beneficial investors and public pension fund beneficiaries.[86] These investors will suffer economic losses because suboptimal voting recommendations will lead to value-reducing decisions

83. Bryce C. Tingle, *Bad Company! The Assumptions Behind Proxy Advisors' Voting Recommendations*, 37 Dalhousie L.J. 709, 723 (2014). Andrew Tuch also argues that institutional investors like to work through proxy advisors as a means to implement their own preferences on shareholder voting because it gives them cover from political reprisal. Andrew F. Tuch, *Proxy Advisor Influence in a Comparative Light*, B.U. L. Rev. 1459, 1462 (2019). For example, working to implement uniform corporate governance policies through proxy advisors allows institutional investors to work collectively without triggering regulatory oversight by the SEC. *Id.* at 1496–1500. While beyond the scope of this Article, this example may have antitrust implications. *See generally* Einer Elhauge, *Horizontal Shareholding*, 129 Harv. L. Rev. 1267 (2016); Einer Elhauge, *How Horizontal Shareholding Harms Our Economy—And Why Antitrust Law Can Fix It*, 10 Harv. Bus. L. Rev. 207 (2020).

84. *See* Bryce C. Tingle, *The Agency Cost Case for Regulating Proxy Advisory Firms*, 49 U.B.C. L. Rev. 725, 746–47 (2016).

85. *See id.* at 782.

86. *See id.*

at public companies.[87] For example, the result of a merger vote could be significantly influenced by imprecise voting recommendations.

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

> For example, I have heard that the Commission should not take any action related to proxy voting advice provided by proxy advisory firms because ". . . the investors themselves . . . the ones paying for proxy advice . . . are not asking for protection." To be clear, in this context, I do not consider asset managers to be the "investors" that the SEC is charged to protect. Rather, the investors that I believe today's recommendations aim to protect are the ultimate retail investors, who may have their life savings invested in our stock markets. These Main Street investors who invest their money in funds are the ones who will benefit from (or bear the cost of) these advisers' voting decisions.[88]

Without these negative externalities, "market forces rather than regulation [would be] the most appropriate and effective oversight mechanism for the proxy advisory industry."[89] However, that is not where the industry stands. Even if voting recommendations are tainted with significant errors in facts, conflicts, or methodological weaknesses, institutional investors are very happy to purchase and use them. This is another significant weakness in shareholder voting, especially when institutional investors dominate the voting of proxies as they do today.

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87. David F. Larcker, Allan L. McCall & Gaizka Ormazabal, *Outsourcing Shareholder Voting to Proxy Advisory Firms*, 58 J.L. & ECON. 173, 173 (2015) ("These results suggest that outsourcing voting to proxy advisory firms appears to have the unintended economic consequence that boards of directors are induced to make choices that decrease shareholder value."); David F. Larcker, Allan L. McCall & Gaizka Ormazabal, *Proxy Advisory Firms and Stock Option Repricing*, 56 J. ACCT. & ECON. 149, 149 (2013) ("Using a comprehensive sample of stock option repricings announced between 2004 and 2009, we find that repricing firms following the restrictive policies of proxy advisors exhibit statistically lower market reactions to the repricing, lower operating performance, and higher employee turnover. These results are consistent with the conclusion that proxy advisory firm recommendations regarding stock option repricings are not value increasing for shareholders." (emphasis omitted)); James R. Copland, David F. Larcker & Brian Tayan, *The Big Thumb on the Scale: An Overview of the Proxy Advisory Industry*, STAN. CLOSER LOOK SERIES 6 (May 30, 2018), https://www.gsb.stanford.edu/faculty-research/publications/big-thumb-scale-overview-proxy-advisory-industry [https://perma.cc/WGP8-CNXG] ("The research literature therefore shows mixed evidence on the degree to which proxy advisory firms influence firm voting and the impact they have on corporate behavior and shareholder returns. For the most part, their influence on voting is shown to be—at a minimum—moderate and their influence on corporate behavior and shareholder value is shown to be negative. Nevertheless, conflicting evidence exists.").

88. Public Statement, Elad L. Roisman, Comm'r, U.S. Sec. & Exch. Comm'n., Statement at the Open Meeting on Commission Guidance and Interpretation Regarding Proxy Voting and Proxy Voting Advice (Aug. 21, 2019) (alteration in original) (citations omitted), https://www.sec.gov/news/public-statement/statement-roisman-082119 [https://perma.cc/EW7A-UY5Y].

89. Tingle, *supra* note 84, at 779 (quoting Letter from Debra L. Sisti, Vice President, & Martha Carter, Managing Director, Inst. S'holder Servs., to B.C. Sec. Comm'n et al. 15 (Aug. 10, 2012), https://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120810_25-401_sistid_carterm.pdf [https://perma.cc/E9KA-K4QU] (Can.)).

IV. SHAREHOLDER WEALTH MAXIMIZATION: THE ASPIRATIONAL OBJECTIVE OF SHAREHOLDER VOTING

According to Vice Chancellor Laster of the Delaware Chancery Court, and quoted with approval by the Delaware Supreme Court, "What legitimizes the stockholder vote as a decision-making mechanism is the *premise* that stockholders with economic ownership are expressing their collective view as to whether a particular course of action serves the corporate goal of [shareholder] wealth maximization."[90] What this statement implies is that courts expect shareholder voting to be done through the lens of shareholder wealth maximization.[91]

As I have argued in other writings,[92] Vice Chancellor Laster's statement is consistent with the premise that the overwhelming majority of the 100 million-plus individual retail investors in the United States that invest in voting stock indirectly through the use of mutual funds and exchange traded funds,[93] as well as the beneficiaries of public pension funds, "simply want to earn the highest risk adjusted financial return possible."[94] This includes when they vote or have votes cast for them by their investment advisers or pension fund managers. That is, it is reasonable to presume that investors "have a uniform interest in maximizing their own wealth."[95]

In addition, "this desire to earn the highest risk-adjusted financial return possible is also arguably shared by the overwhelming number of socially motivated retail investors who align their investments based on their moral or social values, even though they give up some risk-adjusted return in terms of portfolio diversification."[96] This may be the case even

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

91. *See* Robert J. Rhee, *A Legal Theory of Shareholder Primacy*, 102 Minn. L. Rev. 1951, 1954 (2015) (arguing, in a consistent fashion, that "courts have pervasively embraced the concept that corporate managers should maximize shareholder wealth").

92. *See, e.g.*, Sharfman, *supra* note 41, at 700–03.

93. Inv. Co. Inst., 2018 Investment Company Fact Book 32 (2018), https://www.ici.org/pdf/2018_factbook.pdf [https://perma.cc/D49Q-MMMB].

94. 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/ [https://perma.cc/Z7T9-S5ZP].

95. Griffith, *supra* note 39, at 1008; *see also* Paul Brest, Ronald Gilson & Mark Wolfson, *How Investors Can (and Can't) Create Social Value*, Stan. Soc. Innovation Rev. (Dec. 8, 2016), https://ssir.org/up_for_debate/article/how_investors_can_and_cant_create_social_value [https://perma.cc/ZSA5-2UHH].

96. Bernard S. Sharfman, *Commentary: Reforming a Broken System*, Pensions & Invs. (Aug. 27, 2018, 1:00 AM), http://www.pionline.com/article/20180827/ONLINE/180829997/commentary-reforming-a-broken-system [https://perma.cc/2LC2-FR3Z]. According to Paul Brest, Ronald Gilson, and Mark Wolfson:

> Socially motivated investors who wish to create social value through their investments have the much more challenging task of causing an investee company to increase its socially valuable outputs—for example, by enabling it to provide additional health care or education to poor people in developing

if they 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.[97] They may even "pay higher management fees for this customization. That is, these investors are willing to exclude certain stocks from their portfolios because they find them to be socially undesirable, but they are still looking for the highest risk-adjusted return possible given their investment constraints."[98]

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 of investors,[99] can come closest to representing the preferences of their retail investors or beneficiaries. As stated by Sean Griffith:

> [S]hareholder wealth maximization is often posited or assumed not because it is the highest and best thing for real-life shareholders but because it is the most that can be assumed about shareholders as a class. It does not rest upon the results of a poll of shareholder passions, but rather operates as a kind of lowest common denominator solution to their inability to coalesce around other objectives. Indeed, government failures to advance particular social objectives, frustrating to critics of wealth maximization, may reflect the divergent preferences of the political electorate, but these critics have supplied no reason to suppose that corporate electorates will not have similarly divergent preferences.[100]

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

> countries, or inducing it not to despoil the environment. Appropriately called "impact investments," these investments must lower the cost of capital to the enterprise compared to ordinary commercial markets, thereby allowing it to produce more socially valuable outputs or to engage in more socially valuable practices—the criteria for creating social value.

Brest et al., *supra* note 95.

97. *See* Hendrik Bessembinder, *Do Stocks Outperform Treasury Bills?*, 129 J. FIN. ECON. 440, 442 (2018). Bessembinder observed that there is a significant amount of positive skewness in the returns of individual public companies that have made up the stock market from July 1926 to December 2016. *Id.* at 440–43. He found that "in terms of lifetime dollar wealth creation, the best-performing 4% of listed companies explain the net gain for the entire US stock market since 1926, as other stocks collectively matched Treasury bills." *Id.* at 440. Wealth creation "refers to accumulated December 2016 value in excess of the outcome that would have been obtained if the invested capital had earned one-month Treasury bill returns." *Id.* at 454 tbl.5.

98. Sharfman, *supra* note 96.

99. Vanguard, a global investment company, reports that it has thirty million investors as of August 31, 2019. *Fast Facts About Vanguard*, VANGUARD, https://about.vanguard.com/who-we-are/fast-facts/ [https://perma.cc/4PAC-WGW6].

100. Griffith, *supra* note 39, at 1009–10 (footnotes omitted).

A. Corporate Law

Corporate law provides no guidance on what the objective of shareholder voting must be, despite V.C. Laster's compelling dicta.[101] Indeed, statutory corporate law is silent on this issue. This should not be surprising as it is consistent with corporate law's private ordering approach to corporate governance arrangements. Delaware's General Corporation Law enables private ordering by generally providing default, not mandatory, rules.[102]

1. Controlling Shareholders

Moreover, corporate law's fiduciary duties, which are quite extensive when it comes to the activities of the board of directors, only apply to shareholders who have a controlling interest in the company and are also transacting with the corporation.[103] For example, fiduciary duties will generally apply when a controlling shareholder decides that it wants to buy out the minority shareholders in a self-dealing transaction (referred to as a freeze-out merger)[104] or when a company is sold to a third party and the controlling shareholder is alleged to have received special benefits relative to minority shareholders.[105] In both situations, shareholders must vote to approve the transaction. If such transactions are challenged in a post-closing damages suit, the courts will normally apply an entire fairness standard of review unless the transaction has somehow been "sanitized" so as to receive the benefit of the business judgment rule.[106]

Entire fairness is a "court's most onerous" standard of review.[107] The entire fairness standard requires a review of the result for substantive fairness, with the burden of proof on the controlling shareholder and the

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101. *See supra* note 90 and accompanying text.

102. James D. Cox, *Corporate Law and the Limits of Private Ordering*, 93 Wash. U. L. Rev. 257, 261 (2015). Although default rules can be modified, "the default rule is tailored toward what the legislature believes most, but not all, of an organization's stakeholders would agree to if contracting were efficient." *Id.*; *see also* Williams v. Geier, 671 A.2d 1368, 1381 (Del. 1996) ("At its core, the Delaware General Corporation Law is a broad enabling act which leaves latitude for substantial private ordering, provided the statutory parameters and judicially imposed principles of fiduciary duty are honored.").

103. *See* Amy L. Simmerman & Katharine A. Martin, *Controlling-Stockholder Conflicts and How to Handle Them*, 2 PLI Current 593, 595–96 (2018).

104. *Id.* at 597 (citing *In re* Books-A-Million, Inc. S'holder Litig., No. 11343-VCL, 2016 WL 5874974 (Del. Ch. Oct. 10, 2016) (among others)).

105. *Id.* (citing *In re* Martha Stewart Living Omnimedia, Inc. S'holder Litig., No. 11202-VCS, 2017 WL 3568089 (Del. Ch. Aug. 18, 2017) (among others)).

106. Recently, the Delaware courts have allowed relief from the entire fairness standard of review in a freeze out merger if certain conditions are met. *Id.* at 598–99. In a freeze out transaction, if the board appoints a special independent committee to negotiate the transaction on behalf of the minority stockholders and the transaction is approved by an informed majority of minority stockholders, then the transaction may be given the benefit of the much more lenient business judgment rule. *See* Kahn v. M&F Worldwide Corp., 88 A.3d 635, 645 (Del. 2014). This approach was further extended to all mergers. *See, e.g.*, *In re Martha Stewart*, 2017 WL 3568089, at *2.

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

board of the corporation it controls.[108] According to Lawrence Mitchell, a review under entire "fairness contemplates a range of values and fiduciary conduct that properly is analyzed within the totality of a transaction's circumstances."[109] When this standard of review applies, courts must "'consider carefully how the board of directors discharged all of its fiduciary duties with regard to each aspect of the non-bifurcated components of entire fairness: fair dealing and fair price.'"[110] Moreover, "[n]ot even an honest belief that the transaction was entirely fair will be sufficient to establish entire fairness. Rather, the transaction itself must be *objectively* fair, independent of the board's beliefs."[111]

Under entire fairness, fair dealing:

> [E]mbraces questions of when the transaction was timed, how it was initiated, structured, *negotiated*, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. . . .
>
> . . . Moreover, one possessing superior knowledge may not mislead any stockholder by use of corporate information to which the latter is not privy.[112]

This point may be especially relevant when a controlling shareholder is entering into a transaction with the corporation.

Fair price "relates to the economic and financial considerations of the proposed [transaction], including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock."[113] The entire fairness standard of review, while not demanding the highest price possible, is clearly seeking to make sure that the focus is on getting at least a fair deal, especially in terms of price, for the corporation and its minority shareholders.[114] As a result, there is a better chance for shareholder wealth maximization to be achieved. However, there are so few fact patterns where the entire fairness standard will apply to a shareholder vote because it only applies to a controlling shareholder transacting with the corporation when a shareholder vote is required. Therefore, its ability to encourage shareholders to vote with the objective of shareholder wealth maximization must be considered negligible.

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108. *See* Solomon v. Armstrong, 747 A.2d 1098, 1112–13 (Del. Ch. 1999).

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

110. Emerald Partners v. Berlin, 787 A.2d 85, 97 (Del. 2001) (quoting Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1172 (Del. 1995)).

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

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

113. Encite LLC v. Soni, No. 2476-VCG, 2011 Del. Ch. LEXIS 177, at *75 (Del. Ch. Nov. 28, 2011) (quoting *Weinberger*, 457 A.2d at 711).

114. According to the chancery court: "[A]t least in non-fraudulent transactions, price may be the preponderant consideration . . . . That is, although evidence of fair dealing may help demonstrate the fairness of the price obtained, what ultimately matters most is that the price was a fair one." *Id.* at *66 (alteration in original).

2. *Non-Controlling Shareholders*

Unlike controlling shareholders, non-controlling shareholders do not owe fiduciary duties to the company's other shareholders, and therefore, they can vote with whatever objective they feel appropriate (or simply desire), no matter the impact on their fellow shareholders.[115] For example, if an investor's objective in shareholder voting is minimizing carbon emissions of the company, not shareholder wealth maximization, then so be it. This lack of fiduciary duty supports the fundamental principle that shareholders have only limited financial liability when they interact with the corporation.[116] That is, they are only liable up to the dollar amount of their investment in company stock and nothing more.

In sum, even if shareholder wealth maximization was considered under a fiduciary duty analysis, it would be irrelevant in the context of shareholder voting by non-controlling shareholders. This is critically important in the United States where "controlled companies make up only 3.6 percent of S&P 500 and 8.4 percent of the entire Russell 3000."[117] This means that for the overwhelming majority of U.S. public companies, corporate law does not provide any guidance to shareholders on what the corporate objective should be when voting their proxies.

B. Fiduciary Duties Under Federal Law

According to the publication *Pensions & Investments*, institutional investors currently own up to 80% of the market value of U.S. publicly traded equities,[118] compared to approximately 6% in 1950.[119] Institutional investors are susceptible to many different types of opportunistic behaviors and conflicts of interest that may benefit the investment managers or third parties but do not conform to the interests of their beneficial investors or pension fund beneficiaries. For example, a company that set up a pension plan for their employees will be run by trustees who are

115. *See* Simmerman & Martin, *supra* note 103, at 596.

116. *See* Robert Flannigan, *Fiduciary Duties of Shareholders and Directors*, 2004 J. Bus. L. 277, 285 (2004) ("Shareholders do not, as a matter of status, owe fiduciary obligations to each other or to their corporations. As discussed earlier, the interposition of the corporate entity between the shareholders and the business had fundamental consequences. The corporation now carried on the business as a principal. For shareholders, that produced their limited liability, but also negated the mutual fiduciary obligations they would otherwise have if they had carried on the business together without incorporating." (footnote omitted)).

117. Kosmas Papadopoulos, *CEO Ownership, Corporate Governance, and Company Performance*, Harv. L. Sch. F. on Corp. Governance & Fin. Reg. (May 13, 2019), https://corpgov.law.harvard.edu/2019/05/13/ceo-ownership-corporate-governance-and-company-performance/ [https://perma.cc/G2VS-BY8B].

118. Charles McGrath, *80% of Equity Market Cap Held by Institutions*, Pensions & Invs. (Apr. 25, 2017), https://www.pionline.com/article/2017/INTERACTIVE/170/80-of-equity-market-cap-held-by-institutions [https://perma.cc/5GLV-AV54].

119. Matteo Tonello & Stephan Rabimov, Conf. Bd., The 2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition 22 tbl.10 (2010).

selected by the company's management.[120] If the plan includes company stock, it is not too far-fetched to believe that the trustees will vote their shares in compliance with management's wishes.[121] Similarly, investment advisers to mutual funds and exchange traded funds who successfully market their investment management services or investment products to an employer sponsored retirement plan, and have delegated voting authority, will be reluctant to vote against the interests of company management for fear of losing their business.[122]

In addition, a pension fund sponsored by a labor union may vote its shares based on how it financially impacts its members instead of trying to maximize the value of its pension assets.[123] That is, "in situations where they are voting on issues that affect their [members'] jobs or future as workers in a company, they may well vote in their interests as workers at the expense of shareholders," beneficial investors, pension fund beneficiaries, or both.[124] For example, an institutional investor with a strong preference for shareholder empowerment or some component of environmental, social, and corporate governance may prioritize that preference over the default objective of shareholder wealth maximization.[125] Finally, public pension funds' trustees, who are often politicians or political appointees, may vote to maximize their own political ambitions instead of the value of the pension fund.[126]

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

121. *Id.*

122. *Id.* at 535–36; *see also* Bebchuk et al., *supra* note 34, at 90 ("[T]he agency problems of institutional investors can be expected to lead them to . . . side excessively with corporate managers, ..."); Proxy Voting by Investment Advisers, 68 Fed. Reg. 6585 (Feb. 7, 2003) (codified at 17 C.F.R. §§ 275.204-2, 275.206(4)-6).

123. Cox et al., *supra* note 120, at 536.

124. *Id.*

125. Sharfman, *supra* note 60, at 16–17; *see also* Bernard S. Sharfman, *How the SEC Can Help Mitigate the "Proactive" Agency Costs of Agency Capitalism*, 8 AM. U. BUS. L. REV. 1, 15–16 (2019). As stated in that writing:

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

Id. (footnotes omitted).

126. Cox et al., *supra* note 120, at 536.

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

1. The Objective of Shareholder Voting Under the Advisers Act

In the United States, investment managers are primarily regulated by the SEC under the authority of the Investment Advisers Act of 1940 (Advisers Act).[127] Investment advisers[128] to mutual funds, exchange-traded funds, and separately managed accounts are typically delegated the authority to vote their clients' securities.[129] Investment advisers manage 30% of all U.S. publicly traded equity securities[130]—approximately $10.8 trillion of total U.S. equity value (approximately $35.8 trillion as of October 29, 2020).[131] Most significantly, based on projections of the historical trends in the growth of index funds, Lucian Bebchuk and Scott Hirst estimate that the Big Three investment advisers alone will control 34.3% of S&P 500 (an index made up of the five hundred largest companies listed on U.S. stock exchanges) votes by 2028 and 40.8% by 2038.[132] As for the Russell 3000 (an index made up of the three thousand largest publicly held companies incorporated in the U.S.), Bebchuk and Hirst estimate that the Big Three will control 29.8% of votes in 2028 and 36.7% of votes in 2038.[133]

In 2003, with the implementation of the Proxy Voting Rule as promulgated under Section 206 of the Advisers Act, the SEC took the position that an "[investment] adviser is a fiduciary that owes each of its clients duties of *care* and *loyalty* with respect to all services undertaken on the client's behalf, including proxy voting."[134] Moreover, "[t]o satisfy its duty

127. 15 U.S.C. §§ 80b-1 to b-21.

128. *Id.* § 80b-2(a)(11) (defining investment adviser).

129. Proxy Voting by Investment Advisers, 68 Fed. Reg. 6586 (Feb. 7, 2003) (codified at 17 C.F.R. §§ 275.204-2, 275.206(4)-6).

130. Inv. Co. Inst., 2019 Investment Company Fact Book 37 (2019), https://www.ici.org/pdf/2019_factbook.pdf. [https://perma.cc/6F3E-HFSH].

131. *Buffett Indicator: Where Are We with Market Valuations?*, GuruFocus (Oct. 24, 2020, 3:05 PM), https://www.gurufocus.com/stock-market-valuations.php [https://perma.cc/X8TP-F5AP].

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

133. *Id.*

134. Proxy Voting by Investment Advisers, 68 Fed. Reg. 6585 (Feb. 7, 2003) (codified at 17 C.F.R. §§ 275.204-2, 275.206(4)-6) (emphasis added). The fiduciary duties of an investment adviser were formally recognized by the U.S. Supreme Court in *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963). 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

of loyalty, the adviser must cast the proxy votes in a manner consistent with the *best interest of its client and must not subrogate client interests to its own*."[135] In these situations, a fund's adviser may have an incentive to support management recommendations to further its business interests.[136]

Yet, the SEC has done little to enforce these fiduciary duties. There has only been one SEC enforcement action under the Proxy Voting Rule: the action against INTECH.[137] There, the registered investment adviser (INTECH) had initially voted its proxies based on an ISS recommendation platform that was purposely designed to side with management.[138] Between 2003 and 2006, INTECH moved to a different ISS recommendation platform that followed the voting recommendations of the American Federation of Labor and Congress of Industrial Organization (AFL-CIO).[139] According to the SEC's order instituting proceedings, such voting recommendations intended to "promote a position that is consistent with the long-term economic best interests of plan members embodied in the principle of a 'worker–owner view of value.'"[140] Apparently, this approach was significantly different than the one taken in the original recommendation platform.

INTECH switched to this new platform in order "to retain and obtain business from existing and prospective union-affiliated clients."[141] Soon after, some of INTECH's original clients started making inquiries regarding the higher number of votes against management on shareholder proposals.[142]

INTECH made the switch in voting platforms without having any written procedures or policies that addressed material potential conflicts between INTECH's interests in seeking more union-affiliated clients and those of its clients who did not favor the AFL-CIO.[143] By doing so, it had subrogated its client interests to its own—a breach in its fiduciary duty of

> 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.

Id. (footnotes omitted); *see also* Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11, 17 (1979) ("As we have previously recognized, § 206 establishes 'federal fiduciary standards' to govern the conduct of investment advisers. Indeed, the Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations." (citations omitted)).

135. Proxy Voting by Investment Advisers, 68 Fed. Reg. 6589 (Feb. 7, 2003) (codified at 17 C.F.R. §§ 275.204-2, 275.206(4)-6) (emphasis added).

136. *Id.*

137. INTECH Inv. Mgt. LLC, Investment Advisers Act Release No. 2872, 95 S.E.C. Docket 2265, 2009 WL 1271173 (May 7, 2009).

138. *Id.* at *2.

139. *Id.* at *1.

140. *Id.* at *3 n.3 (citations omitted).

141. *Id.* at *2.

142. *Id.* at *3.

143. *Id.* at *4.

loyalty.[144] Therefore, this was a clear violation of the Proxy Voting Rule and INTECH paid a civil penalty of $300,000.[145]

What was conspicuously absent from the INTECH enforcement action, and from any other guidance or regulations proposed or implemented by the SEC, was any explicit acknowledgment that shareholder wealth maximization should be the default objective when an investment adviser votes its proxies. This lack of acknowledgement by the SEC is extremely important because "[i]n *Transamerica Mortgage Advisors v. Lewis*, the U.S. Supreme Court ruled that clients and their shareholders have no express or implied private right of action under Section 206 of the Advisers Act of 1940."[146] Therefore, "[b]y extension, no private right of action exists under the Proxy Voting Rule."[147] Since the SEC is the sole enforcer of the Proxy Voting Rule, its approach of not taking a position on shareholder voting objectives means that fiduciary duties under the Advisers Act are essentially irrelevant in keeping investment advisers focused on their respective objectives, including the default objective of shareholder wealth maximization.

2. *The Objective of Shareholder Voting Under ERISA*

The Department of Labor, through its administration of the ERISA,[148] also has an important role to play as a securities regulator—especially in the area of investment management.[149] This importance is evidenced by the fact that over $11 trillion worth of assets[150] are held in ERISA "employee pension benefit plans."[151]

Under ERISA, plan managers have a fiduciary duty to vote the shares over which they have voting authority. This began with the infamous 1988 DOL letter commonly referred to as the "Avon letter."[152] In the letter the DOL stated, "In general, the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies

144. *Id.* at *3.
145. *Id.* at *6.
146. Sharfman, *supra* note 125, at 20 (citing Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11, 12 (1979)).
147. *Id.*
148. 29 U.S.C. §§ 1001–1461.
149. *See* Anita K. Krug, *The Other Securities Regulator: A Case Study in Regulatory Damage*, 92 TUL. L. REV. 339, 340–41 (2017).
150. Marlene Satter, *Retirement Assets Hit $29.2T: ICI Report*, THINKADVISOR (Dec. 27, 2018), https://www.thinkadvisor.com/2018/12/27/retirement-assets-hit-29-2t-ici-report/ [https://perma.cc/5P6D-V2SU] (noting that there is $8.1 trillion in employer-sponsored Defined Contribution plans and $3.2 trillion in private-sector Defined Benefit plans).
151. 29 U.S.C. § 1002(2)(A) ("[T]he terms 'employee pension benefit plan' and 'pension plan' mean any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund, or program— (i) provides retirement income to employees, or (ii) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond . . . .").
152. Letter from Alan D. Lebowitz, Deputy Assistant Sec'y, U.S. Dep't of Lab., to Helmuth Fandl, Chairman of Ret. Bd., Avon Prods., Inc. (Feb. 23, 1988), 1988 WL 897696 [hereinafter Avon Letter].

appurtenant to those shares of stock."[153] That is, the parties responsible for managing voting stock in pension plans governed by Title I of ERISA have a fiduciary duty to vote their proxies. This policy "has been affirmed by the DOL in 1990, 1994, 2008, 2016, and 2018."[154]

The fiduciary duty under ERISA is "very similar to what is found under the common law of trusts."[155] Under ERISA, those who manage plan assets owe the strictest duties of loyalty and care to their beneficiaries[156] and participants.[157]

Under ERISA's duty of loyalty, a plan fiduciary shall discharge their duties with respect to a plan "'*solely* in the interest of the participants and beneficiaries' and for the '*exclusive* purpose' of 'providing benefits' to them."[158] The duty of loyalty also requires an exclusive focus on the "'*financial* benefits' for the plan beneficiaries."[159] The latter "constrains plan managers to focus solely on rates of return to help ensure that beneficiaries and participants ultimately receive what they are due, expect or hope for in terms of private pension benefits."[160] In terms of investing in equity securities, this is very much a shareholder wealth maximization approach.

Given these fiduciary duties, how a plan manager is expected to approach shareholder voting was long ago summarized in the "Avon letter":

> Section 404(a)(1) requires, among other things, that a fiduciary of a plan act prudently, solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits to participants and beneficiaries. To act prudently in the voting of proxies (as well as in all other fiduciary matters), a plan fiduciary must consider those factors which would affect the value of the plan's investment. Similarly, the [DOL] has construed the requirements that a fiduciary act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives.[161]

153. *Id.* at *2.

154. Bernard S. Sharfman, *Now Is the Time to Designate Proxy Advisors as Fiduciaries under ERISA*, 25 Stanford J.L., Bus. & Fin. 1, 8 (2019).

155. *Id.*

156. 29 U.S.C. § 1002(8) ("The term 'beneficiary' means a person designated by a participant, or by the terms of an employee benefit plan, who is or may become entitled to a benefit thereunder.").

157. *Id.* § 1002(7) ("The term 'participant' means any employee or former employee of an employer, or any member or former member of an employee organization, who is or may become eligible to receive a benefit of any type from an employee benefit plan which covers employees of such employer or members of such organization, or whose beneficiaries may be eligible to receive any such benefit.").

158. Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 Stan. L. Rev. 381, 403 (2020) (quoting 29 U.S.C. § 1104(a)(1)(A)(i)).

159. *Id.* (quoting Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409, 421 (2014)).

160. Sharfman, *supra* note 60, at 14.

161. Avon Letter, *supra* note 149, at *3 n.4.

This guidance sounds very much like a shareholder wealth maximization approach to shareholder voting. Yet, there has been no case law to enforce this approach. However, a proposed DOL rule has been promulgated that does take this approach.[162]

C. Public Pension Funds

According to the U.S. Census Bureau's 2018 Annual Survey of Public Pensions, over five thousand public state and local pension funds held approximately $4.3 trillion worth of assets, of which $1.4 trillion were equity securities.[163] The assets of public pension funds are not evenly distributed. The twenty largest funds held approximately $2.5 trillion in assets.[164]

Even though there is significant diversity between states, trustees of public pension funds have fiduciary duties that closely track what is required under the common law of trusts. This means that their fiduciary duties are the same, or very close, to what is required of ERISA plan managers. Somewhat amazingly, even though ERISA is not applicable to state and local public pension funds, "many states share, or have even copied, ERISA's fiduciary duties to govern their own pension funds,"[165] including California, Florida, and New York, among others.[166] Therefore, an argument can be made that these duties would require a shareholder wealth maximization approach to shareholder voting. But again, there has been no case law to enforce such an approach.

D. Summary of Part IV

There is a strong argument to be made that shareholder wealth maximization should be the default objective of shareholder voting in a public company. Yet, this is not what the law requires. Even though there is a general consensus that investment advisers and plan managers have a fiduciary duty to vote all of their proxies unless they have a good reason not to do so,[167] state courts (applying the common law of trusts or corporate law), the SEC, and the DOL, even though this may change if the DOL's proposed rule is finalized and maintained during the next Admin-

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162. Fiduciary Duties Regarding Proxy Voting and Shareholder Rights, 85 Fed. Reg. 55219 (Sept. 4, 2020).

163. *2018 Annual Survey of Public Pensions: State & Local Tables*, U.S. Census Bureau, https://www.census.gov/data/tables/2018/econ/aspp/aspp-historical-tables.html [https://perma.cc/G867-LPWA].

164. *Funded Status of the Largest U.S. Public Pension Funds*, Pensions & Invs. (Feb. 5, 2018, 12:00 AM), https://www.pionline.com/article/20180205/INTERACTIVE/180209925/funded-status-of-the-largest-u-s-public-pension-funds [https://perma.cc/AA2Y-573G].

165. David H. Webber, *The Use and Abuse of Labor's Capital*, 89 N.Y.U. L. Rev. 2106, 2120 (2014).

166. *Id.* at 2120 n.50.

167. *See* Luca Enriques & Alessandro Romano, *Institutional Investor Voting Behavior: A Network Theory Perspective*, 2019 U. Ill. L. Rev. 223, 236 ("These requirements [the 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." (footnote omitted)).

istration, have declined to provide institutional investors with enforceable guidance on the fiduciary objective of shareholder voting, let alone require that shareholder wealth maximization be the default objective. This means that institutional investors may be tempted to utilize shareholder voting for their own purposes (enhancing the welfare of the institutional investor or its managers) and not for maximizing the wealth of its beneficial investors or public pension fund beneficiaries.

V. HOW SHAREHOLDER VOTING PROVIDES VALUE

So far, this Article has painted a very dismal picture of shareholder voting. Perhaps those scholars of the '50s and '60s who wanted to get rid of shareholder voting were on to something?[168] Obviously, shareholder voting is not a very efficient way to make decisions at a public company. This problem is something that the marketplace for corporate governance arrangements appears to already reflect. Shareholder voting is rarely used when it comes to decision-making at a public company. The default rule under corporate law, whether or not a public company, is that corporate decision-making is to be left in the hands of those who are the most informed about the affairs of the company: the board of directors and its executive management.[169] As so well stated by James Cox, Tomas Mondino, and Randall Thomas:

> Corporations are not democratic institutions. In a democracy, power flows from the voting populace, and it is this body that is then governed. The populace governs the procedures for selecting candidates for office so that continued service as its elected representative depends heavily on popular support to be the nominee in the election. This is not the case with the corporation. By statute, power over corporate affairs is lodged in the corporation's "governor"—the board of directors. Importantly, the source of the board's power and its legitimacy is derived from the statute and not the shareholders. In addition, the power is exercised over interested parties, such as non-voting security holders and labor, who do not vote in the election of directors. Indeed, the spheres within which shareholders have authority are limited in number and deeply circumscribed. . . . To be sure, stockholder approval is required for so-called fundamental transactions, such as mergers and the sale of substantially all of the company's assets. However, these transactions must be initiated by the board of directors, which controls their timing as well as the information upon which shareholders rely in deciding whether to approve the matter.[170]

Moreover, they go on to say:

> The genius of business organizations is their efficiency, which in large measure flows from enabling individuals with very different skills, experiences, and other endowments to combine with resulting syner-

168. *See supra* Part I.
169. *See* DEL. CODE ANN. tit. 8, §§ 141(a), 142(a) (2020).
170. Cox et al., *supra* note 120, at 515–16 (footnotes omitted).

> gies. Business organization law facilitates specialization and, in doing so, accommodates the unique limitations of owners whose personal endowment and circumstances justify their status as owners but not managers of the enterprise.[171]

Finally, the value of authority—as represented by the board of directors and executive management—is a major benefit to public companies; in contrast, shareholders face efficiency issues when they try to involve themselves in the company's decision-making. This value of authority is what Michael Dooley and Stephen Bainbridge consider to be the crown jewel of corporate governance.[172] They have persuasively made their arguments based on Kenneth Arrow's theory of large organizations:[173]

> Arrow's [theory] starts out with the basic proposition that "authority is needed to achieve a coordination of the activities of the members of the organization." But, more importantly, centralized authority enhances organizational efficiency. According to Arrow, efficiency is created in a large organization because "the centralization of decision-making, serves to economize on the transmission and handling of information."[174]

That is, "information scattered throughout a large organization must be both filtered and transmitted to a centralized authority in order for a large organization to make informed decisions and minimize error in decision-making."[175] Obviously, the centralized authority does need to be held accountable to some degree. However, the fear is that in the process of trying to correct errors resulting from irresponsible decisions, "the genuine values of authority" will be destroyed.[176] When that occurs, "accountability can be understood to cross over the line to where a new and competing locus of authority is created—a locus of authority, such as uninformed shareholders, that does not benefit from the informational advantages of the original authority."[177] Or, in the context of Goshen and Squire's "principal-cost theory,"[178] principal costs will greatly outweigh

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171. *Id.* at 517.

172. *See, e.g.*, Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 487 (1992); Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 547 (2003).

173. *See* KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 68–70 (1974). Michael Dooley was the first to make the connection between the work of Kenneth Arrow and the structure of Delaware corporate law. *See* Dooley, *supra* note 172, at 467. Professor Bainbridge has adopted Professor Dooley's application of Arrow's theory and readily acknowledges the contribution Professor Dooley has made in the development of his director primacy model. *See* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 85 n.11 (2004) ("I should acknowledge the debt director primacy owes to Professor Dooley's so-called 'Authority Model,' . . . .").

174. Bernard S. Sharfman, *The Enduring Legacy of* Smith v. Van Gorkom, 33 DEL. J. CORP. L. 287, 294–95 (2008) (quoting Arrow, *supra* note 173, at 68–69).

175. Bernard S. Sharfman, *Shareholder Wealth Maximization and Its Implementation Under Corporate Law*, 66 FLA. L. REV. 389, 403 (2014).

176. Arrow, *supra* note 173, at 77–78.

177. Sharfman, *supra* note 175, at 406.

178. Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 767 (2017) ("[E]ach each firm's optimal

agency costs when total control costs are minimized.[179] This understanding is why Bainbridge has been able to make the bold statement that the "[p]reservation of managerial discretion should always be the null hypothesis."[180] In sum, one does not want to trample on the value of authority, as represented by the board and executive management, with too much shareholder decision-making.

A. Shining the Light on Shareholder Interests

Nevertheless, even with its defects, it can be argued that there is significant value in shareholder voting *if it is used sparingly and wisely*. This is acceptable not only because one does not want to diminish the value of authority by implementing too much accountability through shareholder participation but also because "[t]he necessary conditions for accountability are supplied by competitive forces in the product market, in the internal and external markets for managers[,] . . . in the market for corporate control,"[181] and, most recently, through hedge fund activism.[182] Moreover, as the author has previously stated:

> Shareholder voting, when it happens, has an obvious and very important impact on a publicly traded company; it shines light on corporate decision-making, moving decision-making away from the private confines of the boardroom and into the public arena where the board's approach on how to proceed can be debated by those who have the authority to vote. According to Leo Strine, Chief Justice of the Delaware Supreme Court, shareholder voting, even in its limited scope, is one of the components of corporate law that encourages the board to view decision-making *through the lens of shareholder interests*. However, at the same time, shareholder voting makes corporate decision-making much more unwieldy and potentially subject to the whims of uninformed and/or opportunistic shareholders. Hence, a good rationale for why shareholders are given limited opportunities to weigh in and participate in corporate decision-making.[183]

The key point in the quotation above is that corporate decision-making should be made *through the lens of shareholder interests*. According to former Delaware Chief Justice Leo Strine:

> In American corporate law, only stockholders get to elect directors, vote on corporate transactions and charter amendments, and sue to enforce the corporation's compliance with the corporate law and the directors' compliance with their fiduciary duties. An unsubtle mind might believe that this statutory choice to give only stockholders

governance structure minimizes total control costs, which are the sum of principal costs and agent costs. Principal costs occur when investors exercise control, and agent costs occur when managers exercise control." (emphasis omitted) (footnote omitted)).

179. *See id.* at 771–72.
180. Bainbridge, *supra* note 173, at 109.
181. Dooley, *supra* note 172, at 525.
182. Sharfman, *supra* note 41, at 695.
183. *Id.* at 697–98 (emphasis added) (footnotes omitted).

> 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.[184]

The ability of shareholders, and only shareholders, to "sue to enforce the corporation's compliance with the corporate law and the directors' compliance with their fiduciary duties"[185] requires directors to focus on shareholder interests or else find themselves 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 "the legal responsibility to manage the business of a corporation for the benefit of its shareholders owners." Accordingly, fiduciary duties are imposed upon the directors to regulate their conduct when they perform *that* function.[186]

These fiduciary duties of care and loyalty (good faith is subsumed under the duty of loyalty under Delaware law)[187] enforced under corporate law direct a board to make decisions that promote shareholder interests.[188]

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

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184. 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) (footnotes 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 [https://perma.cc/NC26-YMHT]; *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 cmt. 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*." (citations omitted)); RESTATEMENT (SECOND) OF AGENCY § 14C (AM. LAW INST. 1958) ("Neither the board of directors nor an individual director of a business is, as such, an agent of the corporation or of its members.").

185. Strine, *supra* note 184, at 453–54.

186. N. Am. Cath. Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007) (quoting Malone v. Brincat, 722 A.2d 5, 9 (Del. 1998)).

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

188. *See generally* Sharfman, *supra* note 107, at 63–67 (discussing how fiduciary duties are directed toward satisfying shareholder interests).

> [S]hareholder voting in a public company cannot be looked at as simply another tool of accountability, i.e., a device to minimize agency costs or enhance efficiency, such as when shareholders file a direct or derivative lawsuit [seeking compensatory or injunctive relief from an alleged breach in a board's fiduciary duties], initiate a proxy contest, attempt a hostile takeover, or take significant positions in the company and then advocate for change (hedge fund activism). When shareholders vote they are also participating, alongside the board, in corporate decision-making. That is, they are temporarily transformed into a locus of corporate authority that rivals the authority of the board. As co-decision makers, it is critical that shareholders and those with delegated voting authority, such as mutual fund advisers, have informed and sufficiently precise voting recommendations at their disposal . . . .[189]

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

VI. THE IMPLICATIONS OF SHAREHOLDER VOTING

The following discussion focuses on the widely varied implications of shareholder voting for the corporate governance of public companies.

A. The SEC's Proposed Rules on Shareholder Proposals

The SEC's recently finalized rule changes for shareholder proposals will, according to its own analysis, most likely have the effect of significantly reducing the number of shareholder proposals submitted to public companies.[190] However, this is a reasonable reaction to the risks of shareholder voting. Unfortunately, the more shareholder proposals that are submitted to a public company, the greater the likelihood more corporate decision-making will be done through the inefficient corporate governance mechanism of shareholder voting. Therefore, keeping shareholder proposals—and potential voting on them—to a minimum must be consid-

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189. Sharfman, *supra* note 41, at 695.

190. *See* Procedural Requirements and Resubmission Thresholds under Exchange Act Rule 14a-8, Exchange Act Release No. 34-89964 (Sept. 23, 2020), https://www.sec.gov/rules/final/2020/34-89964.pdf; *see also* Procedural Requirements and Resubmission Thresholds Under Exchange Act Rule 14a-8, Exchange Act Release No. 34-87458, 84 Fed. Reg. 66,502 (proposed Dec. 4, 2019).

ered desirable. Consistent with this argument, Matsusaka, Ozbas, and Yi found that the stock market reacted positively when the SEC determined shareholder proposals could be excluded.[191]

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

> Managers have an incentive to deter proposals from activist shareholders by adjusting corporate policy; one might conjecture that external pressure leads them to choose policies more appealing to other shareholders in order to reduce the electoral prospects of activist proposals. However, we show that when deterrence occurs, it is always by moving policy toward the position favored by the activist, even if this reduces shareholder wealth. Our analysis stresses the central role of *voting uncertainty* in determining the value consequences of shareholder rights and proxy access.[192]

Nickolay Gantchev and Mariassunta Giannetti's recent work supports the implementation of this approach. They found that value-destroying shareholder proposals, typically submitted by high-volume proposal submitters, may actually go to a vote, receive majority support, and be implemented by management.[193] According to Gantchev and Giannetti:

> [O]n average the proposals submitted by the most active individual sponsors seem to be ill-conceived. These proposals receive less voting support and are less likely to be implemented by management,

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191. John G. Matsusaka, Oguzhan Ozbas & Irene Yi, *Can Shareholder Proposals Hurt Shareholders? Evidence from SEC No-Action Letter Decisions* (Univ. S. Cal. Ctr. for L. & Soc. Sci. Working Paper No. CLASS17-4, Marshall Sch. of Bus., Working Paper No. 17-7, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2881408 [https://perma.cc/TY78-Z87A]. According to the authors:

> During the period 2007–2019, the market reacted positively when the SEC permitted exclusion, suggesting that investors viewed those proposals as value-reducing on average. We also find that a company's stock price drifted down over time while waiting for an SEC decision, suggesting that challenged proposals imposed "distraction" costs on companies. . . . Taken together, the evidence suggests that managers may be serving shareholder interests in opposing some proposals, and that the no-action letter process may be helping shareholders by weeding out value-reducing proposals.

Id.

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

193. Nickolay Gantchev & Mariassunta Giannetti, *The Costs and Benefits of Shareholder Democracy: Gadflies and Low-Cost Activism* 2 (Euro. Corp. Governance Inst., Finance Working Paper No. 586/2018, 2020), http://ssrn.com/abstract_id=3269378 [https://perma.cc/UCU8-2FVP].

> but they may nevertheless pass if they end up being supported by a majority of arguably uniformed shareholders. If they pass with a majority in the shareholder meeting, proposals by active individual sponsors trigger sales by informed mutual funds that voted against them and, arguably as a consequence, negative abnormal returns.[194]

The fact that some ill-conceived proposals may actually get majority support and be implemented by management supports the implementation of a risk-averse strategy as described above. Moreover, management's desire to avoid a shareholder vote is most likely heightened when certain shareholders find it desirable to use shareholder proposals as bargaining chips in their negotiations with management. For example, Matsusaka, Ozbas, and Yi found that labor unions used shareholder proposals as bargaining chips to extract side payments from management.[195]

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

B. Substituting the Business Judgment Rule for Entire Fairness in Corporate Law

Shareholder voting as presented in this Article also has implications for corporate law. As mentioned in Part IV, certain transactions involving controlling shareholders are subject to the entire fairness standard of review unless certain procedures were implemented, at which point the more lenient business judgment rule applies. This application of the business judgement rule has expanded quickly, starting in 2014 with *Kahn v. M & F Worldwide Corp.*[196] In *Kahn*, the Delaware Supreme Court affirmed the lower court's holding that, in a post-closing damages suit involving a freeze out merger transaction, a board may get the benefit of the business judgment rule if it appointed a special independent commit-

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194. *Id.* (footnote omitted).

195. John G. Matsusaka, Oguzhan Ozbas & Irene Yi, *Opportunistic Proposals by Union Shareholders*, 32 Rev. Fin. Stud. 3215, 3215 (2018) According to the authors:

> In contract expiration years compared with nonexpiration years, unions increase their proposal rate by one-fifth, particularly proposals concerning executive compensation. Union proposals made during expiration years are less likely to be supported by other shareholders or a leading proxy advisor; the market reacts negatively to union proposals in expiration years; and withdrawn union proposals are accompanied with higher wage settlements.

Id.

196. 88 A.3d 635 (Del. 2014).

tee to negotiate the transaction on behalf of the minority stockholders, and the transaction was approved by an informed majority of minority stockholders.[197]

Kahn was soon followed by *Corwin v. KKR Financial Holdings LLC*, where the court ruled that "when a merger that is not subject to the entire fairness standard of review has been approved by a fully informed, uncoerced majority of the disinterested stockholders" the business judgement rule would apply,[198] not the "enhanced scrutiny" standard under *Revlon, Inc. v. MacAndrews & Forbes Holdings Inc.*[199] or *Unocal Corp. v. Mesa Petroleum Co.*[200] Most recently, the Court of Chancery in *In re Volcano Corp. Stockholder Litigation*, applied *Corwin* to a two-stage merger involving a tender offer, where a majority of shares had been voluntarily tendered.[201] According to Charles Korsmo, "As a result, class actions seeking post-closing damages are effectively a dead letter unless the plaintiff can show a deficiency in disclosure that would render the stockholder vote (or decision to tender) uninformed."[202]

Delaware's desire to apply the business judgment rule and respect the statutory authority of the board is entirely understandable. Trying to figure out where to draw the line between when the court should apply a fairness or entire fairness standard of review, or a business judgment rule standard has been a major concern of the Delaware courts since at least 1927. In *Bodell v. General Gas & Electric Corp.*,[203] perhaps the first Delaware case where the business judgment rule was applied, the court stated its basic approach to drawing the line in the context of no-par stock:

> It may be impossible to lay down a general rule on this subject, but we think the discretion of a board of directors in the sale of its no par value stock should not be interfered with, except for fraud, actual or constructive, such as improper motive or personal gain or arbitrary action or conscious disregard of the interests of the corporation and the rights of its stockholders.[204]

At first glance, the precautions required by *Kahn* and *Corwin* appear to be sufficient for a board and the controlling shareholder to earn a business judgment rule review of the merger. However, the problem with Delaware's application is that it is premised on the misunderstanding that institutional shareholders are informed voters and perhaps, if the dicta of Vice Chancellor Laster still holds,[205] that shareholder voting is only about shareholder wealth maximization. Therefore, this Article concurs with

197. *Id.* at 645.
198. Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304, 306, 312 (Del. 2015).
199. 506 A.2d 173, 184 (Del. 1986).
200. 493 A.2d 946, 954 (Del. 1985).
201. 143 A.3d 727, 744 (Del. Ch. 2016).
202. Charles R. Korsmo, *Delaware's Retreat from Judicial Scrutiny of Mergers*, 10 U.C. Irvine L. Rev. 55, 58 (2019).
203. 140 A. 264 (Del. 1927). For an in-depth discussion of *Bodell*, the business judgment rule, and entire fairness, see Sharfman, *supra* note 107, at 37–39.
204. *Bodell*, 140 A. at 267.
205. *See supra* Part IV.

Korsmo when he provides as one of his reasons why *Kahn* and *Corwin* were wrongly decided:

> And despite the rise in institutional investors, there remains a serious informational asymmetry between corporate managers and stockholders. Even a sophisticated activist investor will find it difficult or impossible to acquire the information—including properly non-public information—that corporate managers acquire in the process of their day-to-day work. Even sophisticated institutional investors are forced to rely, in large part, on the information disclosed to them by management. In many cases, it would be difficult for management to fully convey to investors the information required to accurately value the firm, even if they in good faith wanted to.[206]

Moreover, he goes on to state:

> Though the share of stock held by institutional investors continues to grow, there is also reason to think that information asymmetries will worsen in the near future. A large and growing share of institutional investment is in the form of "passive" index funds. Such investors, who currently hold approximately 30% of U.S. equities, seek to assemble a diversified portfolio tracking a broad index such as the S&P 500. They seek to offer a market return and compete by offering the lowest possible fees to individual investors. As a result, they expend little or no effort seeking to value the firms they invest in. While these index funds are certainly "sophisticated" investors in the sense that they understand the central lesson of modern portfolio theory—that picking stocks is usually a fool's errand—they are not "sophisticated" in the sense of knowing anything about the firms they invest in.[207]

While it is beyond the scope of this Article to opine on whether *Kahn* or *Corwin* were incorrectly decided, the arguments presented here do support one reason why this might be the case. It also makes the point that this author is most concerned about efficient decision-making in a corporation, consistent with Goshen and Squire's principal-cost theory, which states, "[E]ach each firm's optimal governance structure minimizes total control costs, which are the sum of principal costs and agent costs. Principal costs occur when investors exercise control, and agent costs occur when managers exercise control."[208]

C. What Should Be the Role of Proxy Advisors?

If proxy advisors are of generally little or no help in making institutional investors informed, then where should investors go for informed voting recommendations?

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206. Korsmo, *supra* note 202, at 98 (footnote omitted).
207. *Id.* at 99 (footnote omitted).
208. Zohar Goshen & Richard Squire, *supra* note 178, at 770 (emphasis omitted) (foonote omitted).

> Fortunately, the board of a public company already provides this foundational level of information in their own recommendations on how shareholders should vote.
>
> . . . .
>
> 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."[209]

According to Korsmo, "Even a sophisticated activist investor will find it difficult or impossible to acquire the information—including properly non-public information—that corporate managers acquire in the process of their day-to-day work."[210] Accordingly, "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 [presumably] generated through the lens of shareholder wealth maximization."[211]

As the author has previously noted:

> [E]ven 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.
>
> 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").[212]

If bias can interfere with the ability of boards to provide precise voting recommendations, then perhaps the role best played by proxy advisors is not to provide voting recommendations, which may not be adequately informed, but rather to provide assessments on how much bias may be contained in each board's voting recommendations, and how they impact the value of a board's recommendations. This focus on bias would mean a huge change in the business model of a proxy advisor, but one that may yield huge returns for institutional investors.

D. Quality Voting Versus Tenured Voting

Some corporate governance scholars have advocated the use of "tenured voting" to solve what they perceive as the problem of "short-term-

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209. Sharfman, *supra* note 41, at 703–04 (citing Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 Duke L.J. 711, 722 (2006)).

210. *See* Korsmo, *supra* note 202, at 98.

211. Sharfman, *supra* note 41, at 704.

212. *Id.* at 705–06 (footnotes omitted) (quoting Goshen & Squire, *supra* note 180, at 775).

ism."[213] That is, shareholders who are looking for a quick buck and will vote accordingly. This is supposedly harmful to shareholders in general. To solve this issue, "tenured voting" allows shareholders more votes based on how long they hold the company's stock.[214] However, tenured voting ignores the problems discussed above: that of institutional shareholders not being informed and that voting may potentially represent the preferences of institutional investors, not the preferences of beneficial investors or pension fund beneficiaries.[215]

A better option, though not without technical difficulties in its implementation as well as administrative issues,[216] is what Lawrence Cunningham calls "quality voting."[217] Quality voting apportions increased voting power through modifications to a company's charter to those shareholders who show not only longevity in the holding of a company's shares but also a concentration of investment in a small number of companies.[218] The argument being that longevity and concentration serve as a proxy for being informed, representing the interests of beneficial shareholders, and looking out for the long-term interests of the company. The problem, as previously mentioned in Part II, is that there is no guarantee that quality voters will remain informed subsequent to their purchase. That is, there is no incentive if they have a very rigid buy-and-hold strategy.[219] However, if this issue can be worked out, along with the technical and administrative issues discussed in Cunningham's new article, then perhaps quality voting can help increase the amount of informed and unbiased recommendations that occur at shareholder meetings.

E. Composition of Shareholders and Its Impact on Share Price

A final implication, and one that is decidedly speculative, is that the greater the composition of shareholders with voting objectives that do not match shareholder wealth maximization, or are indifferent to that objective, the more an equity analyst may penalize the company in terms of valuation, and in turn put downward pressure on the value of the company's stock price. For example, an equity analyst may mark down her estimated value of a firm's stock when institutional investors are relatively overrepresented and retail investors are underrepresented. This type of result can be inferred from the recent research of Alon Brav, Matthew Cain, and Jonathan Zytnick who found that:

> Retail shareholders and institutional investors vote substantially differently. Retail shareholder support for management proposals is strongly related to lagged firm stock price performance, even with

213. *See* Cunningham, *supra* note 42, at 5, 7.
214. *Id.* at 49.
215. *See id.* at 50.
216. *Id.* at 58–59.
217. *Id.* at 55.
218. *Id.* at 56–57.
219. *Id.* at 10.

> account-firm fixed effects, consistent with a focus on disciplining poorly-performing firms, whereas the voting of the Big Three institutional investors [Blackrock, Vanguard, and State Street Global Advisors] is not statistically significantly correlated with recent stock performance.[220]

Or perhaps this results when public pension funds with a focus on shareholder empowerment, not shareholder wealth maximization, are over-represented in a public company's investor base.[221]

VII. CONCLUSION

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

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220. Brav et al., *supra* note 31.

221. *See* TRACIE WOIDTKE, MAHNATTAN INST., PUBLIC PENSION FUND ACTIVISM AND FIRM VALUE: AN EMPIRICAL ANALYSIS 3 (2015), https://www.manhattan-institute.org/html/public-pension-fund-activism-and-firm-value-7871.html [https://perma.cc/5XNT-943C] (finding "that public pension fund ownership is associated with lower firm value").