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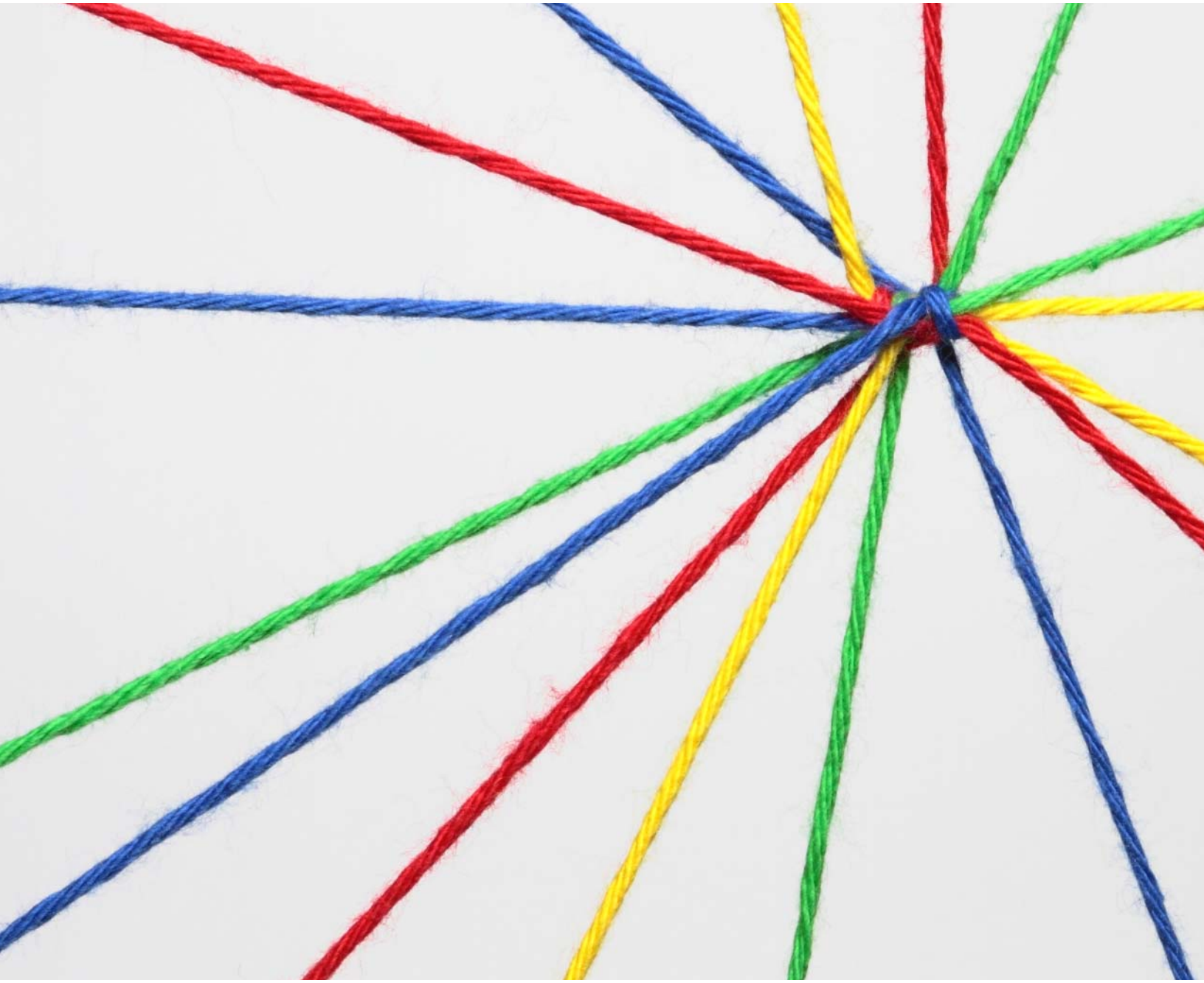
What Is the Optimal Balance in the Relative Roles of Management, Directors, and Investors in the Governance of Public Corporations?



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The Conference Board Governance Center White Paper

What Is the Optimal Balance in the Relative Roles of Management, Directors, and Investors in the Governance of Public Corporations?

By Suneela Jain, Barbara Blackford, Donna Dabney, and James D. Small III

American economic success depends on establishing an effective system of corporate governance. The governance structures and norms existing during the first decade of the twenty-first century did not prevent the excesses and risk taking that led to the recent destructive financial crises and crashes. The layers of bad decision making, ineffective oversight, and, in the case of the accounting scandals, fraudulent behavior, had enormous consequences for the American economy. In April 2010, the International Monetary Fund estimated that losses for US banks from toxic assets or bad loans accumulated in the lead-up to the 2007–2008 crisis would reach $885 billion that year.[1] In 2013, economists at the Dallas Federal Reserve estimated that the financial crisis had cost the US economy between $6 trillion and $14 trillion, the equivalent of $50,000 to $120,000 for every US household.[2] As a result, we have seen in the past few years an intense debate over the structure and underlying policies of our corporate governance system.

Over the last 10 years, federal regulators have imposed, shareholders have pursued, and companies have voluntarily adopted an array of measures aimed at improving corporate governance. Because of the intensity of the financial events and their consequences, though, much of the policy-making process has been reactive. A holistic understanding of the legal framework for American corporate governance, the trends that have shaped (and continue to shape) it, and challenges to the system as we try to move forward have been lacking in policy-making decisions.

Collaboration between the three traditional actors in corporate governance—boards of directors, management, and shareholders—is fundamental to identifying the corporate governance policies and practices that will be most conducive to producing economic growth while reducing attendant financial and legal risk. To provide a forum for such collaboration, The Conference Board Governance Center formed the Task Force on Corporate/Investor Engagement in 2013. As part of its mission, the task force examined the facts, issues, and policy implications of the current state of US corporate governance with the objective of addressing the following questions:

- What is the optimal balance in the relative roles of management, directors, and investors in the governance of public corporations?
- What are the gaps between such an optimally balanced system and the current system?
- How should management, boards, and investors engage with one another to lead to an optimally balanced system?

This white paper is intended to assist the task force in achieving its objectives by providing an overview of the evolution of US corporate governance and describing the principal issues in corporate governance today.

In Part I, we provide background on the historical development of the corporation in the United States and discuss the traditional allocation of roles and responsibilities in public company governance. In Part II, we discuss the legal, market, and social trends that have influenced the traditional allocation of governance roles and responsibilities. In Part III, we summarize some of the principal challenges and issues that confront boards of directors, management, and shareholders as they pursue a path forward.

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A. Roots of the Modern Corporation

Corporations are creatures of state law. A corporation is created and derives its power under state incorporation statutes, and its internal affairs and governance are, traditionally, governed by the laws of the state that grants a corporation its charter. The corporations of the eighteenth century and, generally, the early nineteenth century had to petition state legislatures to issue a charter by special legislative act. Only 335 charters were issued to businesses during the eighteenth century, a majority from 1796 to 1800.[3] Most of the early businesses receiving the charters were banks, insurance companies, and public works companies.[4] The issuing state had a close relationship with the chartered corporation. The state often held stock in the corporation and participated in management, both through direct board representation and by imposing controls through the special charters. The corporations often performed public functions and, in exchange, were granted special privileges (e.g., monopoly rights and eminent domain).[5]

The special incorporation process, however, proved too limiting as the American economy grew and its political identity developed. By the mid-nineteenth century, the Industrial Revolution was generating a deluge of requests for corporate charters, a growing number of which were related to general commercial or industrial production. In Pennsylvania alone, 2,333 special charters were granted between 1790 and 1860.[6] At the same time, disillusionment was mounting with respect to the nature of the public-private relationship in the special charter system. Periodic crashes and panics associated with the economic investments by states threatened state coffers, and the selective and often monopolistic nature of the special charter system was vulnerable to corruption and discordant with America's democratic and egalitarian ideals.[7] In 1811, New York passed the first general incorporation act, and in 1846 amended its constitution to limit the special charter power of the legislature to those "cases where in the judgment of the Legislature, the objects of the corporation cannot be attained under general laws."[8] Other states followed suit.[9] Incorporation was transformed from a process characterized by privilege and exclusive access to one that was essentially administrative—any person could file standardized paperwork, pay a fee, and begin operations. The demand for corporate status continued to increase, corporations grew, and the modern corporate form began to take shape.

B. Unique Advantages and Benefits of the Corporate Form

Until the mid-nineteenth century, the most common business form in the United States was the partnership. Partnerships generally involved two or three people, often related by blood or marriage, and were used by "all types of business, from the small country storekeepers to the great merchant bankers."[10] The corporate form, however, offered unique benefits both to the entrepreneurs seeking to start businesses and the investors who wanted to participate in them. When investing in a corporation, the shareholder investor was granted:

- limited liability, with losses capped at his or her initial capital contribution, should the business enterprise fail;
- the opportunity to receive virtually unlimited upside should the value of the enterprise increase; and
- liquidity, as shares could be transferred with relative ease if a willing buyer could be found.

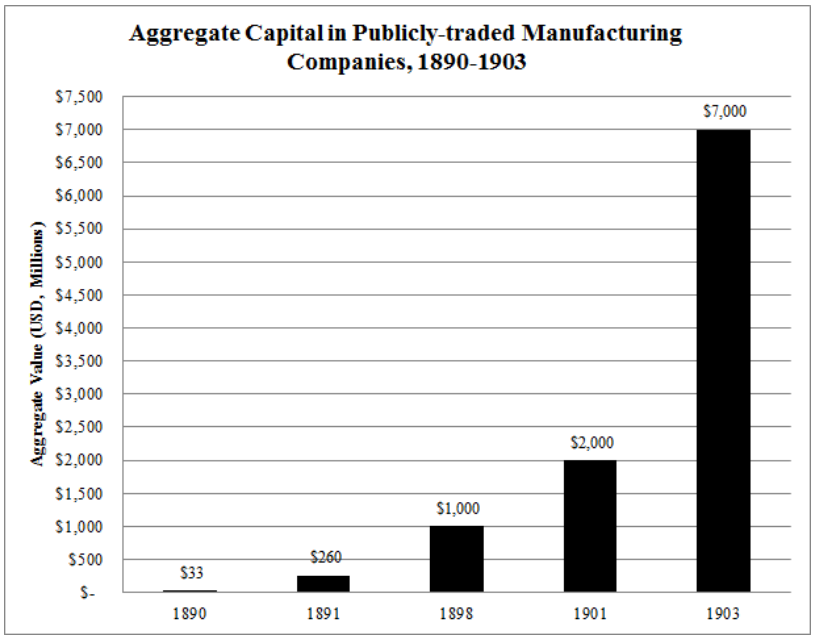
For the entrepreneur, the corporate form offered incredible freedom:

- Shareholders were entitled to dividends only at the discretion of the corporation's board of directors.[11]
- The corporation's funds were "locked in," with management discretion regarding their use limited only by fiduciary duties and general limitations imposed by law. Corporate managers could invest in long-term projects and operational capacity without fear that shareholders would assert control over operations or demand return of the corporation's base capital.

The committed source of capital, together with a legal framework that respected the "legal separateness" of the corporation (and its assets and liabilities) from both its shareholders and managers, allowed corporate managers to make credible commitments to third parties, such as employees and creditors, that were vital to the success of the business enterprise.[12]

The combination of these attributes proved wildly successful in attracting capital. A study of US Census Bureau data found that aggregate capital in publicly traded manufacturing companies increased from $33 million in 1890 to $260 million in 1891, almost $1 billion by 1898, $2 billion in 1901, and over $7 billion by 1903.[13]

Chart 1 Aggregate Capital in Publicly Traded Manufacturing Companies, 1890-1903



Source: William G. Roy, *Socializing Capital: The Risk of the Large Industrial Corporation in America*, (Princeton, NJ: Princeton University Press 1997), pp. 4–5 (see Figure 1.1, which depicts the aggregate value of stocks and bonds of corporations listed on major stock exchanges, 1890–1913).

At the turn of the twenty-first century, the aggregate capital of publicly traded US companies was approximately $15.1 trillion.[14] At the end of 2012, despite an intervening recession, aggregate capital of US public companies stood at $18.7 trillion.[15]

C. Historical Allocation of Control Rights: Board of Directors, Management, and Shareholders

Aside from limited rights reserved for shareholders, laws of all of the states identify the board of directors as a corporation's source of authority,[16] such that the corporation's affairs are to be

managed by or under the direction, supervision, and oversight of the board.[17] As a practical matter, a board's fundamental duties are oversight, advice, and consultation with management regarding major strategic, operational, or financial decisions. In the case of public corporations, boards select and delegate responsibility for actual management to professional managers.

Directors and officers must exercise their corporate functions in accordance with their fiduciary duties of loyalty and care.[18] States offer directors and officers wide latitude to act. Except in certain limited circumstances, courts will apply the "business judgment rule" when the actions of a director or officer are challenged. This doctrine applies a presumption that actions taken by directors and officers are proper when they have exercised due care and acted in a disinterested manner and in good faith. The business judgment rule is a recognition that the ability to manage requires discretion, and it is an acknowledgment that the legal system is not well equipped to second-guess business decisions made using that discretion, even if the decisions turn out not to be optimal or are ultimately proved wrong.

Traditionally, shareholders have played a limited role in controlling the business and affairs of the corporation. Their principal control rights typically consisted of the rights to:

- elect directors; and
- vote on certain fundamental changes or transactions (such as mergers, a sale of all or substantially all the assets of the company, and changes to the certificate of incorporation).

Corporations were not required to accept for submission to a vote at a shareholder meeting any shareholder proposal addressing practices related to the corporation's ordinary business matters, nor (if accepted for a vote) to adopt such practices, even if approved by shareholder resolution.

PART II. LEGAL, SOCIAL, AND MARKET TRENDS THAT HAVE INFLUENCED THE HISTORICAL ALLOCATION OF RIGHTS

The US system of public company corporate governance has changed significantly from the original historical framework, and the rules and regulations are significantly more complex than the default rules established by state corporation laws. Some of the most notable trends and factors that have influenced the allocation of corporate governance rights and responsibilities are:

A. The increased influence of institutional investors resulting from concentration of ownership in institutional investment and savings vehicles, changes in voting rules and practices, and more assertive shareholder activism.

B. Shifting conceptions about the purpose of the corporation and the duty to maximize corporate value, with a strong emphasis at the turn of the century on shareholder wealth maximization.

C. Decreased public trust of business leaders following the corporate scandals and financial disruptions of 2001–2002 and 2007–2008.

D. Federal regulation intended to enhance the influence of shareholders and increase board and management accountability.

E. Continuing efforts to align incentives in executive compensation.

F. The growth in importance of proxy advisory firms in the shareholder voting process.

The following is a review of these key trends.

A. The Increased Influence of Institutional Investors resulting from Concentration of Ownership in Institutional Investment and Savings Vehicles, Changes in Voting Rules and Practices, and More Assertive Shareholder Activism

The makeup of the shareholder constituency has changed significantly over the last three decades, most notably with respect to the proportion of shares owned by institutional investors. The increase in the relative aggregate institutional ownership of US public companies has contributed to a greater ability of investors to influence the governance and management of public companies. That influence has been amplified by efforts of federal regulators to achieve policy objectives by encouraging institutional investors to play a more active role in corporate governance oversight.

The Growth of Institutional Ownership

In the early 1950s, institutional investors held less than 10 percent of the stock of the largest 1,000 public companies. Certain types of institutional investors (mutual funds, pension funds, insurance companies, foundations and savings institutions) together now hold more than 50 percent of US equities. Among the top 1,000 companies in the United States, ownership of these institutions is even higher—representing more than 70 percent of equity holdings.

Individual shareholders are the direct beneficial owners of approximately 32 percent of US public company stock.[19] Most of these individual owners hold their shares through brokers and bank custodians. As of mid-2013, approximately 52 percent of Americans—a 15-year low—

reported owning stock, either directly or indirectly through a mutual fund or self-directed retirement account.[20]

Table 1

Institutional Equity Holdings by Type of Institution (as of 2009)			
Type of Institutional Investor	**Total Assets**	**Equity Holdings**	**% Total Equity Market**
Investment companies (e.g., mutual funds)	$7.196 trillion	$4.229 trillion	20.9%
Pension funds	$10.124 trillion	$4.185 trillion	20.7%
Insurance companies	$6.195 trillion	$1.476 trillion	7.3%
Foundations	$583.4 billion	$326.7 billion	1.6%
Savings institutions	$1.254 trillion	$22.2 billion	0.1%

Source: Matteo Tonello and Stephan Rabimov, *The 2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition*, The Conference Board, Research Report 1468, 2009, p. 26.

For more information regarding types of institutional investors, see Appendix 1 (page 41).

Increase in the Size and Influence of the Institutional Investor Vote

The relative influence that institutional investors are able to exert on corporate decision making is a function both of the growth in their percentage of total equity ownership (including as a result of individuals shifting their resources from direct market investments to investing with institutional investor financial intermediaries) and the frequency with which they exercise their vote. In 2013, institutional investors voted an average 90 percent of their shares, as compared with individual investors, who voted only 30 percent of their shares.[21] Even among companies with a market capitalization of $300 million or less ("microcap" companies), for which institutional investor and individual ownership levels are generally reversed, institutional investors voted approximately 80 percent of their shares, and individual investors voted only 32 percent of their shares (up 4 percentage points from 2012).[22]

Low voting rates among individual investors are not a new phenomenon,[23] but rates have declined in recent years. Some of the efforts by regulators to improve the shareholder voting system (the "proxy" system) have had the unintended consequence of reducing individual shareholder turnout. For example, in the first five months that companies could use new "e-proxy" rules to publish proxy materials online only,[24] those companies that did not deliver paper materials saw the percentage of shares voted by individual holders drop from 31.3 percent to 16.4 percent.[25]

In addition, recent actions by the US Securities and Exchange Commission (SEC) and the New York Stock Exchange (NYSE) to curb broker discretionary voting have exposed companies to the full consequence of low individual shareholder participation in the proxy process. Before 2009, brokers, banks, and other intermediaries that held shares in street name were empowered

to use discretion to vote the shares for all "routine" matters if no voting instructions were provided by the beneficial owners for whom the shares were held. Based on the reasoning that shareholders would have sold their shares (or given instructions) were they not satisfied with company performance, the street holders generally voted these shares in support of management. Since 2009, the SEC and NYSE have systematically curtailed the list of matters for which uninstructed votes can be submitted, eliminating discretionary broker voting in director elections in 2009,[26] for matters related to executive compensation in 2010,[27] and for certain corporate governance matters in 2012, including "proposals to de-stagger the board of directors, majority voting in the election of directors, eliminating supermajority voting requirements, providing for the use of consents, providing rights to call a special meeting, and certain types of anti-takeover provision overrides."[28] Because individual shareholders are far less likely to submit voting instructions than are institutional shareholders, the changes have had the consequence of amplifying the influence of the institutional investor vote.

Shareholder Activism

One of the consequences of the growth of institutional investor ownership of public company stock is that a greater percentage—and a greater variety—of shareholders participate in proposing, evaluating, and supporting (or voting against) shareholder campaigns for company change. Institutional investors, which can hold 50 percent or more of the stock in a public company, are key decision makers and often determine the success or failure of activists' proposals.

Modern shareholder activists fall into two broad categories: "traditional" shareholder activists and activist hedge funds.

"TRADITIONAL" SHAREHOLDER ACTIVISTS

Historically, shareholder activism was carried out by a handful of individuals and institutions that advocated for changes in the policies and practices of public companies. These activists were often labeled "gadflies" because of their persistence in confronting boards of directors to advocate for their issues.[29] Lewis Gilbert, the first shareholder to win the right to propose a proxy resolution and a prominent activist for six decades, was responsible, together with his brother, for 139 of the 286 resolutions submitted from 1948 to 1951.[30] As late as 1982, almost 30 percent of the 972 resolutions submitted to 358 companies that year were proposed by the Gilbert brothers or Evelyn Davis, who was herself a vocal presence at annual meetings through 2011.[31]

Today, gadfly activists still play an outsized role (in 2013, 25 percent of all shareholder proposals were sponsored by two individuals and their family members and family trusts)[32] in using the shareholder platform to seek to change company behavior, but they share that platform with a broader group of pension funds, unions, religious organizations, social organizations, and socially responsible mutual funds. These include the Council of Institutional Investors, which was founded in 1985 to advocate for corporate governance reforms and stronger shareholder rights;[33] the Interfaith Center of Corporate Responsibility, which is the primary coordinator of shareholder proposals relating to social, economic, and environmental corporate policies of concern to faith-based institutional investors;[34] and firms such as Calvert, Domini, and Pax, which manage mutual funds composed mainly of stocks that meet certain ethical guidelines and also invest in some stocks targeted for proposals to change company behavior.[35] According to the Forum for Sustainable and Responsible Investment, as of year-end 2011 approximately 10 percent of US assets under professional management were invested by managers who apply various environmental, social, and governance criteria in their investment analysis and portfolio selection.[36] During the 2006–2013 period, an average of 33 percent of shareholder proposals submitted to Fortune 250 companies were sponsored by labor-affiliated investors; 26 percent by

corporate gadflies; 25 percent by religious-affiliated, social-investing, and public policy investors; 15 percent by other individual investors; and 1 percent by other institutional investors.[37]

Shareholder proposals relating to corporate governance have been the most successful in terms of attracting majority support.[38] Support for corporate governance changes can be tied in part to the determination and continued focus of advocates who seek to increase investor influence in corporate governance.[39] Table 2 shows examples of successful corporate governance campaigns.

Table 2 Successful Governance Campaigns

Campaign	Status at Year-End 2012 (S&P 500)[1]
Annual elections of directors in place of classified boards	Over 83% provided for annual elections (versus just under 43% in 2003)
Change from plurality to majority voting	Approximately 81%[2] provided for majority voting (versus an estimated 16% in 2006)[3]
Eliminating "standing" poison pills	Approximately 7.6% had poison pills in force (versus 57% at year-end 2003)[4]

Sources:

(1) Melissa Aguilar, Thomas Singer, and Matteo Tonello, *Proxy Voting Analytics (2009-2013)*, The Conference Board, Research Report 1532, 2013, p. 31. S&P 500 companies are far more likely than companies in the Russell 3000, generally, to receive proposals from shareholders. In recent years, as activists have been successful in pressuring governance changes at larger companies, they have spread their efforts to target companies in smaller company size groups.

(2) "Takeover Defense Trend Analysis: 2012 Year End Snapshot," SharkRepellent (on file with author). An additional 10.65 percent of companies had a "modified majority voting standard," pursuant to which directors are elected by plurality vote but must tender their resignations for board consideration if they do not receive majority support from shareholders.

(3) Claudia H. Allen, "Study of Majority Voting in Director Elections," Neal, Gerber & Eisenberg LLP, November 12, 2007, p. 1 (http://www.ngelaw.com/files/uploads/documents/majoritystudy111207.pdf).

(4) "Takeover Defense Trend Analysis: 2003 Year End Snapshot," SharkRepellent (on file with author); "Takeover Defense Trend Analysis: 2012 Year End Snapshot."

These types of governance changes have increased institutional investors' ability to negotiate with company boards and management, to launch proxy contests, and to appoint directors to boards of public companies. Additional description regarding these campaigns is provided in Appendix 2 (page 43).

During the 2013 proxy season, proposals on corporate governance represented 37.5 percent of those submitted by shareholders. This represented a smaller share of total proposals filed than such proposals represented in 2012 (41.7 percent). Social and environmental proposals represented 34.1 percent of total proposals filed. [40]

Shareholder proposals that focus on environmental or social issues are a prominent tool used by activists seeking to affect corporate behavior in those areas, even though the proposals themselves rarely result in majority shareholder support.[41] Environmental and social activists often identify success outside the specific vote tally, using the proposal platform to stimulate public conversation or to provide an opening for discussion with management, both of which can lead to action responsive to activist goals.[42] Support for shareholder proposals relating to environmental and social matters has generally increased in recent years. According to The Conference Board 2013 *Proxy Voting Analytics* report, proposals on board diversity, sustainability reporting, and human rights are among those that have seen increased support.

Table 3

Shareholder Proposals on Social and Environmental Policy Average Support Level (2009, 2012, and 2013)			
Topic	2009	2012	2013
Board diversity	20.1%	27.5%	35.1%
Sustainability reporting	17.5%	24.7%	26.3%
Human rights	12.1%	12.0%	13.8%

Source: Melissa Aguilar, Thomas Singer, and Matteo Tonello, *Proxy Voting Analytics (2009-2013)*, The Conference Board, Research Report 1532, 2013. See chart 25 on p. 73, which depicts the average support level of other shareholder proposals on social and environmental policy.

ACTIVIST HEDGE FUNDS

A second form of shareholder activism relies on more aggressive forms of shareholder pressure. Activist hedge fund campaigns frequently take the form of an acquisition of a sizable, but almost always less than 15 percent, equity stake in a company coupled with an effort to emphasize perceived shortcomings in company performance and the threat of a proxy fight. The campaigns generally seek to effect significant change in a company's strategic direction. Topics of activist hedge fund campaigns have included advocacy for replacement of a company's CEO or members of the board; share buybacks or dividends; increased company leverage; and transactions involving asset sales, spin-offs, or business combinations with strategic or private equity buyers (and, in some cases, a combination of many of those).

Activist hedge fund activity has increased significantly over the last decade. During the period from 1994 to 2000, activist hedge funds' public filings reported 757 campaigns to modify strategic decisions by management; 1,283 campaigns were reported during the 2001–2007 period.[43] In 2012, 241 activist campaigns were launched, up from 187 in 2009.[44]

Activist hedge funds have been the most active type of shareholder dissident over the last several years.[45] Of the 35 proxy contests against the management of Russell 3000 companies during the 2013 proxy season, 24 (69 percent) were mounted by activist hedge funds.[46] Activist hedge fund contests represented a majority of the contests seeking board representation (and a majority of

activist hedge fund contests, themselves, sought board representation). One-third of the activist hedge fund contests sought to gain full control of the board.[47]

In recent years, activist hedge funds have been increasingly successful in targeting larger, more established companies with their campaigns by concentrating the rapidly growing size of assets under their management to secure small but influential ownership stakes in those companies and by using public campaigns to garner support among other, more traditional institutional investors.[48] According to Hedge Fund Research, activist hedge funds' assets under management doubled between 2008 and 2012.[49] Among these assets are increasing investments by institutional investors. Between December 2003 and December 2011, the percentage of total institutional assets managed by hedge funds grew from 2.4 percent to approximately 10.5 percent.[50] By December 2011, almost 20 percent of endowment and foundation assets were invested in hedge funds.[51] At the end of September 2013, investment in hedge funds and hedge funds-of-funds by the 200 largest US retirement funds was measured at $134.7 billion, a 20.3 percent increase over the course of that year.[52] By participating actively in derivatives markets, hedge funds are also able to use financial instruments (e.g., options and swaps) to extend the reach of their equity holdings.[53]

During the 2013 proxy season, of the 35 proxy contests waged against Russell 3000 companies, 40 percent targeted companies that had a market capitalization over $1 billion at the time the contest was announced.[54] On August 30, 2013, Microsoft announced a "cooperation agreement" with the hedge fund ValueAct Capital Management, a 0.8 percent holder of Microsoft stock, pursuant to which ValueAct's president, Mason Morfit, will join the Microsoft board of directors in early 2014.[55] Apple, Sony, McDonald's, DuPont, Target, Pepsi, and Kraft are among the large-cap companies that have been the focus of activist campaigns in the last several years.

B. Shifting Conceptions about the Purpose of the Corporation and the Duty to Maximize Corporate Value, with a Strong Emphasis at the Turn of the Century on Shareholder Wealth Maximization

Society's norms about the purpose of the corporation impose limitations and expectations on corporate governance roles and responsibilities that go far beyond the framework established by law. Norms affect the range of business options that US public companies consider, the deliberative process through which business decisions are made, the criteria by which performance is judged, and the outcomes that shareholders believe they have a right to expect. Today, many believe that US companies should (and, not infrequently, that US companies are legally required to) be managed for the sole or primary purpose of maximizing wealth for shareholders, even though the "shareholder primacy model" is neither required by US corporate law, nor has it always been the dominant theme of corporate management.

The roots of the shareholder primacy model can be traced to the writings of professor and lawyer Adolf A. Berle, who, together with economist Gardiner Means, wrote *The Modern Corporation and Private Property* in 1933. The book, published only four years after the stock market crash of 1929, identified a "separation of ownership from control" as the defining characteristic of the "modern" corporation. Ownership, as defined by the provision of capital, rested in the hands of diffuse shareholders, who bore the risk of bad decision-making but had little ability to influence management; corporate management (the control) had virtually limitless authority ("control almost unexplored in permission") but bore little direct risk in relation to those decisions. In his early 1930s writings, Berle ultimately concluded that the only "clear and reasonably enforceable" mechanism for protecting the interests of shareholders was to require managers to serve shareholders as trustee-like fiduciaries: all powers granted to a corporation should be "at all times exercisable only for the ratable benefit of all the shareholders."[56]

Professor E. Merrick Dodd challenged Berle's conclusion. He argued that the corporation, as a legal entity created by the state for the public benefit, had a "social service as well as a profit-making function" and should be run by professional managers seeking to serve a variety of "stakeholders"—including employees and customers as well as shareholders. Managers should act to fulfill the social service function, "even if the proprietary rights of its owners are thereby curtailed."[57] From the 1930s through the 1960s, Dodd's stakeholder-oriented view provided the normative framework for the exercise of corporate governance. Shareholders during that period demonstrated little interest in being involved in corporate governance, and managers exercised great discretionary authority to manage the corporation as they deemed appropriate.

By the 1970s, however, the pendulum had begun to swing in the other direction. Shareholder primacy was reinvigorated by agency theory, which studied the costs associated with a "principal" delegating authority to an "agent" to complete a task on the principal's behalf. When applied to corporate law, agency theory identified shareholders as the principal, management as their agent, and "agency costs" as those that arose as a result of the difficulty of ensuring that management was running the corporation for shareholders' rather than management's benefit.[58] The ideas of "shareholder wealth maximization" and "corporate value maximization" were melded, appeals for management discretion were considered suspect, and share price was ultimately put forth as the most efficient way to evaluate management constancy to the corporate purpose. In an article in the *New York Times Magazine* in 1970, Milton Friedman, leader of the Chicago school of economics and the winner of the Nobel Prize in Economics in 1976, stated that businessmen who speak of the "social responsibilities of business" are "unwitting puppets of the intellectual forces that have been undermining the basis of a free society."[59] Friedman compared decisions made with those considerations to imposing a tax on shareholders. "In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business…there is one and only one social responsibility of business—to use its resources and engage in activities to increase its profits so long as it stays within the rules of the game."[60]

The application of agency theory to corporate law held particular resonance in the economic environment and corporate governance context in which it developed. Boards of directors exerted little oversight over management through the 1970s, and management used its discretion to create corporate conglomerates that faltered under pressure from more innovative overseas competitors. The early successes of corporate raiders and hostile acquirers also exposed weaknesses in the American firms and suggested market discipline might be needed to focus managerial attention on creating value for shareholders.[61]

At the same time that corporate managers were faltering, more Americans were becoming directly dependent on wealth generated by the stock market. Beginning in the 1970s, a series of regulatory, tax, and economic changes drove a shift from defined benefit retirement plans, which had been increasingly provided by employers in the decades following the Second World War, to defined contribution plans.[62] The shift had the consequence not only of placing more investment awareness, and associated risk, directly in the hands of the employee, but also of breaking one of the ties between the employee and his or her company, as defined benefit plans were designed with certain features (e.g., increasing benefits based on length of employment) for employees who stayed with the firm until retirement.[63] Middle-class Americans were becoming "shareholders" at the same time as traditional security from the "employee" title was becoming more tenuous. "Shareholder primacy" and the goal of "shareholder wealth maximization" took on new resonance.[64]

In their 2001 essay *The End of History*, Professors Henry Hansmann and Reinier Kraakman declared a "triumph" of the shareholder value model and the rules it prescribed—"a strong corporate management with duties to serve the interests of shareholders alone, as well as strong minority protections." "We predict…that as equity markets evolve in Europe and throughout the

developed world, the ideological and competitive models will become indisputable…convergence in most aspects of the law and corporate governance is sure to follow."[65]

A decade later, the massive corporate frauds, dramatic stock market losses, and poignant stories of retirees and pensioners who had come to depend on the stock market—all occurring under the promise of shareholder wealth maximization—have led many to challenge shareholder primacy thinking. Alternative theories of the US public corporation—its defining characteristics, its underlying legitimacy, its purpose—have arisen to challenge conceptions of the "Berle-Means" or "principal-agent" firm. While they differ in their details, these theories share fundamental premises: they distinguish between shareholders and "the corporation" in terms of defining the legal focus of management's fiduciary duties, they challenge stock price as an incomplete (and, in many cases, inaccurate) measurement of management performance, and they cite the single-minded focus of the shareholder primacy norm as encouraging behaviors and decisions that undermine long-term economic well-being. Sustainable shareholder value, they assert, can only be created in a system that pays adequate attention to the long-term consequences of its decisions for various stakeholders, including employees and the communities in which corporations operate. Indeed, in countries outside the United States, the focus has often been on actors or goals other than shareholders or maximizing shareholder wealth. For a discussion of cross-border influence on corporate governance, see Appendix 3 (page 45).

Advocates of an alternative norm of corporate governance have called on all players in the corporate governance framework to adopt a more holistic approach to corporate evaluation.[66] Implicit and explicit in this call are more leeway from shareholders for managerial discretion in defining and weighing the factors that contribute to corporate value and a prioritized role for the board (albeit with support from shareholders) in overseeing management decisions in service of that purpose. Ostensibly, such an outcome would require cooperation and communication among all actors in the corporate governance framework, in particular to increase continued low levels of public trust in business leaders that reflect continued fallout from the frauds and financial scandals of the first decade of this century.

C. Decreased Public Trust of Business Leaders following the Corporate Scandals and Financial Disruptions of 2001–2002 and 2007–2008

The historic speculative bubble in dot-com companies that grew in the late 1990s was fueled by the focus of broad-reaching traditional media on what were excessively risky investments, resulting in a classic financial mania. The bursting of the bubble in 2000 unmasked a lack of discipline in a bedrock institution, the stock market. That collapse was followed shortly by the collapse of Enron, the first in a series of corporate scandals that wore away the optimism, expressed by Hansmann and Kraakman in *The End of History*, that the United States had developed an optimal system of corporate governance. The massive frauds perpetrated by the management teams at Enron, WorldCom, Adelphia, and Tyco (among others) eroded trust and confidence in the capital markets. The scale of the fraud—from the complex accounting and entity structuring scheme created by Enron's management to the ostentatious looting by Tyco and Adelphia executives—exposed stark failures of internal and external control mechanisms. The reaction was to attempt to strengthen those control mechanisms. New regulation focused on the board and its oversight of management and internal controls, and it emphasized independence of the board as a means to foster more robust supervision. Evidence of the magnitude of these events and their ability to affect public perceptions is that from early 2000 to mid-2002, the stock market lost $7 trillion in value, more than 1,000 companies disappeared from public markets, workers were hit with massive layoffs, and workers and retirees were left with emptied retirement accounts.[67]

Failures of corporate governance were again blamed for aspects of the 2008–2009 financial crisis, as many perceived that short-term profit seeking, systemic incentives, and lack of risk management at financial institutions contributed to or even caused the financial crisis. CEO pay and rising societal income inequality added to public dissatisfaction and lack of trust. As a result, many perceived both boards and management to be unable to provide adequate oversight of public companies. Institutional investors were seen by some as the logical counterbalance, and responsive regulation sought to empower investors to take a more active role in corporate governance, extending power to matters historically determined by the board of directors. Some also saw the shareholder primacy model, with its exclusive focus on share value maximization, as encouraging a short-term mind-set that contributed to the recurrent crises. (The issue of short-termism is discussed in Part III.F (page 36)).

Each of these developments gave impetus to investors advocating for changes in corporate governance. Today, trust in business remains at low levels. In a September 2013 Consumer Confidence Survey, 56 percent of respondents reported trusting US corporate management "less" than before the 2008–2009 financial crisis. Approximately 50 percent of respondents rated the response of US corporate management, investment firms, and commercial banks to the crisis as "poor" or "very poor"; approximately 1 percent rated the response as "very good"; 10 percent as "good"; and the remainder as "fair."[68] Respondents to the 2013 Edelman Trust Barometer survey, who were asked, among other things, how to improve trust, placed greater emphasis on integrity-based characteristics (e.g., treating employees well, listening to customers, exhibiting ethical and transparent practices) than operational-based attributes (e.g., financial performance), the importance of which dropped by half between 2008 and 2013.[69] Among other consequences, the trust deficit has resulted in increased politicization of governance issues and the enactment of legislation that increases the power of shareholders and carves out an expanded role for federal regulators with respect to the governance of American public companies.

D. Federal Regulation Intended To Enhance the Influence of Shareholders and Increase Board and Management Accountability

While the historical allocation of corporate governance roles is a matter of state law, the federal government has become a strong source of influence on the relative roles and responsibilities of shareholders, the board of directors, and management. The consequence of recent federal regulatory action has been to increase the influence of shareholders both directly, by expanding the matters on which shareholders have a right to vote and emphasizing the fiduciary duty of certain institutional shareholders to exercise the right to vote, and indirectly, by increasing disclosure requirements and mandating new mechanisms designed to enhance board and management accountability.

Expansion of Shareholder Voting Rights and Fiduciary Duties Related To Voting Rights

SHAREHOLDER VOTING RIGHTS

Section 14(a) of the Securities Exchange Act of 1934, as amended (the Exchange Act) provides the SEC with broad authority to adopt rules regulating "proxy voting"—the process by which shareholders submit proposals, make director nominations, and vote at shareholder meetings. The SEC adopted Exchange Act Rule 14a-8 to regulate the process through which proponents seek to have shareholder proposals presented for a vote at the company's annual shareholder meeting in the company's proxy materials.[70] Under the rule, companies generally are required to include shareholder proposals in their proxies but can exclude such proposals for procedural and substantive reasons. For example, a shareholder proposal may be excluded if implementing it would violate law or conflict with a company proposal. Companies can also request permission from the SEC to exclude a shareholder proposal that deals with a matter relating to the

company's ordinary course of business—an exclusion created in recognition of the board of directors' duty to manage the corporation.

Since 1976, the SEC staff has recognized a "substantial policy issue" exception to the ordinary business exclusion right of companies.[71] The SEC staff's interpretation of what constitutes a "substantial policy issue" has expanded and contracted with public dialogue about specific social, environmental, and political issues. The SEC staff has reversed positions with respect to guidance regarding what can be excluded where "experience dealing with proposals in specific subject areas" and "changing societal views" recommend a change in course.[72] In the 1980s, shareholders used this flexibility to push for the inclusion of human rights proposals in proxies, notably with respect to efforts to seek divestiture in apartheid South Africa. Toward the end of the 1990s, shareholders were successful in expanding the social policy exception to areas of employment, successfully pressuring the SEC staff to reverse an earlier interpretation that allowed Cracker Barrel Old Country Stores to exclude from its proxy a shareholder proposal seeking a nondiscrimination policy protecting gay and lesbian employees. After a series of court cases, concentrated shareholder attention, and pressure from members of Congress, the SEC staff announced that it would no longer apply a per se exclusion right to shareholder proposals relating to employment and would instead examine company requests to exclude such proposals "case by case."[73]

More recently, SEC staff interpretations of the ordinary business exclusion have shifted in connection with regulatory and shareholder focus on corporate governance issues. In 2002, for example, the SEC staff changed its earlier interpretation characterizing shareholder proposals requiring companies to obtain shareholder approval of equity compensation plans as shareholder intrusions in the company's ordinary business, and instead set forth specific guidance identifying types of equity compensation plans that shareholders could demand the right to approve.[74] In 2009 the SEC staff reversed its previous guidance that allowed companies to exclude shareholder proposals on oversight of risk and succession planning under the ordinary business exclusion. With respect to both areas, the SEC staff narrowed the circumstances under which the proposals could be excluded by focusing on the potential for the proposals to invoke important policy issues.[75]

Outside of the specific shareholder proposal context, other major federal regulation, most notably the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), has further influenced the nature of the issues deemed appropriate for shareholder input.[76] Dodd-Frank, for example, required the SEC to promulgate rules relating to shareholder consideration of executive compensation packages. In 2011, the SEC adopted rules under Dodd-Frank mandating that companies provide shareholders with advisory votes on the compensation of the company's named executive officers (say on pay), the frequency of the say-on-pay vote, and certain golden parachute arrangements.[77]

SHAREHOLDER FIDUCIARY DUTIES RELATED TO VOTING RIGHTS

Another series of changes that has effectively increased shareholder influence and participation in corporate governance has been the enactment of rules and regulations identifying fiduciary duties related to the exercise of certain proxy votes by certain institutional investors and others with similar fiduciary duties, such as managers of Employee Retirement Income Security Act (ERISA) plan assets.[78]

In particular, the SEC's adoption of Rule 206(4)-6 under the Investment Advisers Act of 1940, as amended (the Advisers Act), had significant implications for institutional investors' perception of their duty to exercise the vote. The rule required registered advisors with proxy voting discretion to adopt policies and procedures reasonably designed to ensure that they vote

proxies in the best interests of their clients. It also required them to disclose both their policies and their actual votes to the relevant clients.[79] In the rule's adopting release, the SEC confirmed an advisor owes fiduciary duties of care and loyalty to its clients with respect to all services undertaken on the client's behalf, including proxy voting, and noted that "[t]he duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies. To satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interest of its client…."[80]

Regulators have similarly stepped in to encourage managers of ERISA plan assets to vote the shares they own. Persons responsible for the investment of ERISA plan assets are subject to strict fiduciary duties, as are, generally, persons responsible for the investment of governmental plan assets.[81] In 1988, the US Department of Labor (DOL) issued an advisory opinion that concluded that the right to vote shares was a "plan asset" to which those fiduciary rules apply, thereby subjecting plan asset managers to an obligation to vote shares owned by benefit plans unless they could show that a failure to vote was in the best interest of plan participants and beneficiaries.[82] The DOL stated: "[t]he fiduciary obligations of prudence and loyalty to plan participants and beneficiaries require the responsible fiduciary to vote proxies on issues that may affect the economic value of the plan's investment."[83]

Rule 206(4)-6 and the DOL opinion have been interpreted by some as requiring entities that are subject to such duties to vote the shares they own on behalf of their clients, even when a cost-benefit analysis might suggest that not voting would better serve the beneficial owners of the fund. While the rule and the opinion are, undoubtedly, strong sources of pressure to exercise a fund's votes, the documents and the guidance related to them do not mandate that conclusion. The SEC rule states explicitly that failure to vote would not necessarily mean a breach of fiduciary duties: "[w]e do not suggest that an adviser that fails to vote every proxy would necessarily violate its fiduciary obligations. There may even be times when refraining from voting a proxy is in the client's best interest, such as when the adviser determines that the cost of voting the proxy exceeds the expected benefit to its client. An adviser may not, however, ignore or be negligent in fulfilling the obligation it has assumed to vote client proxies."[84] Similarly, the DOL has stated that "fiduciaries also need to take into account costs when deciding whether and how to exercise their shareholder rights, including the voting of shares."[85] In written testimony to the House Subcommittee on Capital Markets and Government Sponsored Enterprises (the CII Testimony), the executive director of the Council of Institutional Investors (CII), an association of public, labor, and corporate employee benefit funds, stated the CII view that SEC rules and interpretations do not require institutional investors to vote all proxies, but requested staff interpretive guidance to resolve acknowledged confusion about the issue.[86]

Public Disclosure and the Drive to Enhance Accountability

PUBLIC DISCLOSURE

In remarks to the Society of Corporate Secretaries and Governance Professionals, SEC Commissioner Daniel M. Gallagher described the federal corporate disclosure regime as "a cornerstone of the Commission's tripartite mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation," and summarized the fundamental rationale underlying the regime as follows:

> The underlying premise of the Commission's disclosure regime is that if investors have the appropriate information, they can make rational and informed investment decisions. This is not to say that the disclosure regime was meant to guarantee that investors receive *all* information known to a public company, much less to eliminate all

risk from investing in that company. Instead, the point has always been to ensure that they have access to *material* investment information.[87]

Recently, the scope of what has been deemed material has expanded significantly. In 2006, the SEC overhauled compensation disclosure with the expressed intention of increasing usability and comparability among companies. The changes included requiring a "compensation discussion and analysis" in the company's annual proxy to describe the company's objectives for its most highly compensated executives, its overall compensation program, how that program relates to those objectives, and its decisions about specific elements of compensation.[88] In 2010, the SEC enacted final rules requiring new or revised disclosures about compensation policies and practices that present material risks to the company, stock and option awards of executives and directors, director and nominee qualifications and legal proceedings, board leadership structure, the board's role in risk oversight, and potential conflicts of interest of compensation consultants that advise companies and their boards of directors.[89] Most recently, in September 2013, the SEC proposed a rule requiring public companies to calculate and disclose the ratio of its CEO compensation to its median employee's compensation.[90]

In August 2012 federal regulation of corporate disclosure broke new ground with the "specialized disclosure provisions" of Dodd-Frank. These included requirements that certain public companies provide disclosure about the use of specified conflict minerals sourced from the Democratic Republic of the Congo and nine adjoining countries and requirements that public companies involved in resource extraction disclose payments made to a foreign or the US government for the purpose of the commercial development of oil, natural gas, or minerals.[91] In contrast to other expanded disclosure requirements, which are still justified by lawmakers and regulators as reflecting material investment information for shareholders, many of the new rules are explicitly aimed at changing behaviors and achieving public policy objectives outside of the specific shareholder-company relationship.[92]

THE DRIVE TO ENHANCE BOARD AND MANAGEMENT ACCOUNTABILITY

The Sarbanes-Oxley Act of 2002 (SOX) was passed largely in reaction to the financial scandals that preceded it, its purpose to "protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes."[93] SOX ushered in a host of changes that affected the internal corporate governance of US public companies, including:

- **Independent Audit Committees for Listed Companies** A requirement that listed companies (with certain limited exceptions) have an audit committee consisting entirely of independent directors with authority to engage independent advisors and responsibility for appointing and overseeing the company's outside auditors and for establishing and overseeing whistleblower procedures
- **CEO and CFO Certifications** A requirement that CEOs and CFOs make detailed representations, including representations about accuracy of the information presented and the adequacy of the company's internal controls, with respect to each annual and quarterly report filed by the company with the SEC
- **Other Corporate Matters** SOX also mandated disgorgement requirements for CEOs and CFOs following certain restatements, prohibited directors and officers from improperly influencing audits or obtaining loans from the company, required companies to adopt a code of ethics applicable to the CEO and CFO (or explain why not), prohibited trading by insiders at certain times, and created new criminal and civil penalties.

Collectively, the changes required by SOX transferred significant responsibility from a public company's management to the company's board of directors, particularly the audit committee, and also transferred significant responsibility to "independent" board members, who were likely to show less deference to management and be more responsive to shareholders than directors who were part of the management team. Specific changes also altered the underlying dynamics of the board. Whereas board committees traditionally receive their powers as a consequence of specific delegation by the board, the audit committee provisions of SOX provide that committee with autonomous statutory authority.[94]

E. Continuing Efforts to Align Incentives in Executive Compensation

Stakeholder conflict in corporate governance is perhaps most pronounced in the area of executive compensation. The charge of misaligned incentives and outsized executive pay packages are a flashpoint for scrutiny of public companies by the public, the media, and investors. Executive compensation is a notably intractable issue in the corporate governance debate. Policy makers' attempts to effect corporate policies that align the interests of management with those of shareholders (i.e., that would link executive pay to tangible value creation for shareholders) have resulted in significantly enhanced compensation-related disclosure requirements and, arguably, in better alignment of pay with performance, but not in reduced executive compensation.

In 1978, the SEC revised its executive compensation disclosure rules for public companies to require, for the first time, a table—the summary compensation table—to present to shareholders all quantifiable remuneration paid to individual members of management during a fiscal year.[95] The rule was simple and the details minimal by comparison to disclosure today. The new rule was explicitly adopted as part of an effort to address governance issues, the background of which, as stated in a 1977 SEC release, was that "over the years, questions have frequently been raised relating to the extent to which shareholders should be able to participate in corporate governance. …A number of proposals designed to achieve a new 'corporate governance' have been suggested." The executive compensation disclosure requirements have steadily increased since then, including substantial expansions in the amount of executive compensation information required to be disclosed in 1985, 1992, and 2006. Most recently, Dodd-Frank mandated a handful of new executive compensation disclosure requirements.

A pioneering 1976 paper in the finance literature by Michael Jensen and William Meckling addressing the benefits of alignment (and the costs associated with a lack thereof) focused on the use of equity incentives as part of executive compensation to align the interests of management with those of shareholders.[96] Beginning in the 1990s, when stock options became the single largest component of CEO pay, the use of equity incentives to achieve alignment soared. Various additional factors contributed to the stock option mania of the dot-com period, particularly favorable accounting and tax treatment. Changes in accounting rules, together with the dot-com bust following the turn of this century, resulted in a significant replacement of stock options with other forms of equity. In recent years, equity incentive plan design has continued to evolve, with a notable trend toward the use of performance-based vesting conditions.

The extensive use of equity and other incentives reflects a transition in the composition of public company executive pay packages to emphasize "performance-based" pay elements. The SEC revised its proxy disclosure rules in 1992 to require that proxy statements include a performance graph comparing the company's stock performance to those of a broad market index and a peer group. It noted then that "academic research suggests a positive significant relationship between annual changes in executive compensation and annual changes in corporate performance," but also noted that commentators cautioned that "such findings should not be taken to imply that American corporations have attained the optimum in incentive compensation."[97] While a 1993

book by former Harvard President Derek Bok, *The Cost of Talent*, dated the concept of performance-based pay back to "shortly before the birth of Christ," the extensive use of equity incentives beginning in the 1990s probably represents a modern turning point. Currently, declines in traditional pensions and perquisites, and arguably increases in the value of incentives, have pushed the portion of CEO pay that is performance based to historically high levels.

A steady stream of miscellaneous perquisite issues has continuously claimed a place on the compensation agenda. In 1984, Congress added a special tax to the Internal Revenue Code for the purpose of discouraging golden parachute payments. Since then, pensions, airplane usage, deferred compensation opportunities, country club memberships, loans to executives, tax gross-ups, entertainment allowances, retirement perquisites, and sundry other fringe benefits have taken their turn as a focus of attention. Among other concerns, critics have claimed that perquisites contribute to "stealth compensation" that is not transparent to investors. This aspect of the issue was highlighted in a 2004 book by Professors Lucian Bebchuk and Jesse Fried called *Pay Without Performance: the Unfulfilled Promise of Executive Compensation*.[98] Criticism of perquisites also often invokes larger social issues regarding income inequality.

Bebchuk and Fried's book focused, in particular, on the process of setting pay, as have many legislative and regulatory proposals over the years. Tax, securities law, securities exchange listing standards, and corporate fiduciary law have imposed numerous process-related requirements applicable to executive pay, including at least five different complex standards for what it means for a director to be "independent." Litigation concerning compensation-related issues that turn on aspects of independence has also proliferated, particularly in the fiduciary law context in which procedural aspects of dispute resolution, such as demand necessity and the formation of special litigation committees, may have a substantial practical impact.

Many have argued that the turn to incentive pay to foster alignment creates risk as a by-product. A 2000 research paper titled "Do Executive Stock Options Encourage Risk-Taking?" by Harvard researchers concluded that, while the effect was small, "since options increase in value with the volatility of the underlying stock, executive stock options provide managers with incentives to take actions that increase firm risk."[99] The risk issue was highlighted, and hotly debated, in connection with the financial crisis of 2008. Global financial institution regulators took a strong position in that debate, in some jurisdictions imposing mandatory caps on performance-based pay relative to base salary.

Dodd-Frank's say-on-pay regime has provided shareholders with a specific avenue for providing input on executive compensation. Surprisingly, perhaps, during the first three years of say on pay, average rates of approval of compensation packages have hovered at the 90 percent level, a remarkable degree of consensus concerning an issue that has been the subject of so much debate for so long.

These data point to the possibility that the tension over executive pay between shareholders and companies is entering a quiet period. However, the agenda related to executive compensation remains very full. On the regulatory front, there are still three important Dodd-Frank Act rules that have not been implemented: new disclosure requirements concerning the ratio of CEO pay to median employee pay (for which proposed rules were recently published), disclosure requirements concerning the alignment of pay to performance, and a substantive listing rule concerning compensation clawbacks. Each of these is likely to be controversial. Indeed, the proposed rule regarding the ratio of CEO to employee pay has drawn over 100,000 comments. Furthermore, when these rules are finally written, new legislative proposals will need to be addressed, including a proposal linked to comprehensive tax reform that would revise the rules for employer tax deductions in connection with stock options. From a broader social perspective, executive pay is entangled with one of the principal political issues of the times, namely how to

address increasing degrees of income and wealth inequality. As a result, compensation-related debates will continue and are likely to continue to draw legislative and additional regulatory attention.

F. The Growth in Importance of Proxy Advisory Firms in the Shareholder Voting Process

Proxy advisory firms began offering services to help investors analyze and vote company proxies beginning in 1972, with the founding of the not-for-profit Investor Responsibility Research Center. Today, two proxy advisory firms—Institutional Shareholder Services Inc. (ISS) and Glass Lewis & Co., LLC (Glass Lewis)—represent roughly 97 percent of the US proxy advisory market.[100] In addition to company-specific reports and voting recommendations, both ISS and Glass Lewis release extensive annual voting policies that reflect the firms' determinations of "best practices" for all companies. These annual voting policies provide voting guidelines on a range of potential topics—from recapitalization plans to proposals requiring disclosure regarding animal welfare standards to the company policies that the proxy advisory firms believe merit automatic votes against nominated directors.

With the increase in the size of institutional investors' portfolios, the complexity of proxy statements, and regulatory and market pressures on institutional investors to responsibly exercise their votes, the use of proxy advisory services and the consequent influence of proxy recommendations have also grown. According to the Mercatus Center, a university-based research center, US issuers pose more than 250,000 proxy questions each year, and it is not unusual for large mutual funds and their advisors to be required to cast votes on more than 100,000 of them.[101] At the same time, the issues required to be included in company proxies, including, notably, say on pay, have grown more complicated and can require substantial company-specific analysis. As described by TIAA-CREF in 2010, "[t]hough we dedicate a significant amount of resources to corporate governance research and the voting of proxies, we still would have difficulty processing the 80,000 plus unique agenda items voted by our staff annually without utilizing [proxy advisory firm] research."[102] A survey of institutional investors suggests that there is considerable variation in the manner in which proxy advisory services are used and that the degree of reliance on the services may depend more on firm-specific factors, like resource constraints and perceptions regarding the value of voting, than on sector-specific characteristics like investment strategy (e.g., "passive" or "active" funds).[103]

There are three main channels through which proxy advisory firms influence corporate governance. The most direct is through company-specific voting recommendations that sway voting outcomes. While most observers acknowledge proxy advisory firms' influence on voting results, the actual percentage of votes that are decided based on the recommendations is disputed. A 2010 study of director elections estimated that 6 to 10 percent of votes were shifted as a result of proxy advisory recommendations;[104] other studies have suggested figures greater than 25 percent.[105] In comment letters to the SEC, companies have cited evidence from interim vote reports that a significant number of investors vote in lockstep with proxy advisory recommendations.[106] IBM, for example, reported that the votes cast that exactly mirrored ISS recommendations during the business day immediately following release of the ISS recommendations ultimately amounted to approximately 11.9 percent of total votes cast, whereas no more than 0.27 percent of total IBM votes were cast in any of the five immediately preceding business days.[107]

A second, related channel of influence is with respect to the development of in-house voting policies, the development and disclosure of which became mandatory for registered investment advisors when the SEC adopted Rule 206(4)-6 in 2003. One reason for the rule making was an effort by the SEC to address investment advisors' own potential conflicts of interest when voting clients' proxies. In the adopting release, the SEC noted that "an adviser could demonstrate that

the vote was not a product of a conflict of interest if it voted client securities, in accordance with a predetermined policy, based upon the recommendations of an independent third party."[108] One year later, in response to requests for clarity about the new rules, the SEC staff issued two no-action letters containing guidance that was viewed by many as establishing a "safe harbor" against charges of conflict of interest if a registered advisor relied on an independent proxy advisory firm's voting recommendations, as long as the investor had appropriate written policies and procedures in place to mandate such reliance and made appropriate disclosures to its clients.[109] Such an interpretation provided incentive for registered investment advisors to look to proxy advisory guidelines and other input to establish their own internal voting policies, with the consequence of generating voting outcomes that reflect the ultimate recommendations of proxy advisory firms even when the advisors are not seeking or intentionally following recommendations in a particular year.[110]

The third channel through which proxy advisory firms influence corporate governance is by impacting the governance decisions made by boards and management, who, cognizant of the potential influence of proxy advisory firm recommendations on shareholder votes, incorporate anticipated proxy advisory firm reactions into their decision making when determining what their corporate policies should be.[111] For example, in a 2011 study by The Conference Board, NASDAQ, and the Rock Center for Corporate Governance at Stanford University, 70.4 percent of companies reported that direct or indirect guidance by proxy advisory firms influenced the features of their compensation programs.[112]

The influence of proxy advisory firms (and company concerns regarding it) has come to the attention of regulatory agencies, both in the United States and abroad. In July 2010, the SEC published a concept release on the US proxy system, which discussed and sought company comment on, among other things, concerns related to advisory firms' potential conflicts of interest, a lack of transparency relating to how proxy advisory firms develop voting recommendations, and the absence of regulatory oversight of the industry, and in June 2013, a subcommittee of the Financial Services Committee of the US House of Representatives held a hearing titled "Examining the Market Power and Impact of Proxy Advisory Firms." Both of these spurred significant input from companies, institutional investors, academics, and other analysts (the main issues raised are discussed further in Part III.D, page 30). To date, action on the SEC's concept release has not progressed, given rule-making priorities under Dodd-Frank and other legislation. However, Commissioner Gallagher has expressed support for replacing the Rule 206(4)-6 staff no-action letters (described on page 34) with commission-level guidance that "seek[s] to ensure that institutional shareholders are complying with the original intent of the 2003 rule and effectively carrying out their fiduciary duties. Commission guidance clarifying to institutional investors that they need to take responsibility for their voting decisions rather than engaging in rote reliance on proxy advisory firm recommendations would go a long way toward mitigating the concerns arising from the outsized and potentially conflicted role of proxy advisory firms."[113]

Regulatory agencies abroad have already begun to make recommendations related to their own comment processes. In February 2013, the European Securities and Markets Authority (ESMA) released a final report that concluded the evidence collected did not yet support binding measures for the proxy advisory industry. ESMA recommended a proxy advisory industry code of conduct to address, in particular, improving transparency and disclosure.[114] Canadian regulators found evidence to support regulatory action and, in September 2013, announced that they expect to propose a regulatory approach to proxy advisory firms based on recommended practices and disclosure.[115]

PART III. PRINCIPAL ISSUES MOVING FORWARD

As the trends listed in Part II indicate, we are in an unsettled position with respect to the roles and responsibilities of boards of directors, management, and shareholders in corporate governance. Our current system contains tensions for each of the actors involved in governance and challenges and limitations with respect to their ability to operate effectively to improve the system and to engage with each other.

Boards of directors, for example, continue to operate within a regulatory framework that emphasizes their central role in establishing and maintaining good corporate governance. Recent changes, particularly at the federal level, impose conditions relating to how that role is exercised and have opened more avenues for shareholders to provide governance input. Directors and management continue to be tasked with the fundamental responsibility of creating value for the corporate enterprise, but they face intense scrutiny and conflicting direction regarding the interests they should be responsive to and the measures by which success should be assessed. Shareholders have unprecedented levels of influence on corporate decision making, but they also have capacity and resource issues related to their exercise of that influence. Finally, the financial markets have evolved in fundamental ways that have practical consequences for the way in which directors, management, and shareholders can and should be expected to interact with each other.

The following sections explore a number of different questions related to these issues. The discussions are not intended to provide conclusions or policy prescriptions, but rather summarize some of the dominant positions animating the discussion. The questions examined are:

- Do Federal Mandates Undermine the Benefits of a Historically State-Driven Corporate Law?
- Are Further Changes to Board Processes and Composition Desirable?
- Should Shareholders Assume a More Active Role in Corporate Governance?
- Do Proxy Advisory Firms Replace, rather than Augment, the Shareholder Voice, and Should the Proxy Advisory Industry Be Subject to Greater Regulation and Oversight?
- Can Changes to Voting Mechanics Improve the Effectiveness of Corporate Governance?
- Is Short-Termism a Cause of Concern, and, if so, What Are Its Causes and Remedies?
- What New Challenges Are Presented By Vote Decoupling, High-Speed Trading, and Hyper Portfolio Diversification?

Do Federal Mandates Undermine the Benefits of a Historically State-Driven Corporate Law?

Companies face three major sources of regulation when they choose to participate in US public markets: the federal government (principally through the SEC), state governments (through their corporate codes and the common law of corporations), and the stock exchanges (through their rules and listing requirements).[116] Most federal law relating to public companies has focused on disclosure requirements; substantive corporate law regarding the internal governance of corporations has traditionally been the purview of the state.[117] To many commentators, the regulatory changes imposed by SOX and Dodd-Frank marked notable federal incursions into the state's traditional corporate governance space, drawing criticism from those supportive of a

state-based system and concerns about the potential for future—potentially unpredictable and highly political—federal policies regulating internal corporate activity.[118]

Professor Stephen Bainbridge is a vocal critic of what he has termed "the creeping federalization of corporate law." He and other advocates of the traditional division of regulatory power assert several advantages of state versus federal regulation of corporate law, including:

- **Incrementalism at the state level** State corporation law is developed through constant give and take in state courts. Because corporations are ultimately viewed as creatures of state law, most states have substantial legal precedent, active bars, and expert judges, and Congress tends to step into the corporate law space only at times of intense public dissatisfaction, resulting in a "boom, bust, regulation" cycle that can be dominated by special interest groups, result in confusing or complicated legislation, and fail to permit adequate time for reflective deliberation.[119] State law, moreover, is relatively easily amended and refined over time, whereas federal regulation once passed can be very difficult to change.
- **Federal tendency toward one-size-fits-all solutions** Optimal internal corporate governance, including relating to board composition and formal committee structure, is company specific. State corporation law generally works by providing a set of default governance options and allowing corporations to opt out, subject to "market discipline" should they choose structures disfavored by shareholders.[120] Diversity across state law can also help to reveal best practices; judge-made case law can change as facts and circumstances develop. The federal mandates, in contrast, require adoption of certain "ideal" corporate governance practices that may not be appropriate for all public companies.
- **Potential to conflict with established state law** Many states have developed nuanced case law relating to their corporate governance laws. In Delaware, for example, evaluations of director "independence"—a primary focus of SOX regulations—are functional; when challenged, "independence" is determined based on practical constraints on a director's ability to function effectively with respect to the business issue under consideration.[121] Federal reforms regarding director independence, in contrast, list specific relationships that disqualify a director from being designated as "independent." Prominent Delaware jurists have expressed concern regarding potential confusion over applicable standards and pressure toward harmonization even where state standards have proven effective.

Those that support federal intervention look pointedly to the corporate governance and financial market failures that have unfolded since the turn of the century. Modern failures in corporate governance, they point out, extend far beyond state borders. They can impact the national and global economy. Market discipline and state guidelines have in many cases proven inadequate in preventing such failures; protection of the larger public market requires identifying certain "best practices" from which corporations cannot opt out.

Obviously, both advocates and critics of corporate governance federalization seek to support healthy financial markets. The consequences of the federal mandates enacted through SOX and Dodd-Frank need to be continually evaluated and discussed to determine how useful these mandates are and to add to the pool of information available when the federal government is, inevitably, again called to act.

Are Further Changes to Board Processes and Composition Desirable?

Optimizing corporate governance may require a new focus on board processes and composition. Shareholders, courts, Congress, regulatory agencies, the stock exchanges—and directors themselves—have all focused on identifying board processes and practices that would, if adopted, improve the oversight and advisory capacities of the board.[122]

Identifying specific processes and practices that would lead to positive change is particularly difficult in this area, as creating an effective board involves a consideration of human complexities and interrelated trade-offs that bright-line rules frequently do not reflect. The mix of skills, viewpoints, and professional and personal backgrounds that contribute to a well-functioning board, for example, are difficult to capture concretely—the chemistry that results in a well-functioning board is frequently hard to identify or describe, and predictions about whether a board will gel are usually hard to make, much less capture in an abstract rule or "best practice."[123] Independence requirements, which proliferated in response to the problem of excessive director deference to management[124] (and about which much has been written),[125] can exclude directors from consideration for board service who have demonstrated effectiveness in the role or have industry-specific expertise of particular value to the company.[126] Mandated board processes, moreover, necessarily draw time, money, and attention away from activities on which the board would otherwise choose to focus. A regular refrain of experienced directors is that adequate time is not set aside for matters that deserve considered attention, in part because regulatory requirements demand they focus on issues that, they believe, are not central to the effective management or oversight of their particular companies.

While many boards have implemented policies and procedures designed to improve board functioning, historical practice and the value placed on collegiality can make needed change, absent outside pressure, difficult to achieve. Among the areas in which additional board scrutiny has been recommended are:

- **Board evaluations** Full board evaluations are conducted by 91.8 percent of companies.[127] A concern among governance advocates, though, is that directors are reticent to hold each other accountable for deficiencies in performance. In response to a 2013 survey by PwC, for example, 35 percent of 934 public company directors surveyed stated that someone on their board should be replaced. The top three reasons cited were diminished performance because of aging, a lack of required expertise, and poor preparation for meetings. The most frequently cited impediment to replacing a director was that board leadership was uncomfortable in addressing the issue.[128]
- **Board composition** Board composition speaks to the issue of whether the board has the skills, experience, and constitution required to effectively predict and respond to the risks, strategies, and evolving needs of the company. Unfortunately, as in many fields, there is no proven test for evaluating the presence of those types of skills or experience in particular board members. Under the circumstances, the most effective strategy, perhaps, to maximizing board effectiveness as a function of board composition is for the board to regularly struggle with the appropriate questions relating to board composition, such as whether the members have the right mix of skills and experience, the right degree of cohesion and diversity of temperament, and a commitment to deliberation that would make it effective. Notably, while board turnover has trended downward over the last decade, turnover increased by 16 percent in the 2013 proxy year.[129]
- **Information collection** Establishing an unimpeded and honest information flow from management to the board is essential to a director's ability to understand and critically examine strategy, company performance, and potential sources of a company's risk. In the PwC survey, although directors generally described an increased attention and effort to understand the risks posed by new cybersecurity and related issues, almost a third of respondents expressed that they did not believe their company's strategy and IT risk mitigation was adequately supported by a sufficient understanding of IT at the board level, and only about a quarter "very much" agreed that the company provides them with adequate information for effective oversight.[130] Improving information channels between directors and management could help address these issues, but it requires drawing on the more cooperative aspects of director engagement. Because of the strong current emphasis on independence and critical examination of

management, developing relationships that foster trust and encourage uninhibited information sharing may require more focused effort than in the past.

- **Shareholder communication strategies** As discussed in Part II.D.2 (page 19), the last 10 years of the public company disclosure regime have been characterized by a significant increase in the scope of information that must be provided to shareholders and regulators. As Mary Jo White, chair of the SEC, noted recently, "when disclosure gets to be 'too much' or strays from its core purpose, it could lead to what some have called 'information overload'—a phenomenon in which ever-increasing amounts of disclosure make it difficult for an investor to wade through the volume of information she receives to ferret out the information that is most relevant."[131] However, voluntary communication with shareholders should be considered separately from disclosure mandates. Board engagement with shareholders outside the regulatory process can be vitally important in providing management with the support it needs to pursue the company's strategic plan and to respond and productively consider shareholder input.[132]

Directors face a significant challenge in the current governance environment. As they work to comply with heightened regulations, address new and complex market risks, and more strongly defend their qualifications to serve as directors, they also face a general public that associates them both with the governance failures of the past and with the publicized shortcomings or problems of those currently serving. The consequence can be a tendency to hide or ignore problems to avoid providing fodder for those who are quick to find fault with board processes.

Most directors, though, recognize that greater self-scrutiny and concrete actions taken in response would improve their ability to operate effectively in the role with which they have been entrusted. While past governance failures have left an impression that highly qualified directors continue to try to change, they have also stimulated thoughtful guidance, opportunities for roundtable discussions, and a sharing of practices that are incredibly valuable for boards interested in improvement. Directors who welcome the discussion and rethink their practices and processes in light of it will, ostensibly, be better positioned both to serve their companies and to meaningfully participate in conversations with shareholders and regulators about different approaches to increasing the effectiveness of the board.

Should Shareholders Assume a More Active Role in Corporate Governance?

As a result of changes in the market, popularity of the shareholder value model, federal regulation, and shareholders' own activism, the influence of shareholders in corporate governance has grown to a level not seen before. Still, some argue that corporate governance would be improved if the shareholders assumed an even greater role.

One subset of this discussion is more structural, relating to the legal rights of shareholders. Bebchuk is among those who have advocated for an expansion of shareholders' legal rights. Bebchuk's argument rests largely on agency theory. He argues that the "managerialist" model of US corporate law provides too much opportunity for management to insulate itself from shareholder pressure and pursue activities that support its own interests rather than those that would maximize shareholder value. He supports revising state laws to give shareholders the ability to initiate a greater range of corporate decisions, including "rules-of-the-game" decisions (i.e., relating to charter amendments and changing a corporation's state of incorporation), "game-ending" decisions (i.e., to merge, sell all assets, or dissolve) and "scaling-down" decisions (i.e., to contract the size of a company's assets by ordering a cash or in-kind distribution to shareholders).[133]

Bainbridge and Professors Iman Anabtawi and Lynn Stout are among those who strongly disagree. Bainbridge and others argue that the current framework provides sufficient incentives

for boards of directors to serve shareholder interests and meet shareholder demands and that the hierarchical structure of board control is both well suited and necessary for efficient operation of corporations, which must meet the needs of a diverse group of employees, managers, shareholders (diverse in themselves), creditors, and other constituencies.[134]

In even more direct contrast to Bebchuk, Anabtawi and Stout argue against increasing the legal rights for shareholders and instead support increasing shareholders' legal liabilities. The operating framework for corporate boards of directors, they point out, is one characterized by rights and responsibilities: directors are empowered to use discretion to oversee day-to-day management of the corporation but are bound by fiduciary duties to exercise that discretion in the best interests of the corporation. Shareholders, in contrast, operate almost exclusively within the realm of "rights" and are generally not assumed to have fiduciary duties, either to the corporation or to other shareholders.[135] Anabtawi and Stout describe this scheme as based on conceptions of a more "passive" shareholder[136] and argue that modern increases in the ability and willingness of shareholders to influence corporate policy, coupled with greater opportunity for economics-based conflict among shareholders (e.g., the development of financial tools that allow activists to use the shareholder platform to pursue individualized interests), merit an extension of the fiduciary duty of loyalty to shareholders, with financial repercussions should that duty be breached.[137]

Another subset of the discussion about the role of shareholders in corporate governance focuses on whether institutional investors should be encouraged (or required) to play a more active "stewardship" role in corporate governance. Stewardship advocates point to institutional investors' access to information (largely as a result of enhanced company disclosure requirements), their size and resources, and their duties as managers of individual beneficiaries' wealth. They argue that greater engagement and participation by institutional investors will help achieve long-term sustainable value and curb the type of risk taking that contributed to the financial crisis.[138]

Skeptics of this position cite a number of potential hurdles to institutional investors' successful fulfillment of this role, including:

- *Incentives at the asset manager level that do not support a long-term orientation*, including evaluation of asset managers on relatively short-term performance, which undermines their motivation to invest in corporate governance advocacy that would produce longer-term or widespread gains;[139]
- *Excessive portfolio diversification*, which gives rise to difficulties in monitoring individual companies and weakens the "ownership" mind-set associated with any one asset;
- *The lengthening of the investment chain*, whereby individual beneficiaries are separated from the investee company by many layers of decision makers, resulting in a legal shareholder with incentives and a risk tolerance that can differ substantially from the interests of the ultimate beneficiary of investment decisions (these are also referred to as agency problems arising from the "separation of ownership from ownership");[140] and
- *The potential for increased reliance of institutional investors on proxy advisory firms, should they be required to play a more active role*, and underlying concerns about further increasing the role of proxy advisory firms in corporate governance.

Many stewardship advocates also voice concern about these issues but advocate public policy or private ordering changes to address them.[141] Other corporate governance advocates call for additional facts. In January 2011, the Committee for Economic Development, the Millstein Center for Corporate Governance and Performance at the Yale School of Management, and the Aspen Institute Business and Society Program cosponsored a research roundtable on institutional

investors attended by academics, think-tank analysts, leading practitioners, and former regulators. Their conclusions included seeking additional research on the following questions:

1. Do institutional investors adequately advance the goals of the individuals who give institutions money?
2. Do institutional investors contribute significantly to "undesirable short-termism" in their publicly held investee companies?
3. Can institutional investors become more effective "stewards" of publicly held investee corporations, and how does that "stewardship" role differ from the role of boards of directors to oversee the direction of companies?[142]

Inherent in these questions is the reaction of institutional investors to increased responsibility. The largest institutional investors take seriously their role in corporate governance and would contest the broad brush of these questions. At the same time, there is a concern that some institutional shareholders vote because they believe they have a legal obligation to do so, rather than as the result of internal deliberations that conclude that making a particular voting decision is in the best interests of their clients.

The environment in which boards of directors, management, and shareholders act out their governance roles is virtually unrecognizable from the environment in which those roles were established. Still, there are meaningful justifications for the roles. "More" of any one of the actors is not in itself a benefit to the system—managers that act too much like shareholders may fail to consider the different constituencies that are required for the success of the business, directors that act too much like managers sacrifice the distance needed for appropriate oversight, and shareholders that act too much like either may be doing so without the knowledge or expertise that both roles require. Policy advocacy that supports changing these roles—whether to create rights and responsibilities that drive them further from or that return them closer to their traditional conceptions—should be based on a firm understanding of their underlying rationale and a clear conception about the benefits to governance that such a change is likely contribute.

Do Proxy Advisory Firms Replace, rather than Augment, the Shareholder Voice, and Should the Proxy Advisory Industry Be Subject to Greater Regulation and Oversight?

Modern shareholders, and institutional shareholders in particular, face a substantial task in exercising their proxy votes. Given the large number of voting opportunities for many institutional investors, the complexity of many of the issues on which votes are taken, and the relatively small financial interest of most institutional investors in any particular matter put to a vote, it is rational for institutional investors to seek outside support. And, just as companies are entitled to seek counsel for complex tasks, an institutional investor's decision to secure the support of proxy advisory firms is a legitimate exercise of managerial discretion.

In July 2010 the SEC asked for public comment on proxy advisors in light of growing concerns that proxy advisory firms may be subject to conflicts of interest or may fail to conduct adequate research and base recommendations on erroneous or incomplete facts.[143] The concerns regarding proxy advisors can be summarized as follows:

- lack of transparency and potential conflicts of interest at the firms drive concerns about the legitimacy of their voting recommendations;
- reliance by institutional investors on proxy advisor recommendations drive concerns that the recommendations displace meaningful institutional investor input in the voting process; and

- the "best practice" rules of the proxy advisors drive concerns about forcing all corporations into a "one-size-fits-all" box with little or no evidence that the best practices improve corporate performance.

Critics of proxy advisory firms contend that there is little visibility into the analytical process that guides their recommendations.[144] ISS provides limited opportunity for American companies to fact-check company reports prior to publication. Advance review is only offered to companies in the S&P 500 and then only with respect to issues ISS has deemed noncontroversial.[145] Glass Lewis does not permit review of its company reports prior to their release.

ISS defends its limited interaction with evaluated companies regarding its specific recommendations as intended to ensure the independence of its process and recommendations.[146] The firm also points to its engagement with companies, institutional investors, and industry constituents through roundtables, surveys, and an open-comment period as it develops its annual policy guidelines, which themselves are publicly available and inform ultimate ISS recommendations.[147] Still, critics charge that this engagement, too, has its problems, including with respect to how the feedback is incorporated into the policy guidelines and how the feedback informs application of the policy guidelines to actual voting recommendations. For example, in 2013, ISS reported that it would consider a new policy recommending that investors vote against directors of a company if the directors fail to act on a shareholder policy receiving majority support of votes cast during the previous year. Various companies, including Pfizer, Eli Lilly, FedEx, and Honeywell, protested that this policy directive could run counter to a board's fiduciary duties to act in a manner that it believes to be in the best interests of the company.[148] In its 2013–2014 policy survey, ISS reported that 40 percent of institutional investors indicated that a board should be free to exercise its discretion to respond to a majority-shareholder proposal in a manner it believes is in the best interests of the company, 92 percent of issuer respondents indicated the same, and only 36 percent of institutional investors indicated that the board should implement a specific action to address a proposal with majority shareholder support.[149] ISS nonetheless implemented a policy for 2014 elections to recommend a vote against individual directors, committee members, or the entire board of directors, as appropriate, if the board failed to act on a shareholder proposal that received the support of a majority of the shares cast in the previous year.[150] ISS indicates it will make recommendations to vote against the reelection of directors after considering company-specific issues. However, this assurance does not satisfy company concerns about the conflict between directors' fiduciary duties to consider the best interests of the company and all of its investors and the policy that requires directors to take action approved by some investors, but not necessarily a majority of the total shares outstanding. At least two dozen of the largest 1,000 companies had investor proposals approved by a majority of votes cast in the 2013 annual meeting, but not by a majority of the outstanding shares.[151]

Conflict of interest charges regarding the proxy advisory firms focus on the ownership of Glass Lewis and the services provided by ISS. As a subsidiary of Ontario Teachers' Pension Plan Board and Alberta Investment Management Corp., Glass Lewis has been described as having a "built-in" conflict of interest, as its owners—as active investors with a particular set of constituents—have their own economic and other interests in the proxy outcomes of various companies that Glass Lewis reviews.[152] Potential ISS conflicts of interest stem from its advisory services to both institutional investor and company clients. Specifically, ISS provides governance ratings of companies and voting advice to institutional investor clients at the same time as it provides structural governance advice to company clients about how to improve the policies, structures, and proposals they may be evaluating. Critics charge that this provides opportunities for companies to "game" the system and can create pressure on companies to purchase governance advice from ISS to improve their ISS ratings.[153] In addition, both Glass

Lewis and ISS issue recommendations with respect to proposals submitted by their shareholder clients.

Both companies have policies they believe respond to these charges. Glass Lewis has committed to indicating whether the Ontario Teachers' Pension Plan Board or Alberta Investment Management Corp. has a substantial interest in a particular company in the research report of that company.[154] ISS has conflict management policies and procedures that it says create physical, electronic, and ethical (via annual certification of the company's code of ethics) separations between its company advisory and institutional investor advisory services, and it provides institutional investor clients with a list of its company clients upon request.[155]

Still, transparency and conflict of interest concerns remain strong. In an October 2013 letter, NASDAQ cited the concerns in a petition asking the SEC to modify its 2004 guidance permitting certain registered investment advisors to rely on proxy advisory firm recommendations. Specifically, NASDAQ asked that the SEC condition institutional investor reliance on a proxy advisory firm's disclosure of (i) the models, formulas, and methodologies pursuant to which it develops its voting recommendations, and (ii) all relationships that might give rise to conflicts of interest. In the letter, NASDAQ charged: "as they operate today [proxy advisory firms'] services cannot be evaluated in a meaningful manner…Unless we enable companies and all market participants to have full information about [their] practices and activities…[they] will continue to exert outsized influence from the shadows in which they operate and profit."[156]

The second major concern about proxy advisory firms is the extent to which the firms' recommendations influence proxy voting outcomes. Based on their tabulated voting results and their knowledge about the voting policies of some of their institutional investors, many companies have concluded that a sizable portion of their investors rely heavily on—and in some cases, blindly follow—the advice of proxy advisory firms. In comment letters to the SEC, General Mills and ExxonMobil estimated that 20 and 25 to 30 percent, respectively, of their company shares are voted by shareholders who look to ISS for guidance. In addition to IBM (as described in Part II.F, page 23), UnitedHealth Group and Johnson & Johnson are among those companies that noted a substantial increase in the number of votes that mirrored proxy advisory recommendations in the days immediately following the issuance of the recommendations. A 2008 study by the Investment Company Institute (ICI) of 3.5 million proxy votes cast in 2007 by 160 of the largest fund families found that voting patterns among the funds were broadly consistent with voting recommendations of proxy advisory firms even though, the study found, funds did not reflexively adopt the recommendations of proxy advisors.[157] This has led some to conclude that many institutional investors have established internal voting policies based on proxy advisory firm guidelines and related advice.

Many large institutional investors dispute the characterization of institutional overreliance on proxy advisory firm services. They point out that they are entitled to seek advice—as is any company—from experts of their choosing, and they describe their use of the services, particularly proxy advisory firm research, as one input in a larger process. They also cite the lack of empirical evidence to support claims that institutional investors follow the recommendations of proxy advisors without exercising their own independent evaluation. In its testimony to the House Committee on Financial Services, CII references its own study "of the largest public pension systems and institutional asset managers, [which] found that nearly all have their own proxy voting guidelines and use proxy advisory firms simply for the research; they do not vote based on the advisory firm's voting recommendations."[158] The ICI study, similarly, found that the funds studied devoted "substantial resources" to proxy voting and made "nuanced judgments in determining how to vote on both management and shareholder proposals in order to promote the best interests of funds and their shareholders."[159]

BlackRock, the world's largest asset manager, and Vanguard Group Inc., the biggest mutual fund firm by assets, are among those institutional investors that have expressed frustration regarding the assumption of rote adherence. In June 2011, Laurence D. Fink, chairman and CEO of BlackRock, wrote a widely publicized letter stating: "We reach our voting decisions independently of proxy advisory firms on the basis of guidelines that reflect our perspective."[160] Michelle Edkins, BlackRock's corporate governance team leader, meets with approximately 20 BlackRock analysts every morning during the proxy season to discuss how BlackRock will vote its clients' shares. Vanguard employs about a dozen analysts to research companies year-round. Glenn Booraem, Vanguard's principal and fund controller, says that proxy advisory firms represent only one tool for making voting decisions. "Their recommendations don't determine where we end up," he stated.[161]

The belief that institutional investors blindly follow proxy advisory firm recommendations, institutional investors and others point out, can have a self-fulfilling consequence, as evidence suggests that companies concerned about the influence of proxy advisory firm recommendations modify their policies and proposals to garner proxy advisory firm support. A study by The Conference Board, NASDAQ OMX Group, and Stanford University's Rock Center for Corporate Governance, for example, found that companies increasingly tailor their compensation policies—particularly incentive compensation plans, annual discretionary bonuses, and severance plans and contracts—to fit within ISS's and Glass Lewis's standards and metrics.[162] In instances where a company decision can establish the basis for a "withhold" or "against" vote recommendation against the company's directors (for example, in relation to director reaction to majority-supported shareholder proposals, as described in Part III.D, page 30), the pressure to conform to the standards and policies set forth in the ISS and Glass Lewis voting guidelines can be particularly acute.[163]

The influence of proxy advisory firms, whether from their recommendations, their influence on institutional investor voting policies, or from corporate actions to voluntarily comply in advance with their published policies, raises concerns among many corporate governance advocates about the establishment of "one-size-fits-all" or "check-the- box" corporate governance rules in an arena in which diverse corporate entities and rapid change make flexibility important. Moreover, while proxy advisory firms have the benefit of incorporating information from a broad swath of companies and other stakeholders, they do not have the ability or duty to analyze and deliberate regarding company policies that are required of corporate managers and directors. Most corporate governance advocates do not question whether proxy advisory firms have a role to play in the proxy voting process, but rather whether the current manner in which proxy advisory services are used minimizes the company-specific perspective and replaces meaningful dialogue between institutional investors and management regarding the same. As stated in BlackRock's 2011 letter to its portfolio companies, "Companies that focus only on gaining the support of proxy advisory firms risk forgoing valuable and necessary engagements directly with shareholders."[164] Companies have, with respect to institutional investors' use of proxy advisory firms, expressed the same.

A number of proposals have been made to address concerns, including:

- adopting voluntary standards of conduct,[165] including in relation to minimizing and disclosing potential conflicts, improving transparency into general methodologies, and correcting material errors promptly;[166]
- replacing the two 2004 staff no-action letters cited by NASDAQ and others as encouraging reliance on proxy advisory firm recommendations with commission-level guidance clarifying that such reliance does not effectively fulfill institutional investors' fiduciary duties;[167]
- clarifying that Rule 206(4)-6 does not require all investors to vote in every corporate election;[168]

- requiring firms to file their advice and reports with the SEC (and to permit companies, where appropriate, to respond to those reports);[169]
- reclassifying proxy advisory firms as investment advisors or ERISA fiduciaries, or establishing an oversight body with authority over them; [170]
- eliminating the exemption for proxy advisors from the proxy solicitation rules;[171]
- spinning off businesses that advise companies on corporate governance to avoid conflicts of interest associated with serving two different sets of clients—institutional investors and corporations;[172] and
- requiring evidence that corporate governance standards developed by proxy advisory firms to evaluate corporate performance have a reasonable correlation to increasing corporate value.[173]

Commissioner Gallagher has supported several of these changes, stating in 2013: "I believe that the commission should fundamentally review the role and regulation of proxy advisory firms and explore possible reforms, including, but not limited to, requiring them to follow a universal code of conduct, ensuring that their recommendations are designed to increase shareholder value, increasing the transparency of their methods, ensuring that conflicts of interest are dealt with appropriately, and increasing their overall accountability." In the same 2013 speech, he also supported replacing the two 2004 staff no-action letters cited by NASDAQ and others as encouraging reliance on proxy advisory firm recommendations with commission-level guidance clarifying that such reliance does not effectively fulfill institutional investors' fiduciary duties.[174]

Our current regulatory and political framework focuses on shareholder voting as a means to encourage accountable and effective corporate governance. Issues relating to institutional investor voting patterns and the role of proxy advisory firms in determining governance outcomes strike at the center of the perceived benefits of shareholder democracy. Given the unabated concern expressed by corporations, the steps taken by international regulators (including Canadian regulators and ESMA) to generate transparency in the proxy advisory system, and the inarguable anomaly of the proxy advisory sector operating without any formal governance or disclosure requirements, either required or voluntary governance changes within the proxy advisory industry seem likely.

Can Changes in Voting Mechanics Improve the Effectiveness of Corporate Governance?

Other significant issues that all parties in the corporate governance debate must address concern "proxy plumbing" and voting. These issues affect how shareholders are able to express their views to the companies whose shares they own and, conversely, how those companies can communicate with their shareholder constituents.[175]

There are three important areas of focus relating to the "mechanics" of voting:

1. ensuring that votes are accurately counted;
2. enabling companies to determine who their shareholders actually are at any particular time; and
3. coping with the current ability of beneficial owners of shares to object to the sharing of their names with a company under the SEC's current shareholder communications rules.

The Mechanics of Share Ownership

A principal question is whether proxy votes are being counted accurately. Significant concerns regarding vote reconciliation issues have been identified, and although in at least some cases it may be possible to conduct an end-to-end audit with the approval of all parties involved, no widely used end-to-end vote confirmation system currently exists.[176] Issues about accurate vote

counting stem from: (i) the general characteristics of the intermediated holding system whereby institutional investors hold shares on behalf of individual investors, and (ii) practices with respect to share lending and other similar transactions.[177]

The current shareowner system involves, in many cases, the aggregation of share registration through a single entity (for example, a securities depositary like The Depository Trust Company (DTC) or a DTC participant, or in some cases through a further intermediary such as an investment manager). Under this system, the registered entity maintains accounts for individual investors and for intermediaries and physically votes the registered shares. While legal rules provide the mechanisms by which proxy voting is intended to work and voting instructions should be sought, long investment chains within the intermediary structure can in some cases make the process murkier. While a particular intermediary can identify the holders of aggregate shares that are directly below it on the investment chain, it will not necessarily know the identity of beneficiaries further down the line (which, when those holders include further intermediaries, adds even further complexity). As a practical matter, ultimate determinations about who is entitled to vote typically rely on the procedures established by the various intermediaries. Accordingly, it may difficult or impossible to accurately link particular votes to particular beneficial owners, and timing issues may result in votes being excluded (or, on the other hand, multiple votes being cast with respect to subsequently transferred shares).

Share lending transactions raise similar issues arising from the accounting at securities intermediaries relating to securities loans. Specifically, securities loans are typically made from unallocated pools of securities held for client accounts. Clients frequently do not know that their securities have been loaned, and they may be afforded the opportunity to vote all of the securities beneficially owned by them, even though some undetermined portion of those securities have been loaned to third parties and then sold by those third parties into the market, thereby providing an opportunity for the purchasers of the securities to also vote them, giving rise to an overvoting situation.[178]

One mechanism companies use to determine who holds their shares is the Form 13F filings made by institutional investment managers. Most institutional investment managers that exercise investment discretion over at least $100 million in "Section 13(f) securities" are required to report their holdings to the SEC on a quarterly basis within 45 days of the end of each calendar quarter.[179] The filing obligation continues so long as the institutional investor continues to meet the $100 million filing threshold set forth in Rule 13f-1(a)(1).

These filings, and the filings by large shareholders of Schedules 13D and 13G, represent essentially the only information that companies are readily able to obtain regarding their shareholder base. In many cases, the registered shareholder identified on a company's register maintained by the transfer agent will be DTC or another securities depositary, with only a limited number of holders (frequently employees or others to whom the company grants shares directly) identified as direct registered owners. The filing obligation, as currently structured, is of limited utility to companies during the proxy season—for example, a Form 13F filer who acquires securities on January 1 will not be required to disclose the ownership of those securities on a Form 13F until May 15 (i.e., 45 days after the end of the calendar quarter ending on March 31), meaning that, for most issuers during the annual proxy season, that filing will come too late to use the filed information to engage directly with that investor. There are various proposals to revise the Form 13F filing requirements to make them more useful. For example, the NYSE filed a petition proposing a requirement that the Form 13F be filed two business days, rather than 45 calendar days, after the end of the quarter,[180] although this proposal has been opposed by a number of institutional investors as having the potential to encourage predatory trading practices and other issues. Others have proposed different revisions, such as requiring filings to be made monthly rather than quarterly. At the same time, however, the true utility of Form 13F filings is

fairly limited. Given that securities can trade in significant volumes over very short periods of time, these filings do little more than provide a snapshot of ownership. Similarly, while the filings may reflect ownership at the institutional level, they do not capture beneficial ownership below the level of the institutional investment manager, meaning that even individual holders who actually own shares directly through such an entity (rather than, for example, through a mutual fund or through an entity that itself holds its shares in an institutional account) will still not be known to the company.

Communicating with Shareholders

For years, the SEC has wrestled with balancing the need for companies to communicate with their shareholders against the desire for investors to retain their privacy at times when they are not otherwise required to make public disclosures of their share ownership. Over time, a distinction has been drawn between shareowners who object to sharing their names with a company (objecting beneficial owners, or OBOs) and shareowners who do not (nonobjecting beneficial owners, or NOBOs). Companies can face significant challenges when they conduct shareholder solicitations under the current framework, if for no other reason than that they cannot identify (and direct specific communications to) the persons who are actually the beneficial owners of their shares.[181] In its Proxy Plumbing Release, the SEC sought comment on a wide range of possible reforms relating to the OBO/NOBO framework, including removing the distinction, modifying the system to set one or the other as a default, and increasing related disclosure, or requiring institutional investor securities intermediaries to transfer proxy voting authority to beneficial owners.

By increasing the ability of companies to identify and communicate with shareholders—even if that identification and communication must take place through intermediaries—companies would also potentially be able to take steps to increase voting rates among both institutions and individual investors and to promote interest in the annual meeting process. Of course, the impact that additional communication will have on voting rates is very uncertain. Moreover, while there seems to be a consensus in favor of some type of reform of the OBO/NOBO framework, there are various competing interests at stake having nothing to do with voting that may impede change. For example, some beneficial owners would no doubt prefer to maintain the greatest possible degree of anonymity, while some intermediaries may benefit from their current role, which might be diminished were more direct lines of communication available.

Is Short-Termism a Cause for Concern, and if so, What Are Its Causes and Remedies?

In 1996, Professor Kevin Laverty wrote a cross-disciplinary research paper about "economic short-termism," which refers to the tendency to overweight short-term interests relative to long-term gains:

> The debate…has raged as managers, researchers, and policy makers seek to explain and reverse the economic malaise that has affected the United States for the past two decades. A fundamental argument is that US firms fail to make necessary investments that will have long-run, but not immediate, payoffs. Economic short-termism has been blamed on biases against long-run investment…pressure from the stock market to maintain and increase year-to-year or quarter-to-quarter profitability, and economy-wide high cost of capital.[182]

Today, the debate about economic short-termism continues. Over the last several years, senior policy makers at the SEC, Delaware jurists, academics, prominent members of the bar, think tanks, executives, and corporate analysts have been among those who expressed concern about a perceived pervasiveness of economic short-termism. The rhetoric within the debate can be heated, in part because the two most-often cited causes—executive mismanagement and

shareholder shortsightedness—have implications for the larger debate about the appropriate roles of shareholders and management in public company corporate governance.

Those who perceive management as the primary source of economic short-termism generally point to the proportion of CEO pay that is related to stock price performance; easily liquidated stocks can generate incentives to inflate stock price over the short term. They also cite the pressure created by shorter average CEO tenure. A study by The Conference Board, for example, measured average CEO tenure at 8.1 years in 2012, down from almost 10 years in 2000. The study noted that CEOs who held their positions for less than five years were more likely to be dismissed for a company's poor performance than CEOs with longer tenure.[183] Shorter tenure and time frames for evaluation are among the pressures that can influence CEOs to make decisions that generate more immediately tangible financial results.

Those who point to shareholder shortsightedness as the primary driver of short-termism generally cite the following factors:

1. shorter average stock holding periods[184] and higher portfolio turnover rates ("impatient capital"), which overvalue actions that produce short-term share price increases;
2. compensation and evaluation structures for investment fund managers that are based on quarterly results (even when the time horizons of the funds' investors are long term); and
3. the increased pressure that activist hedge funds place on corporate managers and directors who do not meet short-term stock price expectations.[185]

Others point to structural market factors as driving short-term orientations of both management and shareholders. These include:

- *The replacement of debt with equity as the primary source of permanent capital for American corporations* Professor Lawrence Mitchell notes that holders of common stock of US companies have withdrawn more money from corporations than they have invested since at least 1962. He observes that while debt has replaced equity as the primary source of permanent capital for American corporations, corporate boards are still charged with managing for shareholders. The result, he charges, is "the dangerous anomaly of boards and managers managing for shareholders (with shareholder interests in stock price maximization and shareholder taste for risk) with creditors' money. This ability to use other peoples' money for shareholder profit creates powerful managerial incentives to shortchange the long-term health of the corporation for short-term gain, putting the American productive sector at risk."[186]
- *An excessive focus on quarterly earnings guidance* The Aspen Institute, the CFA Institute, and the corporate and investment leaders they have surveyed are among those who argue that an excessive focus on quarterly guidance draws management attention and corporate resources toward managing to meet the short-term earnings metric and away from effectively communicating and striving to achieve a long-term strategic plan.[187] In response to a 2004 survey relating to financial reporting, for example, nearly 80 percent of the chief financial officer respondents said they would decrease discretionary spending (for research and development, advertising, maintenance, etc.) if it looked like the company might miss the desired earnings target, and 78 percent said they would sacrifice a small, moderate, or large amount of value to achieve a smooth earnings path.[188]
- *The ascendance of shareholder primacy thinking* Stout, Professor Margaret Blair, and others connect short-termism to the rise of "shareholder primacy" thinking, including the perception that there is a "duty" to maximize shareholder value, and the emphasis that the underlying theory places on stock price as the single metric of corporate value.

Those who believe short-term trading is negatively affecting corporate behavior have proposed regulatory changes, such as revising capital gains tax provisions to favor longer-term shareholders, implementing excise taxes to discourage high-speed and other short-term trading,

or permitting corporations to award special dividends or provide other incentives to longer-term shareholders.[189] Others support redefining the context in which decisions are made by adopting a measure of corporate value that expands beyond stock price and empowering managers to use discretion to incorporate a larger variety of stakeholders (e.g., customers, employees, creditors, suppliers, communities, and the environment) into decisions regarding how to maximize that value.[190]

On the other side of the debate, there are academics and business leaders who challenge the idea that short-term interests dominate capital markets and those who dispute the characterization of the weight given to short-term interests as "disproportionate" ("short-term skeptics"). Professor Mark Roe argues that the technology bubble is an example of markets being too long term in their thinking, with shareholders dramatically overvaluing companies whose operations they believed would succeed over the long term, even though the companies had little to no immediate earnings prospects.[191] He also highlights a recent study by Professors Martijn Cremers, Ankur Pareek, and Zacharias Sautner, which found that even though average annualized share turnover grew from 72 percent in 1985 to 300 percent in 2010, the amount of time institutional investors retained particular stock holdings during that period was fairly stable and, if anything, slightly lengthened, from 1.2 years in 1985 to 1.5 years in 2010.[192] They attribute the increase in share turnover largely to high-frequency traders (whose trading activities were not captured by their sample), rather than a general shift toward shorter stockholding periods among the larger pool of institutional investors.[193]

Roe and Fried are among those who also challenge the weighting of short-term interests as "disproportionate." Roe contends that certain realities of the modern economy, including the speed of technological change, globalization, and uncertainty in economic policy, may make significant discounting of the long term a rational managerial strategy.[194] Fried identifies situations in which "long-term" shareholders may act in self-interested ways that reduce the creation of economic value, and he discourages any policy action that would enhance the influence of such shareholders without additional empirical investigation as to their relative impact.[195]

The debate about short-termism has a long history and draws on economic and social assumptions that can be difficult to harmonize. Still, both sides would agree that actions that destroy corporate value, or sacrifice corporate value in favor of ephemeral gains, are not consistent with the corporate purpose or with the goal of creating a healthy economy. Effective communication, essential to resolving any issue in corporate governance, is particularly important in addressing the charge of short-termism. Managers are tasked with acting as stewards of the enterprises they run, which includes a responsibility to explain long-term strategic plans to shareholders. Shareholders who support a more holistic management focus, meanwhile, must find a way to ensure that their ownership and voting decisions reflect that advocacy. For both groups, identifying and enacting corporate policies that support innovation and sustainable growth—policies that should be favored by "short-term" and "long-term" interests alike—will involve not only sending the desired messages, but also ensuring their effective transmission. The complexities of modern markets make this a particular challenge.

What New Challenges Are Presented by Vote Decoupling, High-Speed Trading, and Hyper Portfolio Diversification?

Traditional corporate governance grants shareholders two fundamental rights through which to express their support or disapproval of corporate strategy: buying or selling a company's stock and voting at shareholder meetings. Corporate decision making can be strongly linked to these expressions of support or disapproval, with management called to revisit strategies when shareholders express their disapproval directly (through voting) or indirectly (through selling

activity that depresses stock price). The legitimacy of this system is premised on the assumed motivation of shareholders to act in a way that maximizes the value of the corporation (and, hence, the value of their equity shares). A number of policy changes over the last decade have worked to strengthen the shareholder voice in the hope that it would prove a disciplining force in focusing management on what is presumably the fundamental corporate purpose—maximizing share value. The explosion of the modern derivatives market, high-frequency trading, and "hyper portfolio diversification,"[196] however, are among the trends that pose challenges to traditional assumptions regarding the participation goals and motivations of modern shareholders.

Professors Henry Hu and Bernard Black have documented a number of ways in which derivatives can "decouple" the economic interest of shareholders in encouraging stock appreciation from the voting or control rights that can be used to forward that interest. The result of an equity swap, for example, can be one investor who acquires the economic consequences associated with a referenced stock's ownership (e.g., the receipt of dividends, value appreciation or depreciation) and another investor who owns the underlying stock (and the voting rights associated with it) but who no longer has an incentive to seek the stock's appreciation. In some cases, the holder of the stock is simply neutral—the holder is acting to earn fees, hedge risk, and facilitate transactions in the market. In others, the holder may have the primary motivation of exercising the vote in order to influence corporate policy, though without the corresponding belief that the preferred policy is actually in the best interest of the company.[197]

A significant amount of stock is held passively by shareholders to hedge against risk associated with taking certain derivative positions, and a significant amount of stock is on loan from shareholders like pension funds, mutual funds, and foundations to option traders, hedge funds, and other asset managers, who borrow the securities for the purpose of covering short-sale positions.[198] At the end of January 2012, the balance of securities on loan was $1.8 trillion globally;[199] at any one time, approximately $12 trillion of shares and bonds are available for lending.[200] Under standard lending arrangements, the lender loses the voting rights until the share is "returned."[201] While the loaned stock is generally returned to the market by borrowers who thereby establish a short position, it seems unlikely that the purchasers as a group have the same long-term investment perspectives as do the pension funds, mutual funds, and foundations that are the source of the loaned shares.

High-frequency trading raises a different type of "decoupling" challenge to traditional communication networks between shareholders and boards of directors. Specifically, high-frequency trading separates analysis of company fundamentals from investment decisions. High-frequency traders use automated strategies to rapidly trade securities, applying algorithms to look for arbitrage opportunities that can move them into and out of stock positions in seconds or fractions of a second. According to one study, high-frequency trading accounted for more than 60 percent of all US equity volume in 2010.[202] Today, high-frequency trading constitutes about half of all stock trades in the United States.[203] At the same time that engagement with management is (almost by definition) absent from the high-frequency trading strategy, decisions that the traders make can send market messages about company value that can have cascading effects, with significant consequences for management teams accountable for stock price variation. Short of incidents like the Flash Crash of 2010, the 2012 study conducted by Cremers, Pareek, and Sautner, discussed in Part III.F (page 36), found that the presence of short-term investors within a company's shareholder base was strongly correlated to temporary price distortions in that company's stock price.[204]

Whereas high-frequency trading looks for fleeting arbitrage opportunities in the market—imperfections or time lags that can be used to trade for many small gains—hyper portfolio diversification pulls from the efficient market theory, which assumes a near-perfect integration of all available information into stock price. Individual information that would beat the market is

therefore unavailable, and the best way to assure gains is to diversify an investment portfolio to weed out any nonsystemic risk. This investment approach has long-standing roots, as evidenced by the significant size and history of index funds. The continued appeal of this approach is best illustrated by the recent proliferation of index-based exchange-traded funds (ETFs), which package stock portfolios into individual ETF shares that an investor can buy and sell. According to the ICI, the amount of assets in domestic equity ETFs was approximately $900 billion in August 2013, an increase of nearly $175 billion from the previous year. The global assets of ETFs (including domestic and international equity, bonds, and hybrid funds) were valued at over $1.46 trillion in August 2013, a 21 percent increase from the same time in 2012.[205]

Debates about the challenges these trends—vote decoupling, high-frequency trading, hyper portfolio diversification—pose to corporate governance are distinct from discussions related to the role they play, and the benefits they claim, as investment tools in modern public markets. Even limiting the context to corporate governance, their impact is highly contested. Short sellers, enabled by modern derivatives instruments, are defended as drawing attention to corporate governance failures that may otherwise go unnoticed. Kynikos Associates, a fund that specializes in short selling, for example, has stated that it chooses shares of companies for its portfolio that appear to have (1) materially overstated earnings; (2) an unsustainable or operationally flawed business plan; and/or (3) engaged in outright fraud.[206] Short sellers, Kynikos included, have been credited with bringing attention to some of this century's most egregious corporate frauds, including Enron and Tyco. Outside a market signaling function, others contest the wide brush that is used to paint diversified holders, index funds, and ETFs as "passive" with respect to corporate governance. Many of the largest managers of indexed funds are in fact very active participants in share voting.[207]

These trends are part of a greater complexity within modern public markets that presents wholly new challenges for corporate managers, beneficial owners, and boards to arrive at a settled approach to governance. Today, a pensioner may hold stock in a pension fund, which is governed by trustees, who delegate investment decisions to an investment consultant, who recommends investing money in a fund of funds (among other assets), which is managed by an asset manager who identifies the various target companies that will compose the portfolio. Although the pensioner may get statements indicating individual companies within the portfolio, the stock underlying the pensioner's investment may be passing through different investors' hands in the stock lending market, perhaps even through the hands of hundreds of traders in a day due to the activities of high-frequency traders, if the transfer of a particular share could in fact be actually traced from one investor to the next. The asset manager may, in addition to managing the pension fund, manage much larger index funds and funds with other different investment objectives, or time horizons, than the pension fund. In that context, which investor's preferences as to governance should corporate management and boards take into account, and how do the interested parties have a conversation about the issues?

Appendix 1. Institutional Investor Detail

Mutual funds A mutual fund is the savings vehicle of choice for most Americans who seek a diversified investment that will fund retirement and other long-term needs.[208] An investor in a mutual fund can choose between an actively managed fund—which attempts to beat the market by investing in stocks that appreciate faster than average—or an index fund, which aims to replicate the movements of a particular stock index.[209]

As of 2009, mutual funds controlled 20.9 percent of the outstanding equity market.[210] In certain respects, mutual funds very much resemble conventional corporations—they are formed by a sponsor, managed by a board of directors that is subject to the same fiduciary duties of loyalty and care under state law as a director of a corporation, and have shareholders whose liability is limited to their equity investment. Mutual funds are entirely distinct from conventional corporations, though, in respect of their operations and structure, in that all operations are outsourced to investment advisors, distributors, custodians, transfer agents, and other third parties.

Investment advisors are the most critical of the mutual fund's service providers, empowered with the authority to manage the mutual fund's capital and make all day-to-day investment decisions. As a legal matter, an investment advisor owes fiduciary duties of care, loyalty, and good faith to the mutual fund.[211] Today, the proper exercise of an investment advisor's fiduciary duties includes diligently exercising its right to vote on behalf of its institutional client. This does not require that the investment advisor *actually vote* (if, for example, the advisor determines that the cost of voting the proxy exceeds the expected benefit to the mutual fund), but does involve a duty to "monitor corporate events."[212] (See Part II.F, page 23, for more information)

Pension funds Pension funds are the second largest institutional holders of US equity.[213] Generally, pension funds are classified with respect to whether they are public or private and whether they are defined benefit plans (e.g., the sponsoring entity promises a defined return and bears the risk of generating funds required to meet those obligations) or defined contribution plans (e.g., the sponsoring entity promises only a defined contribution to the investment vehicle/method of the participant's choice, and the participant bears the risk of investment decisions).[214] Public sector plans are not governed by federal pension law, but rather by the state or local law applicable to them.

Private sector plans are subject to the federal Employee Retirement Income Security Act of 1974 (ERISA), which imposes a governance structure pursuant to which assets must be invested. Generally, each plan must designate a "named fiduciary" that has ultimate investment control. The named fiduciary of a corporate pension plan is typically a committee of senior executives of the corporate plan sponsor.[215] While named fiduciaries in some defined benefit plans make individual investment decisions, most only keep responsibility for asset allocation and management selection decisions, with individual investment decisions being made by investment advisors hired for that purpose. The named fiduciaries of defined contribution plans generally designate a limited menu of mutual funds or other commingled investment vehicles that participants can select from; a small portion of participants take advantage of "open brokerage windows" to make individual investment decisions themselves.

Persons who make decisions related to the investment of pension plan assets are generally subject to strict fiduciary duties—the fiduciary obligations imposed by ERISA-governed plans have been described as "the highest known to law."[216] Under ERISA, the duties of plan fiduciaries include those of care, skill, diligence, and prudence (under a "reasonable expert standard"), diversification, and exclusive attention to the interests of plan participants and their beneficiaries. Fiduciaries are also subject to detailed conflict of interest rules.

As with mutual funds, US regulators have issued opinions intended to encourage ERISA plan managers to vote the shares in which they have invested. In 1988, the DOL issued an advisory opinion concluding that the right to vote shares was a “plan asset” to which the fiduciary duties described here apply, thereby subjecting plan asset managers to an obligation to vote shares owned by benefit plans unless they could show that a failure to vote was in the best interest of plan participants and beneficiaries.

Hedge funds Hedge funds are investment partnerships that are marketed privately to sophisticated and wealthy investors (rather than through public offerings, like mutual funds) and are therefore not bound by disclosure and certain other requirements imposed generally on publicly offered commingled investment pools. Hedge funds are also typically distinguishable from mutual funds by their promise of aggressive returns.

As a result of recent regulatory changes, most investment advisors of hedge funds are now required to register as investment advisors under the Investment Advisers Act of 1940. The requirements include disclosure obligations about gross and net asset values, investor concentration, borrowing and liquidity, performance, investment strategies, credit risk and trading, and clearing practices. Large advisors must also disclose information regarding exposures to asset class, geographical concentration, and the monthly value of portfolio turnover by asset class. As with investment advisors to traditional institutional investors, hedge fund advisors are also subject, under common law and the Investment Advisers Act of 1940, to certain fiduciary duties.[217]

Appendix 2. Shareholder Campaigns regarding Majority Voting, Declassification, Poison Pills

Majority voting Under plurality voting standards, the directors who receive the most votes are elected. Because most elections are uncontested, plurality voting essentially guarantees election of the slate of directors put forth by the company, so long as those directors receive any votes in their favor. Plurality voting is the default rule under most state laws.[218] A majority vote standard requires that a director nominee receive support from a majority of votes cast to be elected. The majority threshold increases the impact of "withhold" votes, making directors vulnerable to targeted removal campaigns, and establishes a base threshold of approval for a director to assume his or her position.

The shareholder movement to elect directors by majority vote began in 2005. Since then, over 90 percent[219] of S&P 500 companies have adopted some form of majority voting, many voluntarily to avoid ceding the ground to shareholder proponents. Shareholder support of majority voting resolutions has risen steadily each year, with average support levels of 60 percent of votes cast on the 36 proposals put forth during the 2012 proxy season.[220] As a result of this success, proponents of majority voting are expanding their efforts to convince a wider swath of companies to adopt majority voting policies.[221]

Elimination of "standing" poison pills A poison pill is a mechanism used by companies to cap the share ownership of an unfriendly third party at a specified threshold. When a poison pill is in place, share ownership beyond the specified threshold (without board approval) triggers stock-buying rights for all shareholders other than the triggering acquirer, substantially diluting that holder's shares. Use of poison pills became widespread following confirmation of their legality by the Delaware Supreme Court in 1985. Companies adopted pills with extended lives—10 years or more—to provide a standing defense against corporate raiders and other hostile acquirers and, generally, to force any who sought to challenge company management into a proxy contest for board seats.

The use of poison pills has been limited in recent years. A record total of 99 shareholder proxy proposals targeting poison pills were submitted to companies in 2003[222] and, beginning in 2005, ISS (then known as "Risk Metrics") instituted voting policies recommending "withhold" or "against" votes for directors who adopted or renewed poison pills without shareholder support. By 2010, the percentage of S&P 500 companies with poison pills had dropped to 13 percent, from 53 percent in 2004.[223] Of the 3,453 companies reviewed by SharkRepellent in 2003, just under 50 percent of companies had poison pills; by year-end 2012, 15.33 percent of 3,764 companies surveyed had pills in place.[224] Larger companies are far less likely to adopt pills than smaller companies (which are more susceptible to hostile approaches), and when they do, they adopt pills of shorter duration.

Elimination of classified boards Classified boards are another protective device that has seen a significant reduction in use following concentrated attack by shareholders. The combination of a poison pill and a classified board created a robust, albeit not typically impenetrable as a practical matter, wall of protection around a company—a hostile acquirer was limited in his or her accumulation and, because the board could not be replaced in a single annual election, would have to contemplate winning two successive proxy fights to replace a majority of the board (and, consequently, to cause termination of the pill). Shareholder activists stepped up criticism of classified boards in the early 1990s, but by 2002, roughly 60 percent of public companies still

had classified boards, according to a 2011 publication by The Conference Board.[225] In the years that followed, the corporate governance environment and more targeted shareholder pressure, particularly in the form of the threat of campaigns to withhold votes from director nominees, dramatically increased the rate of declassification. In comparison to the 62 total firms that eliminated their classified boards between 1998 and 2002, between 2003 and 2010, 467 firms put *management proposals* on the shareholder proxies endorsing annual elections. Since 2002, an average of 65 percent of shareholder votes cast have been in favor of declassifying boards, The Conference Board noted. During 2012 and 2013, the Shareholder Rights Project[226] documented as its achievements: 79 declassifications, a commitment by 99 S&P 500 or Fortune 500 companies to move toward annual elections following the submission of board declassification proposals (about three-fourths of the companies targeted), and the passage of 58 precatory declassification proposals, with average support exceeding 80 percent.[227]

Appendix 3. Globalization

There has been significant academic debate about the effect of globalization on governance, and developments in other countries have undoubtedly affected corporate governance initiatives in the United States. However, neither the debate nor recent experience has clarified whether a substantial convergence of global governance practices is likely or desirable.

Many countries have corporate governance systems that offer other stakeholders a more significant role than the shareholder-primacy model does while also permitting successful corporations to develop. The best known of these other models are frequently described as the "European" (or "labor-oriented") model and the "Asian" (or "state-oriented") model. The European model typically places a relatively large weight on the interest of employees and seeks to ensure senior managers take into account concerns like employee training and education, and not simply the market performance of the company. The Asian model traditionally involves a significant direct role in the affairs of large corporations by government as the ultimate arbiter of stakeholder interests. Governments can exert their influence through board representation, enforcing judgments through state-administered criminal sanctions and arranging "back door" deals between officials and the corporation or its shareholders. Accordingly, these systems are demonstrably different from the corporate governance system in use in the United States (although in many cases these systems, too, are evolving in response to recent corporate developments).

There has also been significant international focus on ensuring the existence of strong corporate governance mechanisms, based in part on widespread belief that strong corporate governance plays an important role both in ensuring global financial stability and in maximizing the benefits achieved by the corporation and its stakeholders. In 1999, for example, the Organisation for Economic Co-Operation and Development (OECD) published its original *Principles of Corporate Governance* in order to, among other things, "assist OECD and non-OECD governments in their efforts to evaluate and improve the legal, institutional, and regulatory framework for corporate governance in their countries."[228] These principles, however, represent only one possible approach and may not be right for the corporations of every country, depending in part on the historical underpinnings of their particular governance framework.

The ultimate result of cross-fertilization efforts is unlikely to be the harmonization of those systems in a single standard, but rather a more gradual convergence retaining significant jurisdictional distinctions. One recent example of convergence can be seen in the US implementation of say on pay. The nonbinding say-on-pay vote structure established by Dodd-Frank is similar in many respects to the advisory shareholder vote on annual executive and nonexecutive director compensation practices of many companies incorporated in the United Kingdom that has been required since 2002. In 2013, the United Kingdom changed its requirements to provide for a binding vote on each company's senior executive compensation policy, which cannot be changed without a new shareholder vote.[229] A number of European and other jurisdictions have also recently imposed either binding or nonbinding votes that relate to executive compensation practices.[230] This parallel development of say-on-pay rules in various jurisdictions clearly reflects a certain degree of cross-pollination between regulatory bodies. At the same time, the rules vary significantly between jurisdictions, reflecting general convergence rather than harmonization.

There are also likely to be a few instances in which governments (most notably the United States) impose their views about the best ways to achieve good corporate governance more generally on an extraterritorial basis, which may force harmonization to some extent. One significant recent example was SOX, which directly imposed certain corporate governance-

related structural changes on non-US issuers that had availed themselves of the US capital markets. SOX requires, for example, that audit committees comprise independent directors, which resulted in a substantial extraterritorial application of US law.[231] Changes such as these, however, are relatively infrequent and do not augur a move toward uniformity.

In sum, a global perspective on corporate governance reveals significant differences in underlying premises on the purpose of corporations and concomitant differences in rules and practices. While globalization has resulted and inevitably will continue to result in some borrowing and convergence of ideas, it seems unlikely that the impacts will be material to US corporate practices in the near future.

Additional Research and Analysis Prepared for the Task Force on Corporate/Investor Engagement

1 **The Conference Board Governance Center Task Force on Corporate/Investor Engagement, "Recommendations of the Task Force on Corporate/Investor Engagement," The Conference Board, March 2014.**

A set of recommendations of the task force on corporate/investor engagement intended to align public corporations and their investors to optimize the system of corporate governance and to jointly take responsibility for increasing public trust in business by instilling a culture of integrity, transparency, and engagement in the governance of public corporations.

Available at www.conferenceboard.org/taskforce/recommendations

2 **The Conference Board Governance Center Advisory Board on Corporate/Investor Engagement, "Guidelines for Engagement," The Conference Board, March 2014.**

A practical set of guidelines for direct engagement between senior management and directors of public corporations and their investors. These guidelines were developed by the advisory board to the task force—a group of governance experts from public corporations, major institutional investors, academia, and law firms.

Available at www.conferenceboard.org/taskforce/guidelines

3 **Leslie N. Silverman and Julie L. Yip-Williams, "The Underpinnings of Corporate Governance Approaches and the Shareholder Value Model," The Conference Board,** *Director Notes* **Vol. 5 No. 14, July 2013.**

Based on research generated from the task force, this *Director Notes* endorses proposals by Dominic Barton, global managing director of McKinsey & Company, in "Capitalism for the Long-Term," *Harvard Business Review*, March 2011: Business and finance should revamp incentives to focus their organizations on the long term; business leaders should adopt the perspective that serving the interests of all major stakeholders—employees, suppliers, customers, creditors, communities and the environment—is essential to maximizing corporate value; and pubic company boards should govern like owners.

Available at www.conferenceboard.org/taskforce/underpinnings

4 **Arthur H. Kohn and Julie L. Yip-Williams, "The Separation of Ownership from Ownership: The Concerns Raised by Institutional Investors as Intermediaries," The Conference Board,** *Director Notes* **Vol. 5 No. 22, November 2013.**

A prior *Director Notes* examined the issue of separation of ownership from control inherent in the widely held public company. This *Director Notes* focuses on issues associated with the separation of ownership within the structure of institutional investments.

Available at www.conferenceboard.org/taskforce/ownership

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8 The first general corporation act was passed in New York, but it only applied to certain types of manufacturers, it limited corporate existence to 20 years, and it capped permitted capital at $100,000. Cox and Hazen, *Cox & Hazen on Corporations*, p. 88; Friedman, *A History of American Law,* p. 195 (note 3, *supra*), quoting the New York Constitution of 1846 and citing to Ronald E. Seavoy, *The Origins of the American Business Corporation, 1784-1855* (Westport, CT: Greenwood Press 1982), p. 195.
9 Friedman, *A History of American Law,* p. 512 (note 3, *supra*).
10 Friedman, *A History of American Law,* p.190 (note 3, *supra*), quoting Alfred D. Chandler, *The Visible Hand: The Managerial Revolution in American Business* (Cambridge, MA: Harvard University Press 1977).
11 See Margaret M. Blair, "Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century," *UCLA Law Review* 51, 2003, pp. 387, 430-431, for a description of early cases, charters, and statutes imposing legal limitations on the declaration of dividends.
12 Margaret M. Blair and Lynn A. Stout, "A Team Production Theory of Corporation Law," *Virginia Law Review* 85, 1999, p. 247.
13 Roy, *Socializing Capital*, pp. 4-5 (note 5, *supra*).
14 Calculation excludes capital of investment companies, mutual funds, and other similar investment vehicles.
15 "Market Capitalization of Listed Companies (current US$)," *World Bank*, (http://data.worldbank.org/indicator/CM.MKT.LCAP.CD?order=wbapi_data_value_2000 percent20wbapi_data_value&sort=asc). Despite the continued ability of corporations to

attract capital via the public markets, evidence suggests that, for a notable number of companies, the capital-raising benefit of the public market has been outweighed by the costs associated with filing for and maintaining a public listing. Public company listings, which peaked in 1997 with 8,823 exchange-listed companies, had declined to 4,916 exchange-listed companies by the end of 2012. See David Weild, Edward Kim, and Lisa Newport, "Making Stock Markets Work to Support Economic Growth: Implications for Governments, Regulators, Stock Exchanges, Corporate Issuers and their Investors," *OECD Corporate Governance Working Papers No. 10*, July 11, 2013 (http://dx.doi.org/10.1787/5k43m4p6ccs3-en). Other factors have also affected this trend, however, including mergers of previously separate public companies.
16 Dow Votaw, *Modern Corporations* (Englewood Cliffs, NJ: Prentice-Hall 1965), p. 57.
17 Cox and Hazen, *Cox & Hazen on Corporations*, p. 390 (note 6,*supra*).
18 While all states impose fiduciary duties of loyalty and care on directors and officers, the nuances regarding how a director or officer can fulfill those duties, and what constitutes a breach, is defined by the case law of each state.
19 "ProxyPulse Report (2nd Edition): Does Shareholder Behavior Vary by Company Size?," *Broadridge*, 2013 (http://media.broadridge.com/documents/Broadridge-PwC-ProxyPulse-Second-Edition.pdf).
20 Mark Trumbull, "Dow Hits 15,000, But Percentage of Americans Owning Stocks Hits a Low. Why?," The Christian Science Monitor, May 8, 2013 (http://www.csmonitor.com/Business/2013/0508/Dow-hits-15000-but-percentage-of-Americans-owning-stocks-hits-a-low.-Why).
21 "ProxyPulse Report (3rd Edition): 2013 Proxy Season Recap," *Broadridge*, 2013, p. 2 (http://media.broadridge.com/documents/Broadridge-PwC-ProxyPulse-Third-Edition.pdf).
22 "ProxyPulse Report (2nd Edition): Does Shareholder Behavior Vary by Company Size?," p.2 (note 19, *supra*); "ProxyPulse Report (3rd Edition): 2013 Proxy Season Recap," p. 2 (note 21. *supra*).
23 Historically, fewer than half of individual owners participate in the annual proxy process. Shareholder Choice Regarding Proxy Materials, Release No. 34-56135, SEC (http://www.sec.gov/rules/final/2007/34-56135fr.pdf).
24 E-proxy rules, which became effective for all companies starting from the 2009 proxy season, require issuers to post all proxy materials on a publicly accessible website and allow issuers to provide shareholders with notice of the posting, rather than delivering the materials by mail (the "notice only" option). The rules were created with the goal of lowering the costs of proxy solicitations and improving shareholder communications.
25 Fabio Saccone, "E-Proxy Reform, Activism, and the Decline in Retail Shareholder Voting," *The Conference Board: Director Notes*, December 2010, pp. 1–4.
26 Order Approving Proposed Rule Change, as modified by Amendment No. 4, to Amend NYSE Rule 452 and Corresponding Listed Company Manual Section 402.08 to Eliminate Broker Discretionary Voting for the Election of Directors, Except for Companies Registered under the Investment Company Act, and to Codify Two Previously Published Interpretations that Do Not Permit Broker Discretionary Voting for Material Amendments to Investment Advisory Contracts with an Investment Company, Release No. 34-60215, SEC (http://www.sec.gov/rules/sro/nyse/2009/34-60215.pdf).
27 Notice of Filing and Order Granting Accelerated Approval of a Proposed Rule Change to Amend NYSE Rule 452 and Listed Company Manual Section 402.08 to Eliminate Broker

Discretionary Voting on Executive Compensation Matters, Release No. 34-62874, SEC (http://www.sec.gov/rules/sro/nyse/2010/34-62874.pdf).
28 Application of Rule 452 to Certain Types of Corporate Governance Proxy Proposals, Information Memo 12-4, NYSE (http://www.nyse.com/nysenotices/nyse/information-memos/detail?memo_id=12-4).
29 Stuart L. Gillan and Laura T. Starks, "The Evolution of Shareholder Activism in the United States," 2007, p. 7 (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=959670).
30 Richard Marens, "Inventing Corporate Governance: The Mid-Century Emergence of Shareholder Activism," *Journal of Business and Management* 8, 2002, p. 10 (LEXIS). Four shareholders were responsible for 63 percent of the shareholder resolutions proposed during that four-year period.
31 Nancy L. Ross, "Gadflies Set to Buzz Shareholders' Meetings," *Washington Post*, April 17, 1983, p. G1; Christina Rexrode, "The Loudest Shareholder Activist Ready for a Break," *USA Today*, July 13, 2012 (http://usatoday30.usatoday.com/money/media/story/2012-07-13/evelyn-y-davis-gadfly-retires/56203956/1).
32 "2013 Proxy Season Wrapping Up," *Proxy Monitor*, 2013 (http://www.proxymonitor.org/forms/2013Finding4.aspx).
33 Gillan and Starks, "The Evolution of Shareholder Activism in the United States," p. 8 (note 29, *supra*).
34 Paula Tkac, "One Proxy at a Time: Pursuing Social Change through Shareholder Proposals," *Federal Reserve Bank of Atlanta: Economic Review* 91, 2006, p. 6.
35 Tkac, "One Proxy at a Time," p. 6 (note 34, *supra*).
36 "2012 Report on Sustainable and Responsible Investing Trends in the United States: Executive Summary," *The Forum for Sustainable and Responsible Investment*, p. 11 (http://www.ussif.org/files/Publications/12_Trends_Exec_Summary.pdf).
37 "2013 Proxy Season Wrapping Up," *Proxy Monitor* (http://www.proxymonitor.org/forms/2013Finding4.aspx).
38 Historically, shareholder proposals infrequently attracted majority support. Between 1973 and 2004, only 10 percent of shareholder proposals put on corporate ballots received majority shareholder support. Half of those successes were achieved in the 2000–2004 period, and most of them focused on corporate governance issues. Gillan and Starks, "The Evolution of Shareholder Activism in the United States," p. 23 (note 29, *supra*).
39 The Shareholder Rights Project (SRP), a clinic at Harvard Law School led by Professor Lucian Bebchuk, has been a strong actor in this area. The SRP "provides students with the opportunity to obtain hands-on experience with shareholder rights work. The SRP works on behalf of public pension funds and charitable organizations seeking to improve corporate governance at publicly traded companies in which they are shareowners, as well as on research and policy projects related to corporate governance." Board declassification is a main focus of the SRP's work (http://www.law.harvard.edu/academics/clinical/clinics/srp.html). A description of the SRP's recent efforts is included in Appendix 2.
40 Melissa Aguilar, Thomas Singer, and Matteo Tonello, *Proxy Voting Analytics (2009-2013)*, The Conference Board, Research Report 1532, 2013, p. 23.
41 Shareholder activists who focus on these issues do, of course, engage with companies in a number of other ways as well. A group of 70 investors coordinated by Ceres and the Carbon Tracker Initiative, for example, sent letters to 45 fossil fuel companies in September 2013

asking for information from the companies regarding their commitment to managing financial risks associated with climate change. As of October 23, the investors had received preliminary responses from 30 companies. "Investors Ask Fossil Fuel Companies to Assess How Business Plans Fare in Low-Carbon Future," *Ceres*, October 24, 2013 (https://www.ceres.org/press/press-releases/investors-ask-fossil-fuel-companies-to-assess-how-business-plans-fare-in-low-carbon-future).

42 The shareholder platform has been used by shareholder activists to support general social change for decades, including to support desegregation, anti-apartheid, and union campaigns. See Tkac, "One Proxy at a Time" (note 34, *supra*); Marens, "Inventing Corporate Governance" (note 30, *supra*).

43 See Lucian Bebchuk, Alon Brav, and Wei Jiang, "Long-Term Effects of Hedge Fund Activism," *Columbia Business School Research Paper No. 13-66*, July 9, 2013, p. 7 at Table 1 (http://www.columbia.edu/~wj2006/HF_LTEffects.pdf). The study uses the word "interventions" and describes its data set as including all activist activity reported on Schedule 13D filings.

44 Jessica Toonkel and Soyoung Kim, "Activist Investors Find Allies in Mutual, Pension Funds," *Reuters*, April 9, 2013 (http://www.reuters.com/article/2013/04/09/us-funds-activist-idUSBRE9380DU20130409).

45 Aguilar et al., *Proxy Voting Analytics (2000–2013)*, p. 13 (note 40, *supra*).

46 Only 24 proxy contests were launched in 2012. Aguilar et al., *Proxy Voting Analytics (2009–2013)*, p. 13 (note 40, *supra*).

47 Aguilar et al., *Proxy Voting Analytics (2009–2013)*, p. 126 (note 40, *supra*).

48 Michael J. de la Merced and Julie Creswell, "With Huge War Chests, Activist Investors Tackle Big Companies," *New York Times Dealbook*, August 30, 2013 (http://dealbook.nytimes.com/2013/08/30/with-huge-war-chests-activist-investors-tackle-big-companies/?_r=0); See Aguilar et al., *Proxy Voting Analytics (2009–2013),* pp. 13, 120.

49 It was reported to increase from $32 billion in 2008 to $65 billion in 2012. See Toonkel and Kim, "Activist Investors Find Allies in Mutual, Pension Funds."

50 "Institutional Investment in Hedge Funds: Evolving Investor Portfolio Construction Drives Product Convergence," *Citi Prime Finance*, June 2012, pp. 9, 25 (http://citibank.com/transactionservices3/homepage/demo/tutorials41/IIHF_June2012/files/assets/downloads/publication.pdf).

51 "Institutional Investment in Hedge Funds," p. 27 (note 50, *supra*).

52 Weild et al., "Making Stock Markets Work to Support Economic Growth" (note 15, *supra*).

53 Toonkel and Kim, "Activist Investors Find Allies in Mutual, Pension Funds." See also "Activists Continue to Target Larger Companies," *FactSet Insight*, April 25, 2013 (http://www.factset.com/insight/2013/4/sharkspotlight_4.24.13).

54 Aguilar et al., *Proxy Voting Analytics (2009–2013)*, p. 13.

55 Nathan Vardi, "ValueAct Hedge Fund's Huge Microsoft Victory," *Forbes*, September 3, 2013 (http://www.forbes.com/sites/nathanvardi/2013/09/03/valueact-hedge-funds-huge-microsoft-victory/).

56 Adolf A. Berle, "Corporate Powers as Powers in Trust," *Harvard Law Review* 44, 1931, p. 1049.

57 Merrick Dodd, Jr., "For Whom Are Corporate Managers Trustees?" *Harvard Law Review* 45, 1932, pp. 1145, 1162.

58 Kathleen M. Eisenhardt, "Agency Theory: An Assessment and Review," The Academy of Management Review 14, 1989, pp. 58–59; see also Jensen and Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure"; Eugene F. Fama and Michael C. Jensen, "Separation of Ownership and Control," Journal of Law and Economics 26, 1983, pp. 301-325.
59 Milton Friedman, "The Social Responsibility of Business is to Increase its Profits," The New York Times Magazine, September 13, 1970, pp. 33, 122-126. The "rules of the game" were to engage "in open and free competition without deception or fraud."
60 Friedman, "The Social Responsibility of Business," pp. 33, 122–126 (note 59, *supra*).
61 See Kenneth Martin and John McConnell, "Corporate Performance, Corporate Takeovers, and Management Turnover," *Journal of Finance* 46, June 1991, pp. 671–687.
62 Martin Gelter, "The Pension System and the Rise of Shareholder Primacy," *Seton Hall Law Review* 43, 2013, pp. 909, 921. Defined benefit plans promise employees a certain amount upon retirement, placing the risk of generating sufficient income (whether through investment or otherwise) with the company. Defined contribution plans, by contrast, promise the employee only a certain contribution to a pension account—it is the employee's responsibility to choose among investment vehicles and/or strategies to grow the account for retirement.
63 Gelter, "The Pension System," pp. 923–924. By the mid-1980s, the number of defined contribution plans had eclipsed the number of defined benefit plans.
64 Gelter, "The Pension System," pp. 923–924 (note 63, *supra*).
65 Henry Hansmann and Reinier Kraakman, "Essay: The End of History for Corporate Law," *Georgetown Law Journal* 89, 2001, pp. 439, 468.
66 See, e.g., Lynn A. Stout, "New Thinking On 'Shareholder Primacy,'" *UCLA School of Law, Law-Econ Research Paper No. 11-04*, February 18, 2011 (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1763944); Margaret M. Blair, "Shareholder Value, Corporate Governance, and Corporate Performance: A Post-Enron Reassessment of the Conventional Wisdom," Chapter 3 from *Corporate Governance and Capital Flows in a Global Economy*, (New York: Oxford University Press 2003), eds. Peter K. Cornelius and Bruce Kogut (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=334240); Dominic Barton, "Capitalism for the Long Term," *Harvard Business Review* 89, March 2011, pp. 84–91. See also Jia Lynn Yang, "Maximizing Shareholder Value: The Goal That Changed Corporate America," *Washington Post*, August 26, 2013 (http://articles.washingtonpost.com/2013-08-26/business/41453079_1_shareholder-value-chief-executive-company); Steven Pearlstein, "How the Cult of Shareholder Value Wrecked American Business," *Washington Post*, September 9, 2013 (http://www.washingtonpost.com/blogs/wonkblog/wp/2013/09/09/how-the-cult-of-shareholder-value-wrecked-american-business/); Rick Wartzman, "The Long View: Why "Maximizing Shareholder Value" Is On Its Way Out," *Time*, September 25, 2013 (http://business.time.com/2013/09/25/the-long-view-why-maximizing-shareholder-value-is-on-its-way-out/).
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69 "Trust Barometer 2013 Annual Global Study," *Edelman*, 2013 (http://www.slideshare.net/EdelmanInsights/global-deck-2013-edelman-trust-barometer-16086761).
70 Exchange Act Rule 14a-8 was adopted to deal with issues associated with the separation of ownership from control. As share ownership became more dispersed, corporate managers were tempted to use the proxy voting procedures provided under state law to undermine shareholder influence. The SEC adopted Exchange Act Rule 14a-8 to ensure the exercise of shareholder voting rights was not abused or limited by corporate managers. Rule X-14A-7, the predecessor to Exchange Act Rule 14a-8, was first adopted in Release No. 34-3347, which gave shareholders the right to have their proposals included in management proxy materials if the proposal was a "proper subject for action by security holders." "Solicitation of Proxies under the Act," Release No. 34-3347 (December 18, 1942) 7 Fed. Reg. 10655. The rule was amended in 1952 and renumbered accordingly. "Solicitation of Proxies under the Act," Release No. 34-4775 (December 11, 1952) 17 Fed. Reg. 11431.
71 Kevin W. Waite, "The Ordinary Business Operations Exception to the Shareholder Proposal Rule: A Return to Predictability," *Fordham Law Review* 64, 1995, pp. 1253, 1255.
72 Final Rule: Amendments to Rules on Shareholder Proposals, Release No. 34-40018, SEC (http://www.sec.gov/rules/final/34-40018.htm); Waite, "The Ordinary Business Operations Exception to the Shareholder Proposal Rule" (note 71, *supra*)
73 Adam M. Kanzer, "Putting Human Rights on the Agenda: The Use of Shareholder Proposals to Address Corporate Human Rights Performance," Chapter 5 from *Finance for a Better World* (New York: Palgrave Macmillan 2009), eds. Henri-Claude de Bettignies and François Lépineux (http://www.domini.com/common/pdf/finance_for_a_better_world_kanzer.pdf at p. 7). See Amendments to Rules on Shareholder Proposals, Release No. 34-40018, SEC (http://www.sec.gov/rules/final/34-40018.htm).
74 Staff Legal Bulletin No. 14A, SEC (http://www.sec.gov/interps/legal/cfslb14a.htm) (SLB 14A). SLB 14 As noted, among other matters, that a company may not rely on Exchange Act Rule 14a-8(i)(7) to omit from its proxy materials proposals focusing on equity compensation plans that may be used to compensate (1) only senior executive officers and directors (noting that had been the staff's position since 1992); (2) senior executive officers, directors, and the general workforce, if the proposal seeks to obtain shareholder approval of all such equity compensation plans that potentially would result in material dilution to existing shareholders; and (3) the general workforce only, with no senior executive officer or director participation, if the proposal seeks to obtain shareholder approval of all such equity compensation plans that potentially would result in material dilution to existing shareholders.
75 The SEC staff stated that "on a going-forward basis, rather than focusing on whether a proposal and supporting statement relate to the company engaging in an evaluation of risk, we will instead focus on the subject matter to which the risk pertains or that gives rise to the risk. The fact that a proposal would require an evaluation of risk will not be dispositive of whether the proposal may be excluded under Exchange Act Rule 14a-8(i)(7)…In those cases in which a proposal's underlying subject matter transcends the day-to-day business matters of the company and raises policy issues so significant that it would be appropriate for a shareholder vote, the proposal generally will not be excludable under Exchange Act Rule 14a-8(i)(7) as long as a sufficient nexus exists between the nature of the proposal and the company." Staff Legal Bulletin No. 14E, SEC (http://www.sec.gov/interps/legal/cfslb14e.htm). The SEC staff

determined that issues involving oversight of a company's management of risk and CEO succession planning were matters transcending day-to-day business matters and, accordingly, were not appropriately excluded under Exchange Act Rule 14a-8(i)(7).

76 Dodd-Frank is a wide-ranging piece of legislation that touches on many aspects of the financial services industry, including matters as diverse as consumer protection, revisions to the Federal Reserve System, comprehensive changes to the regulation of financial markets, and the creation of tools to better deal with future financial crises. Pub.L. No. 111-203, 124 Stat. 1376 (enacted July 21, 2010).

77 Section 953(a) of Dodd-Frank also requires the SEC to amend its executive compensation rules to enhance "pay versus performance" disclosure. This part of the legislative mandate still remains to be implemented. In September 2013, the SEC proposed regulations pursuant to Section 953(b) of Dodd-Frank, which requires disclosure by reporting companies of the median annual total compensation of all their employees and the ratio of that median to the annual total compensation of their chief executive officer.

78 Those duties generally include duties of care (e.g., requiring such entities and persons to exercise prudence and reasonableness in making investment decisions, sometimes under a so-called reasonable expert standard), loyalty (e.g., placing the client's interests first, acting in the client's best interests, and avoiding conflicts of interest), and good faith (e.g., being truthful and accurate in all communications and disclosures). Particular persons such as ERISA plan managers may also have duties of diversification or exclusive attention (e.g., to plan participants and their beneficiaries). These duties are typically rooted in a combination of common law (principally the laws of agency and trust) and federal statutory law (principally the Investment Company Act of 1940 as amended, the Investment Advisers Act of 1940 as amended, and federal case law).

79 See 17 C.F.R. § 275.206(4)-6 (2003); see also 17 C.F.R. § 270.30b1-4 (2003).

80 Proxy Voting by Investment Advisers, Release No. IA-2106, SEC (http://www.sec.gov/rules/final/ia-2106.htm).

81 Courts have described the fiduciary obligations imposed by ERISA as "the highest known to law." See *Donovan v. Bierwirth*, 680 F.2d 263, 272 n.8 (2d Cir. 1982), cert. denied, 459 US 1069 (1982).

82 Letter from Alan D. Lebowitz, Deputy Assistant Secretary, Dep't of Labor, to Helmuth Fandl, Chairman of the Retirement Board, Avon Products Inc. (February 23, 1988), reprinted at 15 Pens. Rptr 391 (BNA).

83 Interpretive bulletin relating to the exercise of shareholder rights and written statements of investment policy, including proxy voting policies of guidelines, 29 C.F.R. § 2509.08-2 (2008).

84 Proxy Voting by Investment Advisers, Release No. IA-2106, SEC (http://www.sec.gov/rules/final/ia-2106.htm).

85 Interpretive bulletin relating to the exercise of shareholder rights and written statements of investment policy, including proxy voting policies of guidelines, 29 C.F.R. § 2509.08-2 (2008).

86 "Examining the Market Power and Impact of Proxy Advisory Firms," Statement of Ann Yerger, Executive Director, CII, to the US House of Representatives' Committee on Financial Services: Subcommittee on Capital Markets and Government Sponsored Enterprises, June 5, 2013, p. 4 (http://www.cii.org/files/publications/misc/0605_13_cii_proxy_advisor_hearing_submission_ann_yerger.pdf) (Yerger Statement).

87 SEC Commissioner Daniel M. Gallagher, "The Importance of the SEC Disclosure Regime," *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, July 16, 2013 (emphasis in original) (http://blogs.law.harvard.edu/corpgov/2013/07/16/the-importance-of-the-sec-disclosure-regime/).
88 Executive Compensation and Related Person Disclosure (conforming amendments), Release Nos. 33-8732A; 34-54302A, SEC (http://www.sec.gov/rules/final/2006/33-8732afr.pdf).
89 Proxy Disclosure Enhancements, Release No. 33-9089, SEC (www.http://www.sec.gov/rules/final/2009/33-9089fr.pdf).
90 Pay Ratio Disclosure, Release No. 33-9452, SEC (http://www.gpo.gov/fdsys/pkg/FR-2013-10-01/pdf/2013-23073.pdf).
91 Specialized Corporate Disclosure, SEC, May 30, 2013 (http://www.sec.gov/spotlight/dodd-frank/speccorpdisclosure.shtml).
92 A goal of the conflict minerals disclosure is to dissuade companies from engaging in trade that supports regional conflicts; the resource extraction rules are tied to increasing transparency and accountability with respect to the relationships between resource extractors and governments, thereby enabling local communities in extraction countries to pressure their governments to reduce corruption and use resource-extraction funds for the greater public good. Release No. 34-67716, at 77 Fed. Reg. 56,275 (September 12, 2012); See "Another Side of Dodd-Frank: Understanding Section 1504," PwC, p. 2 (http://www.pwc.com/us/en/forensic-services/assets/another-side-of-dodd-frank-understanding-section-1504-final.pdf).
93 Pub.L. 107-204, 116 Stat. 745 (enacted July 30, 2002).
94 Other regulatory bodies also took similar steps. For example, both the NYSE and NASDAQ now require that, for most public companies, a majority of the board members be independent, and only independent directors may serve on the three core board committees: Audit, Compensation, and Nominating/Governance. NYSE Listed Company Manual § 303A.02; NASDAQ Stock Market Rule 5605(a)(2).
95 Uniform and Integrated Reporting Requirements: Management Remuneration, Release Nos. 33-6003, 34-15280, and IA-10505, Fed. Sec. L. Rep. (CCH) ¶ 81,765 (December 4, 1978). See also David Lynn, Mark Borges, and Broc Romanek, *Executive Compensation Disclosure Treatise and Reporting Guide* (Concord, CA: Executive Press 2014), pp. 1-1 – 1-28, for a history of the SEC's executive compensation disclosure rules.
96 Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics* 3, No. 4, October 1976, pp. 305–360.
97 Executive Compensation Disclosure, Release Nos. 33-6940, 34-30851, Fed. Sec. L. Rep. (CCH) ¶ 85,003 (June 23, 1992).
98 Lucian A. Bebchuk and Jesse M. Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press, 2004).
99 Randolph B. Cohen, Brian J. Hall, and Luis M. Viceira, "Do Executive Stock Options Encourage Risk-Taking?" *Harvard Business School Working Paper*, 2000 (http://www.people.hbs.edu/lviceira/cohallvic3.pdf).
100 James K. Glassman and J.W. Verret, "How to Fix Our Broken Proxy Advisory System," *Mercatus Research*, April 16, 2013, p. 8, FN12 (http://mercatus.org/sites/default/files/Glassman_ProxyAdvisorySystem_04152013.pdf).

101 Glassman and Verret, "How to Fix Our Broken Proxy Advisory System," p. 8 (note 100, *supra*).
102 Letter to Elizabeth Murphy, Secretary, Div. Corp. Fin., SEC, from Jonathan Feigelson, Senior VP, General Counsel, and Head of Corporate Governance, TIAA-CREF, re: Concept Release on the US Proxy System, File No. S7-14-10, November 8, 2010, p. 5 (http://www.sec.gov/comments/s7-14-10/s71410-263.pdf).
103 Robyn Bew and Richard Fields, "Voting Decisions at US Mutual Funds: How Investors Really Use Proxy Advisers," IRRC Institute / Tapestry Networks, June 2012 (http://www.irrcinstitute.org/pdf/Voting_Decisions_at percent20US_Mutual_Funds.pdf).
104 Stephen Choi, Jill Fisch, and Marcel Kahan, "The Power of Proxy Advisors: Myth or Reality?" *Emory Law Journal* 59, 2010, p. 869 (finding that, a recommendation from ISS shifts the outcome of non-say-on-pay votes by 6 to 10 percent, but when both ISS and Glass Lewis recommended shareholders vote against say-on-pay proposals, opposition to the plans was 38.3 percent higher than would be predicted based on average support for such proposals).
105 A 2012 study by Yonca Ertimur, et al., showed that a negative recommendation by ISS is associated with 24.7 percent more votes against a compensation plan and a negative recommendation by Glass Lewis is associated with 12.9 percent more votes against the compensation plan. Yonca Ertimur, Fabrizio Ferri, and David Oesch, "Shareholder Votes and Proxy Advisors: Evidence from Say on Pay," *Journal of Accounting Research*, 2013, p. 3 (http://onlinelibrary.wiley.com/doi/10.1111/1475-679X.12024/abstract); "A Call for Change in the Proxy Advisory Industry Status Quo: The Case for Greater Accountability and Oversight," *Center on Executive Compensation*, January 2011, p. 11 (http://www.execcomp.org/docs/c11-07a percent20Proxy percent20Advisory percent20White percent20Paper percent20_FULL percent20COLOR_.pdf). The different measurements may reflect the fact that different studies focus on different types of votes (e.g., director elections versus compensation) and make different types of distinctions (e.g., a Glass Lewis versus an ISS recommendation, or both). In comparison to Choi's work, for example, a study of management-sponsored proposals pertaining to compensation programs found that opposition by a proxy advisor resulted in a "20 percent increase in negative votes cast"; David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, "Outsourcing Shareholder Voting to Proxy Advisory Firms," *Rock Center for Corporate Governance at Stanford University Working Paper No. 119,* May 10, 2013, p. 12 (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2101453).
106 Kenneth L. Altman and James F. Burke, "Proxy Advisory Firms: The Debate Over Changing the Regulatory Framework: An Analysis of Comments Submitted to the SEC in Response to the Concept Release on the US Proxy System," *The Altman Group*, March 1, 2011, pp. 11–13. (http://www.altmangroup.com/pdf/TAGSpecRptProxyAdv.pdf).
107 Letter to Elizabeth Murphy, Secretary, Div. Corp. Fin., SEC, from Andrew Bonzani, Vice President, Assistant General Counsel and Secretary, IBM, Armonk, New York, October 15, 2010 (http://www.sec.gov/comments/s7-14-10/s71410-84.pdf).
108 Proxy Voting by Investment Advisers, Release No. IA-2106, SEC (http://www.sec.gov/rules/final/ia-2106.htm).
109 See SEC Commissioner Daniel M. Gallagher, Remarks at Society of Corporate Secretaries & Governance Professionals' 67th National Conference, Seattle, WA, July 11, 2013 (http://www.sec.gov/News/Speech/Detail/Speech/1370539700301#.Um1gzKuUpyw) (Commissioner Gallagher Speech). The requests for guidance were submitted by ISS and Egan-

Jones Proxy Services. In its response to Egan-Jones, the SEC advised that "[a]n investment adviser that votes client proxies in accordance with a predetermined policy based on the recommendations of an independent third party will not necessarily breach its fiduciary duty of loyalty to its clients even though the recommendations may be consistent with the adviser's own interests. In essence, the recommendations of a third party that are in fact independent of an investment adviser may cleanse the vote of the adviser's conflict." *Egan-Jones Proxy Services*, SEC No-Action Letter, May 27, 2004 (http://www.sec.gov/divisions/investment/noaction/egan052704.htm); See also *Institutional Shareholder Services, Inc.*, SEC No-Action Letter, September 15, 2004 (http://www.sec.gov/divisions/investment/noaction/iss091504.htm).

110 See e.g., Letter to Elizabeth Murphy, Secretary, Div. Corp. Fin., SEC, from Karrie McMillan, General Counsel, Investment Company Institute, Washington, DC, October 20, 2010 (http://www.sec.gov/comments/s7-14-10/s71410-167.pdf), which describes a 2008 study by the Investment Company Institute of 3.5 million proxy votes cast in 2007 by 160 of the largest fund families. The study found that fund voting patterns were broadly consistent with vote recommendations of proxy advisory firms, but that the funds did not reflexively adopt the recommendations of proxy advisors.

111 Letter to Elizabeth Murphy, Secretary, Div. Corp. Fin., SEC, from Tina Davis, Senior Vice President, tw telecom inc., Littleton, CO, October 20, 2010 (http://www.sec.gov/comments/s7-14-10/s71410-162.pdf).

112 David F. Larcker, Allan L. McCall, and Brian Tayan, "The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions," *The Conference Board: Director Notes*, March 2012, p. 4.

113 Commissioner Gallagher Speech (note 109, *supra*).

114 "Final Report: Feedback Statement on the Consultation regarding the Role of the Proxy Advisory Industry," 2013/84, *ESMA* (http://www.esma.europa.eu/system/files/2013-84.pdf).

115 "Update on CSA Consultation Paper 25-401 Potential Regulation of Proxy Advisory Firms," CSA Notice 25-301 (www.osc.gov.on.ca/en/SecuritiesLaw_csa_20130919_25-301_update-25-401.htm), which says the Canadian Securities Administrators intends to publish for comment a proposal that would promote transparency and understanding of proxy advisory services by first quarter 2014.

116 William B. Chandler III and Leo F. Strine, Jr., "Views from the Bench—The New Federalism of the American Corporate Governance System: Preliminary Reflection of Two Residents of One Small State," *University of Pennsylvania Law Review* 152, 2003, pp. 953, 958.

117 Chandler and Strine, "Views from the Bench," pp. 953, 958. See also Roberta Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance," *Yale Law Journal* 114, 2005, pp. 1521, 1523.

118 The provisions of SOX that sparked the strongest reaction on both substantive and authority-related grounds were those relating to the requirement for independent audit committees, restrictions on corporations' purchases of nonauditing services from their auditors, prohibitions on corporate loans to officers, and the requirement for executive certification of compliance with SEC reporting requirements. Dodd-Frank's clawback and say-on-pay requirements drew similar criticism, and its more traditional disclosure-related corporate governance requirements have been termed "therapeutic disclosure"—not requiring

specific action but created with the intention of eliciting governance changes in light of the required disclosure.

119 Stephen M. Bainbridge, "Dodd-Frank: Quack Federal Corporate Governance Round II," *Minnesota Law Review* 95, 2011, pp. 1779, 1785–1786; Chandler and Strine, "Views from the Bench" (note 116, *supra*); Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance" (note 117, *supra*); Mark J. Roe, "Delaware and Washington as Corporate Lawmakers," *Delaware Journal of Corporate Law* 34, 2009, p. 1.

120 Jill E. Fisch, "The New Federal Regulation of Corporate Governance," *Harvard Journal of Law & Public Policy* 28, 2004, pp. 39, 42–44.

121 A director can be independent with respect to assessing the legitimacy of a shareholder derivative suit, for example, but not with respect to determining a CEO's compensation package. Fisch, "The New Federal Regulation of Corporate Governance," p. 45 (note 120, *supra*).

122 See, e.g., "Bridging Board Gaps: Report of the Study Group on Corporate Boards," *National Association of Corporate Directors*, 2011 (on file with author); Maureen Errity, "Is Your Board Governing Itself Effectively?" *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, June 24, 2013 (https://blogs.law.harvard.edu/corpgov/2013/06/24/is-your-board-governing-itself-effectively/).

123 In a 2013 survey of the literature, researchers discussed studies addressing the effect of demographic issues (including age, education, gender, race and ethnicity, and demographic diversity), skills and experience (including industry experience, experience as CEO, venture capital experience, financial expertise, experience with specific activities [such as doing acquisitions or firing a CEO], experiential diversity, and organizational tenure), and social capital issues (including ties to other firms, personal relationships and affiliations, and social standing) on board success. While the results are thought provoking in many respects, they yield little by way of direction: the summary states that "as our review highlights, there is no consistent relationship between any demographic characteristic and firm performance, …there is no category of experience that has unequivocal benefits, and even diversity of experiences has mixed effects, [and] research on each social capital dimension has provided equivocal findings." Scott G. Johnson, Karen Schnatterly, and Aaron D. Hill, "Board Composition Beyond Independence: Social Capital, Human Capital, and Demographics," *Journal of Management* 39, 2013, pp. 232, 243. See also "Director Roundtable: Refreshing the Board—Introducing New Skills to the Boardroom" (VIDEO), *The Conference Board*, (http://www.conference-board.org/governance/index.cfm?id=14351); Lawrence J. Trautman, "Corporate Director Selection and Recruitment: A Matrix," *The Conference Board: Director Notes*, May 2013.

124 Exchange Act Rule 10C-1, as mandated by Dodd-Frank, and the other independence requirements pursuant to state corporate law as well as Exchange Act § 16, Exchange Act Rule 10A-3, NYSE Listed Company Manual § 303A.02, NASDAQ Stock Market Rule 5605(a)(2), and 26 C.F.R. § 1.162(m)-27(e)(3).

125 See Steven M. Davidoff, "The Case Against Too Much Independence on the Board," *New York Times Dealbook*, November 11, 2013 (http://dealbook.nytimes.com/2013/11/11/the-case-against-too-much-independence-on-the-board/?_r=0); John Coates, "Is Your Board Governing Itself Effectively?" *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, July 30, 2009 (http://blogs.law.harvard.edu/corpgov/2009/07/30/protecting-shareholders-and-enhancing-public-confidence-through-corporate-governance/).

126 See Simon Lorne, "Have We Taken Independence a Step Too Far?" *Directors & Boards*, July 2013, pp. 16–20.
127 See "2012–2013 NACD Public Company Governance Survey," which is cited in "Bridging Effectiveness Gaps: A Candid Look at Board Practices," *National Association of Corporate Directors*, January 1, 2013 (http://www.nacdonline.org/Resources/Article.cfm?ItemNumber=6114).
128 "PwC's 2013 Annual Corporate Directors Survey," *PwC*, p. 1 (http://www.pwc.com/us/en/corporate-governance/annual-corporate-directors-survey/assets/pdf/pwc-annual-corporate-directors-survey-full-report.pdf) (2013 PwC Survey).
129 "Spencer Stuart Board Index 2013," *Spencer Stuart*, pp. 6, 8 (https://www.spencerstuart.com/~/media/PDF percent20Files/Research percent20and percent20Insight percent20PDFs/SSBI-2013_01Nov2013.pdf).
130 2013 PwC Survey, p. 2 (note 128, *supra*).
131 See Mary Jo White, Remarks at the National Association of Corporate Directors—Leadership Conference 2013, National Harbor, MD, October 15, 2013 (http://www.sec.gov/News/Speech/Detail/Speech/1370539878806).
132 Directors can be wary about engaging in these types of communications because of concerns about running afoul of Regulation FD, which imposes penalties on companies for "selective disclosure" of material nonpublic information, and about personally violating federal securities law restrictions on tipping of material nonpublic information.
133 Bebchuk's proposal is set forth in his article "The Case for Increasing Shareholder Power," *Harvard Law Review* 118, 2005, p. 833. Under the current governance framework, shareholders only have a veto right over "rules-of-the-game" and "game-ending decisions," and decisions to distribute corporate assets rest entirely in the hands of the board.
134 Bainbridge responded to Bebchuk's proposal in his article "Director Primacy and Shareholder Disempowerment," *Harvard Law Review* 119, p. 1735 (2005). See also Iman Anabtawi, "Some Skepticism about Increasing Shareholder Power," August 2005 (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=783044) for a discussion of the divergent interests of shareholders.
135 Certain "controlling" shareholders, including shareholders of closely held corporations, are assigned some fiduciary duties for taking certain actions that will affect the other shareholders of the corporation. Majority shareholders who wish to purchase the outstanding shares of a public company (a "going private" transaction), for example, must adopt certain substantive and procedural safeguards to ensure that the transaction is "fair" to minority shareholders. Iman Anabtawi and Lynn Stout, "Fiduciary Duties for Activist Shareholders," *Stanford Law Review* 60, 2008, pp. 1255, 1273–1274.
136 Anabtawi and Stout argue that shareholder fiduciary duties have traditionally been assumed not to be necessary because of perceptions regarding shareholder "passivity" and homogeneity among shareholders with respect to those interests (economic maximization) that would drive activism. These perceptions, they assert, are no longer accurate, given an increased ability among shareholders to influence corporate policy (e.g., because of the growth of institutional investors, ISS, and activist hedge funds, and because of proxy rules and financial instruments that enable more effective or targeted campaigns) and the particularized interests that can drive modern shareholders to do so. Anabtawi and Stout, "Fiduciary Duties for Activist Shareholders," p. 1258.

137 The professors advocate applying a framework of fiduciary duties for shareholders that mirrors the duty of loyalty required of corporate directors and management: the shareholder duty "would be triggered whenever a shareholder successfully employs its shareholder status to promote a corporate action that gives it a personal, material economic benefit to the detriment or exclusion of other shareholders." A shareholder found guilty of a breach of fiduciary duties would be required to surrender any ill-gotten gains. Anabtawi and Stout, "Fiduciary Duties for Activist Shareholders," p. 1307 (note 135, *supra*).
138 See Ben W. Heineman, Jr. and Stephen Davis, "Are Institutional Investors Part of the Problem or Part of the Solution?: Key Descriptive and Prescriptive Questions about Shareholders' Role in US Public Equity Markets," *Committee for Economic Development, Millstein Center for Corporate Governance and Performance, Yale School of Management*, October 2011 (http://www.ced.org/pdf/Are-Institutional-Investors-Part-of-the-Problem-or-Part-of-the-Solution.pdf); Stephen Davis, Jon Lukomnik, and David Pitt-Watson, "Active Shareowner Stewardship: A New Paradigm for Capitalism," *Rotman International Journal of Pension Management* 2, 2009, pp. 10–17 (http://utpjournals.metapress.com/content/8477108p51u08694/fulltext.pdf).
139 Some have also noted a potential misinterpretation of fiduciary duties by institutional investors, whereby investment managers believe they are required to make decisions on the basis of readily quantifiable financial gains (or limitation of financial losses). This interpretation can encourage short-term thinking and formulaic decision making and discourage investment in long-term corporate performance. Simon CY Wong, "Why Stewardship Is Proving Elusive for Institutional Investors," *Butterworths Journal of International Banking and Financial Law*, July/August 2010, pp. 406 (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1635662).
140 Heineman and Davis, "Are Institutional Investors Part of the Problem or Part of the Solution?" p. 4 (note 138, *supra*).
141 Heineman and Davis, "Are Institutional Investors Part of the Problem or Part of the Solution?" p. 20 (note 138, *supra*); Wong, "Why Stewardship Is Proving Elusive for Institutional Investors," p. 411 (note 139, *supra*).
142 Heineman and Davis, "Are Institutional Investors Part of the Problem or Part of the Solution?" p. 5 (note 138,*supra*).
143 SEC "Concept Release on the US Proxy System", File No. S7-14-10.
144 David F. Larcker, Allan L. McCall, and Brian Tayan, "And Then A Miracle Happens!: How Do Proxy Advisory Firms Develop Their Voting Recommendations?" *Stanford Closer Look Series*, February 25,2013 (http://www.gsb.stanford.edu/sites/default/files/13); see also David F. Larcker and Allan L. McCall, "Proxy Advisors Don't Help Shareholders," *Wall Street Journal*, December 8, 2013.
145 "Frequently Asked Questions on US Policy Interpretation and Research," *ISS*, August 28, 2012 (http://www.issgovernance.com/policy/USResearchFAQ).
146 "Engaging with ISS: Process for Engagement on Proxy Voting Matters," *ISS*, July 2012 (http://www.issgovernance.com/policy/EngagingWithISS).
147 "ISS Comments on Principles Regarding the Proxy Advisory Industry Derived from ESMA's Analysis," *ISS*, March 18, 2013 (http://www.issgovernance.com/press/esmaprinciples).
148 David F. Larcker, Allan L. McCall, and Brian Tayan, "And Then A Miracle Happens!: How Do Proxy Advisory Firms Develop Their Voting Recommendations?" *Stanford Closer Look Series*,

February 25, 2013, p. 3
(http://www.gsb.stanford.edu/sites/default/files/31_MiracleHappens.pdf).
149 ISS reported that 128 institutional investors responded to the survey, approximately 46 percent of which had the US as their market of focus, and 350 corporate issuers responded to the survey, 80 percent of which had the US as their market of focus. "2013-2014 Policy Survey Summary of Results," *ISS*, October 2013 (http://www.issgovernance.com/files/ISS2013-2014PolicySurveyResultsReport.pdf).
150 US Corporate Governance Policy, 2014 Updates, November 21, 2013
(http://www.issgovernance.com/files/2014USPolicyUpdates.pdf).
151 Liz Hoffman, "Little-Known ISS Change Shakes Up Boards," *Wall Street Journal*, December 27, 2013
(http://online.wsj.com/news/article_email/SB10001424052702304244904579276871340085280-lMyQjAxMTAzMDIwNzEyNDcyWj).
152 See Letter to Elizabeth Murphy, Secretary, SEC, from Edward S. Knight, Executive VP, General Counsel and Chief Regulatory Officer, NASDAQ OMX, re: Petition Related to Proxy Advisory Firms, File No. 4-666 (http://www.sec.gov/rules/petitions/2013/petn4-666.pdf) at p. 8 (NASDAQ OMX Rulemaking Petition).
153 Scott Fenn, "A Call for Change in the Proxy Advisory Industry Status Quo: The Case for Greater Accountability and Oversight," *Center on Executive Compensation*, January 2011, pp. 7-8
(http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf); "Corporate Shareholder Meetings: Issues Relating to Firms that Advise Institutional Investors on Proxy Voting," *US Government Accountability Office*, Rep. No. GAO-07-765, June 2007, pp. 7–8 (http://www.gao.gov/new.items/d07765.pdf).
154 "Conflict of Interest Statement," *Glass Lewis* (http://www.glasslewis.com/about-glass-lewis/disclosure-of-conflict/).
155 "ISS Comments on Principles" (note 147, *supra*).
156 NASDAQ OMX Rulemaking Petition (note 152, *supra*).
157 Letter to Elizabeth Murphy, Secretary, Div. Corp. Fin., SEC, from Karrie McMillan, General Counsel, Investment Company Institute, Washington, DC, October 20, 2010
(http://www.sec.gov/comments/s7-14-10/s71410-167.pdf) (ICI Comment Letter).
158 Yerger Statement, p. 8 (note 86, *supra*).
159 ICI Comment Letter (note 157, *supra*).
160 Susanne Craig, "The Giant of Shareholders, Quietly Stirring," *New York Times*, May 18, 2013 (http://www.nytimes.com/2013/05/19/business/blackrock-a-shareholding-giant-is-quietly-stirring.html?smid=pl-share).
161 Joann S. Lublin and Kirsten Grind, "For Proxy Advisers, Influence Wanes," *Wall Street Journal*, May 22, 2013
(http://online.wsj.com/article/SB10001424127887323336104578499554143793198.html).
162 The Conference Board, NASDAQ OMX Group, and Stanford University's Rock Center for Corporate Governance conducted a study that found that more than two-thirds of US companies say their executive compensation program is influenced by the policies and voting recommendations of proxy voting advisors. The study also found that corporate boards are likely to change CEO compensation to gain favorable say-on-pay recommendations. See

Larcker et al., "The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions," (note 112, *supra*).
163 This is enhanced, as well, by the fact that many companies have adopted majority voting policies in director elections, which makes directors more vulnerable to a "withhold" vote campaign.
164 Craig, "The Giant of Shareholders, Quietly Stirring" (note 160, *supra*).
165 Yerger Statement, p. 4 (note 86, *supra*), recommending that proxy advisors (i) register as investment advisors under the Investment Advisers Act of 1940; (i) provide substantive rationales for vote recommendations; (iii) minimize conflicts of interest and disclose details of potential conflicts, including those involving companies or resolution sponsors, in the applicable meeting report; (iv) correct material errors promptly and notify affected clients as soon as practicable; and (v) provide transparency into the general methodologies—without compromising proprietary models—used to make recommendations. See also, "Policy Briefing No. 3: Voting Integrity Practices for Investors and the Global Proxy Advisory Industry," *Millstein Center for Corporate Governance and Performance, Yale School of Management*, 2009, Appendix A, p. 22 (http://web.law.columbia.edu/sites/default/files/microsites/millstein-center/Voting% percent20Integrity% percent20Policy% percent20Briefing% percent20No% percent203% percent2002% percent2027% percent2009.pdf).
166 "Examining the Market Power and Impact of Proxy Advisory Firms," Statement of Harvey Pitt, on behalf of the US Chamber of Commerce, to the US House of Representatives' Committee on Financial Services: Subcommittee on Capital Markets and Government Sponsored Enterprises, June 5, 2013, (http://docs.house.gov/meetings/BA/BA16/20130605/100958/HHRG-113-BA16-Wstate-PittH-20130605.pdf).
167 Commissioner Gallagher Speech (note 109, *supra*); NASDAQ OMX Rulemaking Petition (note 152, *supra*).
168 SEC rule 206(4)-6 does not contain any language requiring all proxies be voted. The SEC staff release states explicitly that failure to vote would not necessarily mean a breach of fiduciary duties: "[w]e do not suggest that an adviser that fails to vote every proxy would necessarily violate its fiduciary obligations. There may even be times when refraining from voting a proxy is in the client's best interest, such as when the adviser determines that the cost of voting the proxy exceeds the expected benefit to its client." However, the staff release contains a footnote giving an example of when costs would outweigh benefits in the case of voting proxies in a foreign country. See 17 C.F.R. § 275.206(4)-6 (2003); see also 17 C.F.R. § 270.30b1-4 (2003); The executive director of the Council of Institutional Investors (CII), an association of public, labor, and corporate employee benefit funds, stated the CII view that SEC rules and interpretations do not require institutional investors to vote all proxies, but requested staff interpretive guidance to resolve acknowledged confusion about the issue. Yerger Statement, p.4 (note 86, *supra*).
169 Statement of Jeffrey D. Morgan, President & CEO National Investor Relations Institute to the US House of Representatives' Committee on Financial Services: Subcommittee on Capital Markets and Government Sponsored Enterprises, June 5, 2013, p.9 (http://financialservices.house.gov/uploadedfiles/hhrg-113-ba16-wstate-jmorgan-20130605.pdf). See also, Statement of Harvey Pitt, US Chamber of Commerce, to the US House of Representatives' Committee on Financial Services: Subcommittee on Capital Markets

and Government Sponsored Enterprises, June 5, 2013, exhibit: "Best Practices and Core Principals for the Development, Dispensation and Receipt of Proxy Advice"(http://financialservices.house.gov/uploadedfiles/hhrg-113-ba16-wstate-hpitt-20130605.pdf).

170 Statement of Jeffrey D. Morgan, June 5, 2013,p. 8 (http://financialservices.house.gov/uploadedfiles/hhrg-113-ba16-wstate-jmorgan-20130605.pdf).

171 Statement of Darla Stuckey, Senior Vice President Policy and Advocacy, Society of Corporate Secretaries and Governance Professionals to the US House of Representatives' Committee on Financial Services: Subcommittee on Capital Markets and Government Sponsored Enterprises, June 5, 2013, p. 6 (http://financialservices.house.gov/uploadedfiles/hhrg-113-ba16-wstate-dstuckey-20130605.pdf).

172 Statement of Nell Minnow, a founder of ISS, made to the Council of Institutional Investors conference, September 2013 (http://www.pionline.com/article/20130927/DAILYREG/130929857/proxy-advisory-firms-should-split-businesses-8212-cii-speakers).

173 Larcker et al., "And Then A Miracle Happens!" p. 3 (note 144, *supra*).

174 Commissioner Gallagher Speech (note 109, *supra*).

175 In recent years, one of the most talked-about corporate governance initiatives has been the "proxy access" proposals. Through these proposals, the SEC intended to grant shareholders greater access to the director nominating process by giving them the right to include their own director nominees in the company's proxy materials. The end result of this process, however, was mixed—the SEC's proposed rule was overturned in federal court, and the number of subsequent shareholder-initiated proxy access proposals was relatively small, suggesting this area, while the focus of significant publicity, may not be a true area of significant shareholder focus. Only eight proxy access proposals (of 17 submitted) came to a vote in the 2013 proxy season. See Amy Goodman, "Shareholder Proposal Developments During the 2013 Proxy Season," *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, July 22, 2013 (http://blogs.law.harvard.edu/corpgov/2013/07/22/shareholder-proposal-developments-during-the-2013-proxy-season/).

176 See, e.g., the November 2013 submission by the Pension Investment Association of Canada in response to a request for comments about the proxy voting infrastructure by the Canadian Securities Administrators (http://www.osc.gov.on.ca/documents/en/Securities-Category5-Comments/com_20131127_54-401_piac.pdf).

177 The issues identified with share lending are distinct from the related issues referred to commonly as "empty voting" issues, in which the vote is separated from economic ownership. Significant academic research has focused on empty voting, including in particular seminal work by Professors Hu and Black, who were among the first to delve into the concepts and risks underlying empty voting. See, e.g., Henry T. C. Hu and Bernard Black, "The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership," *Southern California Law Review* 79, 2006, p. 811; Hu and Black, "Equity and Debt Decoupling and Empty Voting II: Importance and Extensions," *University of Pennsylvania Law Review* 156, 2008, p. 625. See Part III.G (p. 38) for a further discussion of these issues.

178 Concept Release on the US Proxy System, Release Nos. 34-62495; IA-3052; IC-29340, SEC, pp. 42989–42993 (http://www.sec.gov/rules/concept/2010/34-62495fr.pdf), at Section III.A.1.a, addressing the accuracy, transparency, and efficiency of the voting process; see also Steven J. Cutler et al., "Every Vote Should Count—But Only Once: CSA Publishes Proxy Voting Consultation Paper," *Gowlings,* August 2013 (http://www.gowlings.com/KnowledgeCentre/article.asp?pubID=2988), discussing similar issues faced by Canadian regulators.
179 "Section 13(f) securities" are generally defined to include equity securities that trade on a US exchange, certain equity options and warrants, shares of closed-end investment companies, and certain convertible debt securities. The shares of open-end investment companies (e.g., mutual funds) are not Section 13(f) securities. The SEC publishes quarterly (on its website) a list of Section 13(f) securities. For a discussion by the SEC staff of frequently asked questions about Form 13F, see http://www.sec.gov/divisions/investment/13ffaq.htm.
[180] See Letter to Elizabeth Murphy, Secretary, SEC, from Janet McGinness, Executive VP and Corporate Secretary, NYSE Euronext; Kenneth A. Bertsch, President and CEO, Society of Corporate Secretaries and Governance Professionals; and Jeffrey D. Morgan, President and CEO, National Investor Relations Institute re: Petition for Rulemaking under Section 13(f) of the Securities Exchange Act of 1934, File No. 4-659 (http://www.sec.gov/rules/petitions/2013/petn4-659.pdf).
181 For a description of the OBO/NOBO framework under existing law, see Alan Beller and Janet Fisher, "The OBO-NOBO Distinction in Beneficial Ownership: Implications for Shareowner Communications and Voting," *Council of Institutional Investors*, February 2010 (http://www.sec.gov/comments/s7-14-10/s71410-22.pdf); see also Alan Beller and Janet Fisher, "Client Directed Voting: Selected Issues and Design Perspectives," *Council of Institutional Investors*, August 2010 (http://www.sec.gov/comments/s7-14-10/s71410-93.pdf).
182 Kevin J. Laverty, "Economic 'Short-Termism': The Debate, the Unresolved Issues, and the Implications for Management Practice and Research," *The Academy of Management Review* 21, 1996, pp. 825, 826.
183 "Departing CEO Age and Tenure," *The Conference Board*: *Chart of the Week*, No. 19, June 2013.
184 Mark Roe, "Corporate Short-Termism—In the Boardroom and in the Courtroom," *Harvard Law School Public Law & Legal Theory Working Paper Series, Paper No. 13-18*, April 18, 2013, p. 8 (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2239132), which cites John Graham, Campbell R. Harvey, and Shiva Rajgopal, "Value Destruction and Financial Reporting Decisions," *Financial Analysts Journal* 62, 2006, pp. 27–39; Sanjeev Bhojraj and Robert Libby, "Capital Market Pressure, Disclosure Frequency-Inducted Earnings/Cash Flow Conflict, and Managerial Myopia," *The Accounting Review* 80, 2005, pp. 1–20.
185 The economic consequence of activism by hedge funds is widely debated. Bebchuk and Martin Lipton, a founding partner of the law firm Wachtell, Lipton, Rosen & Katz, for example, have occupied opposite corners in a public debate about whether activist hedge funds erode targeted companies' long-term value. In July 2013, Bebchuk and Professors Alon Brav and Wei Jiang published a study that claimed to empirically disprove the assertion that activist campaigns are long-term detrimental to the involved companies (Lucian Bebchuk, Alon Brav, and Wei Jiang, "The Long-Term Effects of Hedge Fund Activism," *Columbia Business School Research Paper No. 13-66*, July 9, 2013

[http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2291577]). Lipton, a vocal critic of activist hedge funds, attacked the soundness of the study's evidence and challenged its conclusions: "No empirical study, with imperfect proxies for value creation and flawed attempts to isolate the effects of activism over a long-term horizon influenced by varying economic, market, and firm-specific conditions, is capable of measuring the damage done to American companies and the American economy by the short-term focus that dominates both investment strategy and business-management strategy today"; see Martin Lipton, "The Bebchuk Syllogism," *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, August 26, 2013 (http://blogs.law.harvard.edu/corpgov/2013/08/26/the-bebchuk-syllogism/). See also Martin Lipton, Steven A. Rosenblum, and Sabastian V. Niles, "Current Thoughts about Activism," *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, August 9, 2013 (http://blogs.law.harvard.edu/corpgov/2013/08/09/current-thoughts-about-activism/); Lucian Bebchuk, Alon Brav, and Wei Jiang, "Don't Run Away from the Evidence: A Reply to Wachtell," *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, September 17, 2013 (http://blogs.law.harvard.edu/corpgov/2013/09/17/dont-run-away-from-the-evidence-a-reply-to-wachtell-lipton/).

186 Lawrence E. Mitchell, "Whose Capital, What Gains?" *Brookings Institution: Issues in Governance Studies* 49, July 10, 2012 (http://www.brookings.edu/research/papers/2012/07/10-corporate-purpose-mitchell).

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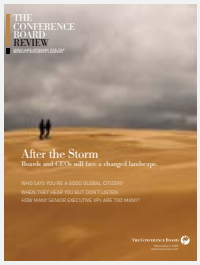

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