October 12, 2018

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

File Number 4-725

RE: Submission in advance of Staff Roundtable on the Proxy Process (Proxy Advisors)

Submitted By: Bernard S. Sharfman*

Dear Mr. Fields,

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

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

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

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

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

INTRODUCTION

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

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

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

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

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

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

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

[5] *Id.*

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

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

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

I. THE OBJECTIVE OF SHAREHOLDER VOTING

This Article is based on the premise that the objective of shareholder voting is shareholder wealth maximization. This view is consistent with the Delaware Courts understanding of why shareholder voting adds value to corporate governance: "[w]hat legitimizes the stockholder vote as a decision-making mechanism is the premise that stockholders with economic ownership are expressing their collective view as to whether a particular course of action serves the corporate goal of stockholder wealth maximization."[8]

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

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

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

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[8] Kurz v. Holbrook, 989 A.2d 140, 178 (Del. Ch. 2010) *aff'd* Crown Emak Partners v. Kurz, 992 A.2d 377 388-89 (Del. 2010) (*quoting* Kurz with approval).

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

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

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

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

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

II. THE PRIMARY SOURCE OF INFORMED VOTING

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

The board of directors is not only the default locus of authority in a public company; it is also the most informed. Directors, as well as executive management, are often referred to as "insiders." According to Goshen and Parchomovsky, "insiders have access to inside information due to their proximity to the firm; they also have the knowledge and ability to price and evaluate this information."[16]

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

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

[13] Bernard S. Sharfman, *Commentary: Reforming a broken system*, *Pensions & Investments*, (August 27, 2018), http://www.pionline.com/article/20180827/ONLINE/180829997/commentary-reforming-a-broken-system.

[14] *Id.*

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

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

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

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

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

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

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

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

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

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

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

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

III. THE LIMITATIONS OF PROXY ADVISOR RECOMMENDATIONS

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

A. Being Informed

As a foundational matter, for a proxy advisor to generate a recommendation that has value, the proxy advisor must be *truly* informed. For a proxy advisor to be truly informed it needs to be held to the standard of an informed investor or what Goshen and Parchomovsky would call an "information trader."[22] According to Goshen and Parchomovsky, an information trader, even though she lacks access to the information possessed by the board of directors, is identified by her willingness and ability "to devote resources to gathering and analyzing information as a basis for its [her] investment decisions,"[23] including the gathering of private information.[24] Moreover, "information traders have the ability and knowledge to collect, evaluate and price firm-specific and general market information."[25] Furthermore, "[s]earching for, verifying, analyzing, and pricing general market and firm-specific information are costly tasks."[26]

B. The Low Cost, Low Value Approach

Yet, this high cost, informed approach is not what proxy advisors appear to be providing. As observed by Enriques and Romano, "The core function of proxy advisors is to offer institutional investors relatively cheap suggestions on how to vote portfolio companies' shares."[27] According to Nathan and Barrall, "As a result of the large number of voting recommendations that must be made in a short time period, it is inconceivable that proxy advisors' recommendations can or will be based on a thorough analysis of the facts and circumstances of each company in the context of each voting decision."[28]

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

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

[22] *Id.*

[23] *Id*. at 723.

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

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

[26] *Id.*

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

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

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

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

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

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

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

[31] *Id.*

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

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

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

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

[36] *Id.*

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

C. The One-Size-Fits-All Approach

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

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

Moreover,

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

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

IV. THE PREFERENCE FOR LOW COST, LOW VALUE RECOMMENDATIONS

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

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[37] *Id.*

[38] *Id.*

[39] *See* Institutional Shareholder Services Inc., *Current Voting Policies* (2018), https://www.issgovernance.com/policy-gateway/voting-policies/ and Glass Lewis, Policy Guidelines (2018), http://www.glasslewis.com/guidelines/.

[40] Albert H. Choi, Andrew Lund, and Robert J. Schonlau, *Shareholder Voting on Golden Parachutes: Determinants and Consequences*, Virginia Law and Economics Research Paper No. 2018-13 (August 10, 2018), available at SSRN: https://ssrn.com/abstract=3229962.

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

[42] *Id.*

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

A. The Regulatory Demand to Vote

Demand for low cost, low value recommendations began with the infamous 1988 DOL letter that is commonly referred to as the "Avon letter."[44] In that letter, the DOL stated that "In general, the fiduciary act of managing plan assets that are shares of corporate stock includes the management of voting rights appurtenant to those shares of stock."[45] That is, the parties responsible for managing voting stock in pension plans governed by Title I of The Employee Retirement Income Security Act of 1974 ("ERISA") have a fiduciary duty to vote their proxies.[46]

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

> Properly designated investment managers may not be passive on the issue of exercising proxy votes, even if plan and trust documents are sent to this effect. For example, investment managers may not, as a general policy, decline to vote proxies, or vote only non-controversial proxies.[48]

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

> The duty of care requires an adviser with voting authority to monitor corporate actions and vote client proxies…. We do not suggest that an adviser that fails to vote every proxy would necessarily violate its fiduciary obligations. There may even be times when refraining from voting a proxy is in the client's best interest, such as when the adviser determines that the cost

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

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

[45] *Id.*

[46] *Id.* The DOL affirmed the Avon Letter in 2008. *See* Department of Labor, *Interpretive Bulletins Relating to the Employee Retirement Income Security Act of 1974*, 73 Fed. Reg. 61,732 (Oct. 17, 2008), https://www.gpo.gov/fdsys/pkg/FR-2008-10-17/pdf/E8-24552.pdf.

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

[48] *Id.* at 8.

[49] 17 C.F.R. § 275.206(4)-6.

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

> of voting the proxy exceeds the expected benefit to the client. An adviser may not, however, ignore or be negligent in fulfilling the obligation it has assumed to vote client proxies.[51]

Moreover, the SEC stated that the investment adviser could use an independent third party, such as a proxy advisor, to demonstrate that it was voting absent a conflict of interest.[52] This SEC endorsement of the use of a proxy advisor was reinforced in the SEC's 2014 Staff Bulletin, *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms*.[53] However, this endorsement was recently weakened when the SEC withdrew two long-standing no-action letters that supported this approach.[54]

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

B. The Preferences of Index Fund Managers

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

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

[51] *Id.* at 4.

[52] *Id.* at 5.

[53] Division of Investment Management, Securities and Exchange Commission, *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms*, Staff Legal Bulletin No. 20 (IM/CF) (June 30, 2014), https://www.sec.gov/interps/legal/cfslb20.htm.

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

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

[56] *Id.*

[57] Vanguard, *Investor Stewardship 2018 Annual Report* at 34, https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2018_investment_stewardship_annual_report.pdf (On a global basis, Vanguard's Investor Stewardship team cast nearly 169,000 votes in the 2018 proxy year.).

> the index. Nor would it lead to any increase relative to the investment manager's rivals that follow the same index, as any increase in the value of the corporation would also be captured by all other mutual funds investing according to the index, even though they had not made any additional expenditure on stewardship.
>
> Thus, if the investment manager were to take actions that increase the value of the portfolio company, and therefore also the portfolio that tracks the index, doing so would not result in a superior performance that could enable the manager to attract funds currently invested with rival investment managers.[58]

Moreover,

> [I]f the index fund were to raise its fees and improve its stewardship, each individual investor in the fund would have an incentive to switch to rival index funds. That is, a move by any given index fund manager to improve stewardship and raise fees would unravel, because its investors would prefer to free-ride on the investment manager's efforts by switching to another investment fund that offers the same indexed portfolio but without stewardship or higher fees.[59]

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

C. Actively Managed Funds

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

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

[59] *Id.*

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

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

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

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

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

V. FIDUCIARY DUTIES UNDER THE ADVISERS ACT

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

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

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

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

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

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

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[64] *Id.* at 99.

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

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

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

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

[69] 375 U.S. 180 (1963). *See also*, Transamerica Mtg. Advisors, Inc. v. Lewis, 444 U.S. 11 (1979) ("As we have previously recognized, § 206 establishes "federal fiduciary standards" to govern the conduct of investment advisers, Santa Fe Industries, Inc. v. Green, supra, at 430 U. S. 471, n. 11; Burks v. Lasker, 441 U. S. 471, 441 U. S. 481-482, n. 10; SEC v. Capital Gains Research Bureau, Inc., 375 U. S. 180, 375 U. S. 191-192. Indeed, the Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations. See H.R.Rep. No. 2639, 76th Cong., 3d Sess., 28 (1940); S.Rep. No. 1775, 76th").

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

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

B. The Conflict

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

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

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

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

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

VI. WHAT CAN BE DONE?

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

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

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

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

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

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

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

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

This mistaken understanding of Department of Labor policy most likely originated from an article written many years ago by David George Ball, a former Assistant Secretary of Labor for Pension and Welfare Benefits Administration. In that article Secretary Ball stated, "A fiduciary who fails to vote, or casts a vote without

consistent with the understanding that the voting recommendations provided by the board of directors are informed as they are based on inside information and enhanced by the expertise of executive management.

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

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

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

CONCLUSION

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

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

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

Very truly yours,

Bernard S. Sharfman

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