The Harvard Law School Forum on Corporate Governance and Financial Regulation

SUPPORTED BY: CSC CORPORATION SERVICE COMPANY

The Future of Institutional Share Voting: Three Paradigms

Posted by Charles M. Nathan, Latham & Watkins LLP, on Friday July 23, 2010

Editor's Note: Charles Nathan is Of Counsel at Latham & Watkins LLP and is co-chair of the firm's Corporate Governance Task Force. This post is based on a recent Latham Corporate Governance Commentary, and follows up on an earlier Latham Commentary, *The Parallel Universes of Institutional Investing and Institutional Voting*, which is available here.

In a recent Corporate Governance *Commentary*, titled "The Parallel Universes of Institutional Investing and Institutional Voting,"[1] we observed the increasing discontinuity at most institutional equity investors between the persons who make the buy and sell decisions (or who create and maintain the quantitative models that make those decisions) and those who make the decisions on how to vote portfolio shares. We analogized the separation of the two functions to parallel universes to highlight the autonomous nature of each function. While we noted that this pattern is not universal among institutional equity investors, we stated our belief that it is the prevailing method by which institutional investors solve the financial dilemma created by the large, and for some institutions literally overwhelming, number of votes they are required to cast each proxy season by the federal government's imposition of a fiduciary duty to vote all portfolio shares on all matters brought to shareholders.

An obvious question is where will the discontinuity of investment decision making and voting decision making go from here? We believe there are three paradigms that describe the most likely outcomes:

- Continuation and growth of our current parallel universes paradigm, which consists of one autonomous universe devoted to investment decisions and a second autonomous universe devoted to voting decisions.
- Recognition that the persons who make buy and sell decisions, institutional and retail, don't really care about voting their shares except on matters of clear economic significance to them as owners of equity and that our current structure of annual shareholder meetings and a plethora of shareholder proposals is simply not interesting or relevant to the vast majority of investment decision makers. A logical consequence would

[1] http://www.lw.com/upload/pubContent/_pdf/pub3463_1.pdf (the "Parallel Universes Commentary").

be to reduce the frequency and number of non-economic votes throughout Corporate America to better align the investment decision making reality and the voting processes involved in corporate governance.

- Re-evaluation of the application of fiduciary duty principles to the current parallel universes, leading to modification or abandonment of the current prevailing model of voting according to *ex ante* voting policies without regard to the particular circumstances of the public company in question.

This Corporate Governance Commentary examines each of these paradigms in terms of its logic, its implications for the future of corporate governance and its likelihood of continuing as or becoming the dominant model.

First Paradigm: Continuation of the Current Parallel Universes Model

There are a number of very persuasive reasons for concluding that the current First Paradigm of parallel universes will continue to prevail.

- As we noted in our Parallel Universes Commentary, there are powerful economic motives for institutional investors to utilize this model as the basis for voting decisions. While some institutions may engage portfolio managers in voting decisions to a greater extent than others, the economic value of the paradigm rests on creation and implementation of one-size-fits-all voting policies that permit the bulk of the voting decisions to be made on the equivalent of "auto pilot."
- The universe of voting decision makers is dominated by the activist corporate governance movement. Corporate governance activism has achieved widely accepted legitimacy by its successful seizure of the rhetorical high ground, based in large part on a number of simplistic but viscerally appealing slogans, such as:
    - Shareholders are the "owners" of the company.
    - The legitimacy of the public company depends on "shareholder democracy," expressed, among other ways, through shareholder election of directors and shareholder votes on other matters that shareholders believe important.
    - Directors should be held "accountable" to the company's owners, among other ways, through annual elections of the entire board, majority voting, proxy access, the right to call special meetings and act by majority written consent, elimination of all super majority voting requirements and expansion of the right of shareholders to submit proposals for consideration at shareholders' meetings.
    - The corporate governance personnel within institutional money managers are "investors" or "shareowners" for purposes of all corporate governance

discussions and the existence of the parallel universes can and should be ignored.

While critics have pointed out on many occasions that these and other slogans of the corporate governance parallel universe are insufficiently nuanced or tell only a part of the story or are just wrong as a matter of theory and practice,[2] their voices have been lost in the "proverbial" wilderness.

This brings us to another, perhaps the key, reason that the corporate governance parallel universe has to date thoroughly won the thought leadership contest — its slogan-oriented principles have been widely accepted and adopted by three important constituencies:

- Labor, as purported "investors"[3] (*e.g.*, state and local pension funds and unions), and also as self-appointed spokesman for unionized and other employees who own stocks.
- The press.
- The political classes in general, and most ardently the Democratic Party, at least on the national level.

One can debate how much of the corporate governance activists' victory with these constituencies is principles-based, how much of the corporate governance movement's influence with the financial press and politicians is a function of Labor's political (as opposed to its intellectual) clout, and how much of the corporate governance activists' intellectual victory is due to growth of populist and progressive sentiments in our country over the past several years. For our purposes, however, the relative share of credit or blame is not nearly as important as the reality that all these underlying currents are powerful and busily at work, and they will be hard to reverse.

So there we have it. Absent some rather dramatic change among the relevant constituencies, the corporate governance parallel universe will not only continue into the future, but as it achieves its agenda it will only get stronger and more ambitious. The implications include:

- A good part of the corporate governance agenda is explicitly aimed at making the board of directors "accountable" to shareholders, not merely on an annual basis but rather on a

[2] Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 Va. L. Rev. 733 (2007); Martin Lipton & Steven A. Resenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW 67, 69 (2003); Martin Lipton & Paul K. Rowe, *The Inconvenient Truth About Corporate Governance: Some Thoughts on Vice-Chancellor Strine's Essay*, 33 J. Corp. L. 63 (2007); ABA Section of Business Law, *Report of The Task Force of the ABA Section of Business Law Corporate Governance Committee on Delineation Of Governance Roles &Responsibilities* (2009), http://www.abanet.org/buslaw/committees/CL260000pub/materials/20090801/delineation-final.pdf.

[3] State and local employee pension plans and national and local labor unions control the assets in their various pension funds, but they routinely hire third-party investment managers to actually make the investment decisions. Thus, like the corporate governance specialists who control institutional investors' voting, they are "investors" in name only.

continuing year-round basis. The Dodd-Frank Act seals victory for a portion of the current agenda of the corporate governance community, principally proxy access and "say on pay." The remaining agenda includes legislatively mandating majority voting in uncontested elections, permitting as few as 10 percent of the shareholders to call special meetings, permitting action by majority shareholder consent without a meeting throughout the year and eliminating all supermajority voting provisions. A new concept that is receiving significant exposure and could well become a corporate governance agenda item in the next year or two borrows from Sweden a requirement that investor representatives constitute some or all of the nominating committee for directors.[4]

- "Accountability" in the lexicon of the corporate governance universe more clearly than ever means that directors should at all times act in accordance with the wishes of the then prevailing majority of voting decision makers. Failure to do so is seen as ample cause for not re-electing the recalcitrant directors at the next annual meeting.[5]
- Real and increasing power will flow to the corporate governance universe as its agenda of corporate governance reforms is adopted by legislation, regulation or corporate action at individual companies; success will breed further success. Moreover, to maintain its importance and relevance, the corporate governance universe will find it important to exercise its increased power and to continue to develop a "reform" agenda that will add to its power at the expense of the directors and management.
- Increased prescriptive federal legislation and regulation is the best vehicle for rapid and universal adoption of the future agenda of the corporate governance universe.
    - The leaders of the corporate governance community undoubtedly understand that the numbers of corporate governance specialists comprising their alternative universe must remain limited to satisfy the economic motivations of institutional investors to contain the costs of the parallel voting universe. As a result, the sheer number of public companies is a real life problem for the corporate governance community in achieving its existing and future "reform" agenda. With over 10,000 in the US and the enabling premise of state corporation laws, the actual governance schemes of the public company universe are kaleidoscopic.
    - The variation in corporate governance details among US public companies presents a severe challenge if the corporate governance universe is forced to act on a case by case basis through a shareholder vote or a believable threat of a

[4] Corporate governance activists frequently argue that these reforms are intended for use only in extraordinary situations. This argument ignores the leverage created by the ability of corporate governance activists to threaten a company with their use if the company resists demanded "reforms" being advanced by the corporate governance universe.

[5] RiskMetrics, for example, has long maintained a voting policy of recommending that shareholders withhold voting for an entire board of a company if the board has not implemented to RiskMetrics' satisfaction a shareholder proposal that has carried a majority of the votes cast at two successive annual meeting or a majority of the outstanding shares at a single annual meeting. RiskMetrics justifies this policy by the need for a board to be accountable to shareholders. The RiskMetrics policy has had great success in motivating boards to implement shareholder proposals that have carried a majority vote or are perceived likely to do so.

shareholder vote at each public company. The obvious solution is to eliminate the need for company-by-company campaigns through adoption of one-size-fits-all prescriptive laws and regulation. This is the principal argument made by the corporate governance community in its lobbying campaign at the SEC against permitting meaningful shareholder choice under the SEC's proxy access rules.[6] It is also a major argument used by the corporate governance community in lobbying Congress for adoption of prescriptive corporate governance legislation in the pending financial services legislation. This argument will be heard and, based on the precedent in the proxy access debate, frequently responded to by the SEC and quite possibly Congress. The result could well be further inroads in our once almost sacrosanct division between state and federal authority in the regulation of the internal affairs of public companies.

- Indeed, it is not wholly far-fetched to predict that the corporate governance universe may begin sponsoring a full federalization of corporate law under a prescriptive statutory scheme. Were this to occur, it is not difficult to predict that the prescriptive federal statute would "level" all of the structural devices that are perceived to reduce the accountability of all directors to shareholders at large.[7]

Left to run its course, the parallel universe of corporate governance will increase its domination over the board room and executive suite. While there will be differences among the one-size-fits-all voting policies at different institutions and third party proxy advisors, they will be at the margin. The central core voting policies will continue to be determined by a relatively small coterie of corporate governance leaders, without meaningful input from persons with alternative views of shareholder, board and executive officer dynamics and functions.

Second Paradigm: Recognition of Investing Decision Makers' Lack of Interest in Shareholder Voting

It should not come as a shock to anyone involved in equity investing or corporate governance that, on the whole, persons who participate in portfolio management, those who make the buy sell decisions or create and manage the programs that make the buy and sell decisions, have little to no interest in voting portfolio shares, except in cases of clear economic significance (principally

[6] *E.g.*, CII, Comment Letter to the SEC Concerning Proposed Rule Facilitating Shareholder Director Nominations, File No. S7-10-09 (Jan. 14. 2010), http://www.sec.gov/comments/s7-10-09/s71009-592.pdf; CalSTRS, Comment Letter to the SEC Concerning Proposed Rule Facilitating Shareholder Director Nominations, File No. S7-10-09 (Nov. 18, 2009), http://www.sec.gov/comments/s7-10-09/s71009-573.pdf; TIAA-CREF, Comment Letter to the SEC Concerning Proposed Rule Facilitating Shareholder Director Nominations, File No. S7-10-09 (Sept. 18, 2009), http://www.sec.gov/comments/s7-10-09/s71009-536.pdf.

[7] This would probably include permitting only one class of common stock with equal voting rights, limiting the ability of preferred classes to participate in corporate governance to avoid undermining the hegemony of the mandatory one vote per share common stock, prescribing that all directors may be removed without cause, eliminating all forms of classified boards (including two classes of stock, each with the right to elect a specified number of directors), mandating investor participation at the nominating committee, and so on and so forth.

mergers, fundamental corporate restructurings and control contests). This is also true of retail investors, whatever their investment style. For portfolio managers, active or quantitative, institutional or retail,[8] the only corporate governance (as opposed to economic) vote that counts is the buy or sell decision. If an active manager of a portfolio likes a company's performance and it fits his portfolio's objectives it's a buy or hold. If the performance is disappointing or worse it's a sale. The quantitative manager is even further removed from voting because its investment thesis is based on quantitative models that operate on the basis of their internal logic. Voting shares is not just an afterthought for the quantitative manager, it is simply irrelevant.[9]

The reality of investment decision makers' apathy with regard to exercise of the corporate franchise on votes without obvious economic significance raises a truly fundamental question. Why do we have, and do we need, so many shareholder votes?

- Shareholder democracy is not an answer. Democracy does not demand annual elections for the governing body. Indeed, it would be hard to find any federal or state legislator in the US who would espouse the wisdom of an annual election cycle. Nor does shareholder democracy demand that there be a corporate analog to the California voter initiative system in the form of shareholder proposals, binding and non-binding.[10] Add to the mix an ability for shareholders to meet between annual meetings at the behest of as few as 10 percent of the shareholders or to act by majority written consent at any time, coupled with a right to remove directors without cause (all key items on the corporate governance movement's current agenda and a reality at a meaningful number of public companies). While the result is like an Athenian style democracy, it is hardly the only democratic model available.
- One consequence of the corporate governance universe's drive toward total director and management "accountability" on an annual or more frequent basis is its implicit rejection of a long time horizon for corporate strategy and investment. Commentators across the spectrum of corporate governance issues often decry the quarterly growth ethos that seems to dominate management, board and investment decision makers thinking and

[8] The SEC has recently added senior staff in its Office of Investor Education and Advocacy and created a web site devoted to educating retail investors and encouraging them to vote their shares, http://www.sec.gov/investor/pubs/sec-guide-to-proxy-brochures.pdf. Whether this effort will change the current sorry demographics of retail voting remains to be seen. What is clear is that retail investors historically have not had a high voting rate and consciously or otherwise relied on broker discretionary voting to be heard at the corporate polls. With the practical demise of broker discretionary voting, the retail investing community has become relatively insignificant in share voting on non-economic matters.

[9] The principal exception to these generalizations about investor disinterest in voting are hedge funds and other activist managers that follow a so-called "event driven" investment style. For these investors, the Icahns and Ackmans of the world, voting is inextricably part of their investing style. In many ways, they are the inheritors of the classic shareholders of the early days of the American corporation, when shareholders were "owners" in a very direct way and there was little or no intermediation between the capitalists who made investments of their personal funds and the men who ran their companies.

[10] Indeed, the corporate analog is arguably more insidious because under Rule 14a-8 virtually any shareholder can get a proposal onto the ballot.

action.[11] The inexorable pressure of producing quarter-over-quarter growth is frequently blamed for the excesses and mistakes of Corporate America, whether it be the financial institutions of the second half of this decade or the telecoms and other high-flyers of the first half. A particular irony is that the corporate governance universe often boasts of its pre-eminence at the table of long term investors because its predominant investment style is indexing, not stock picking, and thus, by hypothesis, its investment arms own indefinitely the stocks that make up their target index. Yet, very often it is the very same long term index "investors" who are driving the corporate governance universe's campaign to create an Athenian style corporate democracy, which practically insures short term thinking by boards and management.

Shareholder democracy can easily take forms other than an Athenian democracy model. We have only to look at our national legislature to find a very different democratic model.

- US senators serve staggered six year terms, with elections of one-third only every other year. US representatives serve two year terms. On a national level, there is no annual election cycle. Moreover, the framers of our Constitution clearly saw considerable merit in having the senior representative body elected for longer, staggered terms, to promote stability, longer term thinking and some measure of insulation from the vagaries of public opinion on an annual or even biennial basis. Applying these principles to boards of directors would be fully consistent with shareholder democracy and would avoid the obvious economic and policy pitfalls of an annual or more frequent election cycle.
- Objectors to lengthening the term of directors and revitalizing staggered boards might reject the analogy to the Congressional pattern, arguing that directors, unlike Senators and Representatives, rarely run against opposition, thus making the nature of the election different. However, this difference is narrowing rapidly under the pressure from the corporate governance universe's agenda. Proxy access will undoubtedly lead to a larger number of contested elections. Moreover, withhold-vote campaigns are increasingly frequent and successful, and the possible advent of universally required majority voting will vastly increase the threat of withhold-vote and vote "no" campaigns. Finally, whether or not proxy access nominations and withhold-vote campaigns are actually used by unhappy members of the corporate governance universe at many companies, the threat of use is ever present.

[11] Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733 (2007); Martin Lipton & Steven A. Resenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. LAW. 67, 69 (2003); Leo E. Strine, Jr., *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance*, 33 J. CORP. L. 1, 16 (2007); Leo R. Strine, Jr., Keynote Address at the University of Iowa Journal of Corporation Law Symposium (2007); CalPERS, *Global Principles of Accountable Corporate Governance* (2010), http://www.calpers-governance.org/docs-sof/principles/2010-5-2-global-principles-of-accountable-corp-gov.pdf; CalSTRS, *CalSTRS Executive Compensation Model Policy Guidelines* (2009), http://www.calstrs.com/investments/ExecutiveCompensationGuidelines.pdf.

The basic point of this analysis is that one obvious, if seemingly radical, way to deal with the reality that investment decision makers simply don't care about most shareholder votes would be to reduce the number and subject matter of shareholder votes. For example:

- We could abandon the annual meeting for a biennial meeting. As suggested above, directors could be elected for longer terms and boards could be staggered. Literally adopting the election scheme of the US Senate would provide a far longer time horizon for directors and management, while preserving the ability of shareholders to reshape the board over time.
- Special meetings called by management to consider transformational changes would remain unaffected by the reforms in director elections, in recognition of the fact that these events are not only appropriate for shareholder voting but also ones for which investment decision makers want a voice.
- We could also eliminate the ability of shareholders to submit non-binding, precatory proposals at shareholder meetings.[12] In lieu of non-binding shareholder resolutions, we could empower shareholders to make suggestions for change in corporate governance or company policy by facilitating electronic shareholder bulletin boards, straw polls or the like. The rapidly evolving world of social networking is readily available and contains a number of models that could be utilized for effective shareholder communications with the board and management.
- We could deal with concerns about director entrenchment by limiting the duration of poison pills, for instance, to one year. We could also create a fail-safe mechanism for director removal in extreme cases through a right of a meaningful minority of shareholders (say 25-35 percent) to convene a special shareholders' meeting solely for that purpose.

In sum, there is nothing sacrosanct about our current shareholder voting system. It can be altered in many ways to achieve the goal of lessening the short-termism inherent in an Athenian democratic model, while preserving the rights of shareholders to elect directors periodically, vote on economically significant transactions and communicate more effectively and with less risk to the enterprise's stability.

On the other hand, there is no denying that a reform of our current shareholder voting system, or even a proposal for reform, will be seen by the corporate governance universe, and many others, as radical, counter-productive, undemocratic and worse. Academics and others will argue

[12] As Vice Chancellor Strine frequently notes, the non-binding shareholder resolution is largely the product of Rule 14a-8 and has no basis or analog in state corporation law. Leo E. Strine, Jr., Vice Chancellor, Del. Court of Chancery, SEC Roundtable Discussion on Proposals for Shareholders (May 25, 2007) (transcript available at http://www.sec.gov/news/openmeetings/2007/openmtg_trans052507.pdf).

passionately that it doesn't merely ignore the agency costs that are rife in Corporate America, it exacerbates them. It will be characterized as a clumsy, but revealing, defense of the status quo and the underserved prerogatives of boards and management. Recounting of recent and not so recent tales of board and management errors and misdeeds will be recited with glee. And so forth and so on.

If a debate results it will probably be for the good. At least it will help illuminate the "dirty little" secret that lies at the heart of our current system of corporate governance — that investment decision makers are not on the whole very interested in corporate governance as it is currently practiced, or at least in the voting opportunities increasingly demanded by the prevailing corporate governance agenda.

Third Paradigm: Reevaluation of Institutional Investors' Fiduciary Duty to Vote All Portfolio Shares

As noted in our Parallel Universes Commentary, the parallel investing and voting universes were effectively created in the 1980's and 1990's when federal agencies imposed on US institutional investors a fiduciary duty to vote all portfolio shares on all ballot matters. The cost and challenge of doing so have been met by the creation of the parallel corporate governance universe armed with detailed *ex ante* voting policies which are applied predominantly on a one-size-fits-all basis across the panoply of US public companies.

The effectiveness of this model rests on the assumption that voting decisions can be delegated to specialists and third party proxy advisors so as to fulfill the institution's fiduciary duties without imposing undue costs on the institution. It is not clear, however, that the parallel voting universe that has evolved over the past 25 years successfully discharges institutional investors' fiduciary duties of due care and loyalty.

Let us first examine the duty of care. It is commonly articulated in terms of a prudent man standard. That is, the obligation to vote portfolio shares must be discharged with the same degree of care that would be used by a prudent investor under like circumstances.[13] The question is whether the alternative voting universe meets that standard. A number of considerations suggest that it may not.

[13] See Letter from U.S. Dep't of Labor to Helmuth Fandl, Chairman of Retirement Board, Avon Products, Inc. (Feb. 23, 1988); *see also* 73 Fed. Reg. 61731 (Oct. 17, 2008) (requiring "monitoring of corporate management of plan fiduciaries" under ERISA). For a recent restatement of this policy, see Proxy Voting by Investment Advisors, 68 Fed. Reg. 6585 (Feb. 7, 2003) ("The 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 and must not subrogate client interests to its own" (*internal citations omitted*)).

- A critical underlying premise of the parallel voting universe is that there is a body of good governance principles and best practices which, if implemented at a public company, will create shareholder value. Indeed, this is the bedrock assumption that supports the edifice of the voting universe. However, at best there is a lack consensus among scholars whether this is empirically true. And many academic critics would go further and assert there is no persuasive empirical evidence that good corporate governance, as defined in the parallel voting universe, has a meaningful impact on corporate performance or the creation of positive value for shareholders.[14]
- A second cause for concern is that much of what is proclaimed to be good corporate governance lacks a strong theoretical foundation and seems to be a product of a mindset more than a discipline. For example, a unifying theme of the corporate governance universe is that directors must be "accountable" to shareholders who are the true "owners" of the business. As noted above, this sentiment may be appealing rhetorically, but accountability is not self-defining and may be interpreted and applied in a number of ways. Moreover, the corporate governance universe has not clearly defined how its concept of accountability fits into a more comprehensive model of corporate governance? How does it relate to other corporate governance issues, such as the role and responsibilities of a board with regard to the company's management and its business and finances? Should a board's first priority be monitoring management and, if so, on what bases and to what end; or should a board's priority be to actively counsel management on strategic planning and implementation? Moreover, what is the basis for assuming that there is but one answer to these and other structural questions about a board's role and responsibilities? Why should the governance model be the same for all public companies? In short, accountability sounds good as an aspiration, but it is nothing more than a slogan unless and until it is defined precisely and fit into the far broader context of a comprehensive corporate governance model for managing the broad array of public companies and for creating shareholder value.

[14] See Sanjai Bhagat et al., *The Promise and Peril of Corporate Governance Indices*, 108 COLUM. L. REV. 1803 (2008) (arguing that there is no consistent relation between particular governance measures and corporate performance); *see also* Daines et al., *Rating the Ratings: How Good are Commercial Governance Ratings*, Working Paper, September 4, 2009, *available at* http://ssrn.com/abstract=1152093; *see also* Richard Leblanc & James Gillies, Inside the Boardroom: How Boards Really Work and the Coming Revolution in Corporate Governance, pp. 62-63, 80, 107-108, 120-126 (2005); *id.* at p. 125 ("where independent governance [is] clearly of superior benefit to shareholders, we would expect to see the results reflected in the results of scholarly research. Such results, however, are not evident. Other studies of the relationship between board size and firm performance provide no consensus about the direction of the relationship and suggest there is no statistical evidence of a relationship between corporate performance and proportion of outside directors of a board" (*internal citations omitted*); *id.* at p. 125 ("for every company that one can quote as an example demonstrating a positive correlation between good corporate governance, as defined by board structure, and good corporate financial performance, another that followed very good corporate governance practices can be found with a negative relationship"); Jeffrey Sonnenfeld, *Good Governance and the Misleading Myths of Bad Metrics*, *available at* http://www.sec.gov/spotlight/dir-nominations/sonnenfeld012004.pdf ("we are finding no support for a relationship between structural dimensions of board governance and company performance").

- A closely related issue is the circular and self-validating nature of the generation and confirmation of governance best practices within the corporate governance universe. A frequent pattern is for a corporate governance reform to be surfaced by one or several thought leaders within the universe as an appealing idea, for other members of the universe to endorse the idea, for RiskMetrics to propose incorporating the idea into its voting policies and for the very same thought leaders who sponsored the idea to confirm their support of RiskMetrics' adoption of the standard as part of its voting policies. When the circle ends, the proposed best practice is viewed as validated by members of the voting universe (who are referred to as "investors" for purposes of further validation) and incorporated in RiskMetric's and other institutional investor voting policies on the basis of its wide-spread acceptance within the parallel voting universe. Notably, empirical evidence of suitability and value creation for the broad swath of US public companies is at best scanty and often simply not part of the process.
- Another conceptual problem with the corporate governance model that has been developed and implemented by the parallel voting universe is its core one-size-fits-all structure. Indeed, as noted above, the model has to be largely automated to create the economies of scale on which the universe depends for cost containment. Having to apply corporate governance principles on a case-by-case basis in the context of the facts and circumstances of over 10,000 public companies would undermine the economic utility of the separate voting universe.
- A final fundamental problem inherent in the parallel corporate governance universe and its voting policies model is that members of that universe do not have any responsibility or accountability for the economic performance of their institution's stock portfolio. The lack of accountability and responsibility is even more obvious at the proxy advisory firms. By hypothesis, the parallel corporate governance universe is simply not about portfolio performance. While governance professionals frequently assert that good corporate governance leads to good corporate performance, to date this remains a matter of belief for which there is at best only equivocal empirical support. At the end of the day, the fact that corporate governance exists in a parallel universe, which is essentially separate from the universe of investment decision making is the strongest indictment of the paradigm and one that should give great pause to a prudent investment decision maker.

The duty of care issue boils down to whether a truly prudent investor — one who makes buy and sell decisions — would and should be comfortable using the model that the parallel corporate governance universe has created. The model may be expedient; it may contain costs and make the voting process economically sustainable for the institutional investor. But in what sense is it an expression of how a prudent investment decision maker, one who is responsible and accountable for the economic performance of a portfolio, would vote his or her portfolio shares?

The foregoing discussion also highlights the challenge in fitting the alternative universe's corporate governance model into a duty of loyalty analysis. One of the bedrock principles of the duty of loyalty is that the fiduciary should act solely for the benefit of the beneficiary, not for the fiduciary's economic self-interest.[15] Yet the latter motive, not the former, is the informing principle for use of ex ante voting policies intended to be broadly applicable to all public companies, without regard to the wide variation in facts and circumstances among more than 10,000 public companies. To defend the corporate governance parallel universe in the context of the duty of loyalty seemingly requires total acceptance of the basic premise that voting policies developed by the members of the parallel voting universe are universally applicable to all public companies and do, in fact, generate value for each separately managed equity portfolio, even if the value creation is not subject to empirical proof.

At the end of the day it is for courts to decide the question whether the parallel corporate governance universe fulfills the fiduciary duties of investment managers.

There is, however, a third paradgm that would be far easier to defend under a fiduciary duty analysis and that would answer most of the criticisms of the prevailing parallel universes paradigm. The third paradigm would concede that variations in company circumstances can impact the suitability and desirability of applying particular corporate governance policies to that company. Accordingly, it would require an informed inquiry into those circumstances and an analysis of the pros and cons of application of a specific governance policy to a particular company at a particular time.

Corporate governance professionals are not suited to a company specific analysis. By hypothesis, they are not investment professionals. But active investment decision makers are. They and their staffs meet company managements, attend quarterly earnings calls, road shows and management presentations, and typically care about the quality and foibles of each portfolio company's management. They will often have a sense of whether a particular governance reform makes sense in the context of the companies they follow.

In the third paradigm, the existing corporate governance model of virtually rote voting in accordance with *ex ante* voting policies would be modified by requiring input and final decisions on voting by investment professionals, not governance professionals. This paradigm, to continue the analogy, would tilt the existing parallel universes' axes so that the two universes intersect and

[15] The duty of loyalty does not allow a director or officer to consider or represent interests other than the best interests of the corporation and its stockholders in making a business decision. Belotti R. Franklin, *Delaware Law of Corporations and Business Organizations* 4-117 (2010) (citing *Andarko Petroleum Corp. v. Panhandle E. Corp.*, 545 A.2d 1171, 1174 (Del. 1998)). The Model Business Corporation Act states that a fiduciary has a duty to act "in a manner the officer believes is in the best interest of the corporation" and when a fiduciary or a related person enters into a transaction with a material financial interest opposite of the corporation's interest, the fiduciary may be in breach of his duties. MBCA §§ 8.30, 8.42, 8.60 (4th ed. 2008).

overlap to a meaningful degree. Rather than voting decisions defaulting to corporate governance specialists unless an investment decision maker mustered a persuasive case for a different outcome, the default would be to the investment decision maker unless a corporate governance professional mustered a persuasive case for a different outcome.

By reuniting the investing and voting functions and according final decision making to investment professional based on the specifics of each company, the third paradigm would successfully resolve many of the more troublesome weaknesses of the parallel universes paradigm:

- It would create economic accountability and responsibility for voting decisions by requiring votes to be cast by investment managers actually responsible for investment performance, not by parties with no economic “skin in the game”.
- It would eliminate the one-size-fits-all application of voting policies in favor of more specific company-based voting decisions.
- It would require corporate governance specialists to make the case for application of an *ex ante* voting policy to a specific company, thereby eliminating some of most insidious aspects of the current paradigm’s closed circle of creation and validation.

The third paradigm certainly raises a number of practical issues. Not the least is that it would impose more cost on institutional investors than the current parallel universes model. However, that cost is part and parcel of the fiduciary duty imposed on institutional investors by the federal government. The solution to the cost issue should not be to minimize costs for investment managers at the expense of prudent investment decision making. If the cost of requiring that voting decisions be company specific outweighs the benefit of requiring institutional investors to vote all portfolio shares on all matters, the logical answer is to eliminate the requirement to vote all portfolio shares on all matters.

Opponents of the proposed third paradigm could also argue that requiring greater participation by investment decision makers in the voting process is all fine and good for active money managers. But it makes no sense for quantitative investors, which like the governance specialists, have no company specific knowledge to apply to the voting decision.

This is where proxy advisory firms could supply a truly useful function, beyond being a cog in the circular process of validation of corporate governance ideas and a cheaper provider of the application of one-size-fits-all voting policies to the tens of thousands of proxy votes needed each proxy season. Proxy advisory firms could establish an infrastructure composed of investment decision making professionals which would be tasked with developing sufficient company specific knowledge to make informed voting decisions for all quantitative investors.

- True, such an expanded infrastructure would be far more costly than the current proxy advisory firm model. But this cost would be shared among all quantitative investment advisers. Doing so would add cost to the quantitative investment model, but again that cost is inherent in the fiduciary duty to vote all portfolio shares imposed on all investment managers.
- For active managers, the cost of the third paradigm would be the time required to be spent by portfolio managers in taking responsibility for voting decisions. For quantitative managers, the cost would be the institution's share of the "utility services" provided by proxy advisory firms which would be required to utilize investment professionals to analyze voting recommendations on a case-by-case basis.

Conclusion

To recap, there are three basic paradigms for the future of share voting decisions by institutional investors in the US.

- Continuation and growth of the current parallel universes of investment and voting decision making.
- Abandonment of the current model of annual shareholder meetings (replete with election of directors increasingly for one year terms and often contentious shareholder proposals) in favor of fewer meetings, longer terms for directors and curtailment or abandonment of the SEC created shareholder proposal system.
- Elimination of the parallel universes in favor of a more integrated voting model that takes into account differences in company circumstances and requires investment decision makers to have a far greater role in the voting process than the currently prevailing model.

Of these paradigms, the last seems to us by far the best. It is not without its conceptual and practical issues and certainly not without its costs. However, by reuniting the investing function and the voting function, it far better serves the fiduciary duty requirements of federal law and resolves the most glaring weakness of our current share voting system which is dominated by a parallel corporate governance universe that is without responsibility or accountability for the effect of those votes on particular companies and those companies' ability to generate shareholder value.