2023

Congressional Testimony: Shareholder Proposals, Index Fund Voting and the Need for Proxy Advisor Reform

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SHAREHOLDER PROPOSALS, INDEX FUND VOTING, PROXY ADVISORS

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Testimony Before the U.S. House Committee on Financial Services
"Protecting Investor Interests:
Examining Environmental and Social Policy in Financial Regulation"
2128 Rayburn House Office Building
July 12, 2023

Chairman McHenry, Ranking Member Waters, and Committee Members, thank you for inviting me to appear. I appreciate the opportunity to discuss how our securities laws may be updated to protect investors. I have spent my career addressing the topics you are considering, currently as Special Counsel with Mayer Brown LLP, Emeritus Professor at The George Washington University, and Founding Partner of Quality Shareholders Group.[1] I will introduce my testimony by providing a historical arc of the investing and governance landscape over the past few decades, offer perspectives on three critical topics, then conclude with forward looking thoughts about the form your bills might take.

1. Introduction

For three decades, I have been a corporate and securities lawyer, business law professor, and champion of America's quality shareholders—those with long holding periods and high concentration levels. Throughout those years, I have engaged deeply in the fields of investing, corporate governance, and securities regulation, having written extensively on all these subjects in both academic and popular forums.[2]

When I began my career in the late 1980s and early 1990s, the landscape looked quite different than it does today. Back then:

- individual investors were the primary owners of publicly-traded stock, though institutional investors were gaining ground as intermediaries;
- investors and securities analysts focused on, and researched, company fundamentals, though index funds had begun to emerge to skip that step and just buy all stocks in a market grouping, such as the Standard & Poor's 500 (the "S&P 500");
- asset managers prioritized financial returns for beneficiaries and customers and voted shares accordingly, often deferring to a company's fiduciary board;
- the proxy advisor industry was inchoate, comprised of thought leaders and corporate governance gurus but exerting limited influence; and
- the protection of shareholder voting and voice prioritized the economic interests of investors, though special interest groups sometimes asserted themselves, including through the federal shareholder proposal rule.[3]

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[1] These comments and views are mine, not necessarily those of Mayer Brown LLP nor attributable to any of its clients or any organizations with which I am associated.

[2] My curriculum vitae is available here.

[3] *See Roosevelt v. E.I. Du Pont de Nemours & Co*., 958 F.2d 416 (D.C. Cir.1992) (Ginsberg, J.) (permitting company to exclude shareholder proposal by environmental group regarding phasing out production of chlorofluorocarbons); *Lovenheim v. Iroquois Brands, Ltd*., 618 F. Supp. 554 (D.D.C. 1985) (requiring company to

Today:

- individual investors now mostly own stocks through intermediary institutions, which now hold approximately 70% of public equity and wield great power;
- among institutions, a large percentage practice index investing rather than selecting individual companies, dispensing with company-specific investment research;
- when voting shares, indexers often use one-size-fits-all formulas or engage proxy advisor firms, private for-profit companies, the largest of which are owned by private equity firms and Deutsche Börse AG, and now wield great influence but operate under scant U.S. government oversight or market competition and owe no fiduciary duties to shareholders;
- federal authorities adjusted to the rise of index funds and proxy advisors by allowing funds to fulfill their fiduciary duty by engaging advisors for voting recommendations, but periodic efforts to enhance much needed oversight for proxy advisors have been stymied; and
- taking advantage of these changes in the landscape, a small but vocal cohort of individuals and special interest groups have seized the corporate machinery for parochial ends, eroding the economic interests of investors.

When times change so much, our securities laws, which are 90 years old and written in sometimes-vague language, need updating; the Securities and Exchange Commission (the "SEC"), a vital agency Congress has charged with administering those laws, needs Congressional guidance. The legislation under consideration responds to these needs and appears well-intended to correct serious problems, generally restoring federal protection of investors' economic interests. More specifically, the effort would reorient the shareholder proposal process to prevent its seizure by special interests, reset the voting practices of index funds to promote investors' economic interests, and provide oversight of proxy advisors to assure that they act in the best economic interests of investors. Each topic is addressed in turn.

2. Shareholder Proposal Rule[4]

Almost all public companies are business organizations chartered under state laws that permit companies wide leeway in organizing their internal affairs, meaning relations among boards of directors, executive officers, and shareholders.[5] Companies structure such corporate

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include shareholder proposal by individual owner of 200 shares regarding procedure used to force-feed geese to make *paté de foie gras* the company sold).

The landscape of previous decades (1940s to early 1980s) was similar, including few shareholder proposals, *see* Susan W. Liebeler, *A Proposal to Rescind the Shareholder Proposal Rule*, 18 GA. L. REV. 425 (1984), with the dramatic exception of *Medical Comm. for Human Rights v. SEC*, 432 F.2d 659 (D.C. Cir. 1970) (requiring company to include shareholder proposal by human rights group regarding its production of napalm for use in Vietnam conflict).

[4] For my recent published views on this topic, see Lawrence A. Cunningham, *Dump Buffett as Berkshire's Chairman? That's Exactly What's Wrong with So Many Shareholder Proposals*, MARKETWATCH (April 2021); Lawrence A. Cunningham, Activist *Disclosure Proposal Runs Counter to SEC Mission*, LAW360 (Feb. 2022); Lawrence A. Cunningham, *As Shareholder Proposals Proliferate, Boards Might Consider this Framework to Evaluate Voting Results*, CORP. GOV. ADVISOR (July 2023).

[5] *See CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69 (1987); *VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108 (Del. 2005).

governance in accordance with state statutes through charters and bylaws in a practice called private ordering.[6]

Although corporation laws vary by state, they generally vest boards with plenary power, imposing on them fiduciary duties to act in the best interests of the company and its shareholders.[7] Those laws grant shareholders, who generally do not owe such fiduciary duties,[8] voting rights on a limited number of discrete topics such as director elections and most mergers.[9] Corporation law also give shareholders limited rights to make proposals, prohibiting those that impinge on director duties.[10] For instance, shareholder proposals may not mandate any action and are only considered "proper" when advisory (or "precatory").[11]

Federal securities law is a distinct body of law designed to promote fair and efficient capital markets and protect investors, largely through a mandatory disclosure system applied to companies, along with substantive regulation of investment advisers and other capital market participants.[12] The scope of disclosure is defined by the overarching principle of materiality, meaning information reasonable investors would consider important in making investment or voting decisions.[13] In certain areas, federal securities regulation overlays state corporation law, including for disclosures related to shareholder meetings, which are conducted almost entirely through written proxy materials and remote voting.[14]

Those proxy rules and other federal laws applicable to public companies respect state corporation law prerogatives and internal corporate governance arrangements.[15] The SEC's statutory authority is accordingly limited by a boundary between substantive corporate governance, which belongs to states, and disclosure, the principal province of federal securities law.[16]

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[6] *See Elf Atochem North America, Inc. v. Jaffari and Malek LLC*, 727 A.2d 286 (Del. 1999) (Veasey, C.J.).

[7] *E.g.*, MODEL BUS. CORP. ACT § 8.01(b) (2023); 8 DEL. C. § 141(a) (2023); *see Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

[8] Exceptions, which are not relevant to this discussion of shareholder proposals, are for majority or controlling shareholders, *Sinclair Oil Corp. v. Levien* (Del. 1971) and, in some states, minority shareholders in closely held corporations, *Donahue v. Rodd Electrotype Co*., 328 N.E.2d 505 (Mass. 1975).

[9] *E.g.*, *Hariton v. Arco Electronics, Inc*., 188 A.2d 123 (Del. 1963); *Paramount Communications, Inc. v. Time Inc*., 571 A.2d 1140 (Del. 1990); *see* Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601 (2006); Emiliano M. Catan & Marcel Kahan, *The Never-Ending Quest for Shareholder Rights: Special Meetings and Written Consent*, 99 B.U. L. REV. 743 (2019).

[10] *See Campbell v. Loew's, Inc*., 134 A.2d 852 (Del. Ch. 1957); *State ex rel. Pillsbury v. Honeywell, Inc*., 191 N.W.2d 406 (Minn. 1971); *Grimes v. Donald*, 673 A.2d 1207 (Del. 1996).

[11] *Auer v. Dressel*, 118 N.E.2d 590 (N.Y. 1954). Proposals to amend a company's bylaws or charter are proper subjects for shareholders. *See* Matthew F. Sullivan, *Shareholder Bylaw Proposals, Delaware Certification, and the SEC After CA, Inc. v. AFSCME Employees Pension Plan*, 87 U. DET. MERCY L. REV. 193 (2010).

[12] The statutes that created the SEC in the 1930s authorize the SEC to promulgate disclosure regulations that are "necessary or appropriate in the public interest or for the protection of investors." Securities Act of 1933, 15 U.S.C. 77a *et seq*., §§ 7, 10, 19(a); Securities Exchange Act of 1934, 15 U.S.C. 78a *et seq*., §§ 3(b), 12, 13, 14, 15(d), 23(a).

[13] *TSC Industries v. Northway, Inc*., 426 U.S. 438, 449 (1976); *see Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

[14] *See Amalgamated Clothing & Textile Workers Union v. Wal–Mart Stores, Inc*., 821 F. Supp. 877, 881 (S.D.N.Y. 1993) (proxy voting has "become an indispensable part of corporate governance because the 'realities of modern corporate life have all but gutted the myth that shareholders in large publicly held companies personally attend annual meetings.'") (quoting *Stroud v. Grace*, 606 A.2d 75, 86 (Del. 1992)).

[15] *See Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 479 (1977) ("Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations . . . , particularly where established state policies of corporate regulation would be overridden").

Within that legal framework, both state corporation law and federal securities law recognize that shareholder voice and voting rights are central to corporate governance, enabling owners to weigh in to protect their economic interests.[17] Some matters are momentous, such as those upon which state law requires shareholder votes, from dilutive stock issuances to contested director elections.[18] Management makes other important proposals as well, from seeking shareholder opinion on various corporate policies to approving external auditors.[19]

Proposals submitted by shareholders, however, run the gamut from important governance policies, such as majority voting in director elections or declassifying boards,[20] to contentious social debates.[21] Shareholder proposals can be made by company-focused shareholders, such as those who hold large stakes for long periods; by short-term holders or fully-diversified ones; and even by nominal shareholders who use corporate machinery to pursue their own ends.[22] While corporate machinery has long attracted special interest groups to use modest share ownership to push social agendas, state corporation law and federal securities regulation have historically limited the efficacy of doing so.[23]

For decades, the SEC's shareholder proposal rule ("Rule 14a-8" under the Securities Exchange Act of 1934)[24] has been used to channel shareholder proposals to align with state corporation laws that vest corporate authority in the board and to filter out those that are illegal, irrelevant, illegitimate, or otherwise inappropriate.[25] First, Rule 14a-8 limits eligibility based on

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[16] *See Business Roundtable v. SEC*, 905 F.2d 406, 410 (D.C. Cir. 1990) (SEC lacks authority to promulgate rule of corporate governance concerning shareholder voting rights as that is the province of state law whereas Congress intended SEC regulations to bear "almost exclusively on disclosure").

[17] A venerable academic literature debates the legitimate scope of SEC regulations on shareholder proposals, from strictly disclosure-oriented to protecting shareholder voting rights as well. *E.g.*, Frank D. Emerson & Franklin C. Latcham, *The SEC Proxy Proposal Rule: The Corporate Gadfly*, 19 U. CHI. L. REV. 807 (1952); David C. Bayne, *The Basic Rationale of Proper Subject*, 34 U. DET. L.J. 575 (1957); Donald E. Schwartz & Elliott J. Weiss, *An Assessment of the SEC Shareholder Proposal Rule*, 65 GEO. L. J. 635 (1977); George W. Dent, Jr., *SEC Rule 14a-8: A Study in Regulatory Failure*, 30 N.Y.L. SCH. L. REV. 1 (1985); Jill E. Fisch, *From Legitimacy to Logic: Reconstructing Proxy Regulation*, 46 VAND. L. REV. 1129 (1993).

[18] *Coster v. UIP Companies*, C.A. No. 2018-044, ___ A.3d ____ (Del. June 2023)*; Blasius Industries, Inc. v. Atlas Corp*., 564 A.2d 651 (Del. Ch. 1988).

[19] *See* Jagan Krishnan & Zhongxia Ye, *Why Some Companies Seek Shareholder Ratification on Auditor Selection*, 19 ACCOUNTING HORIZONS 237 (2005).

[20] *See* Kosmas Papadopoulos, *The Long View: The Role of Shareholder Proposals in Shaping U.S. Corporate Governance (2000-2018)*, HARV. L. FORUM CORP. GOV. (Feb. 6, 2019).

[21] *See Trinity Wall Street v. Wal-Mart Stories, Inc*, 792 F.3d 323 (3d Cir. 2015) (permitting company to exclude shareholder proposal made by a religious organization prescribing merchandising policy encompassing restrictions on the sale of dangerous products such as guns); Alexis Keenan, *Most Investors Don't Want to Know More About Abortion Risk Companies Face*, YAHOO! FIN. (June 10, 2023) (reporting that abortion activists filed shareholder proposals at 30 companies in 2023, none of which received much support).

[22] *See* John G. Matsusaka *et. al*., *Opportunistic Proposals by Union Shareholders*, 32 REV. FIN. STUDS. 3215 (2019); Luc Renneboog & Peter G. Szilagyi, *The Role of Shareholder Proposals in Corporate Governance*, 17 J. CORP. FIN. 167 (2011).

[23] *See* Sarah C. Haan, *Civil Rights and Shareholder Activism: SEC v. Medical Committee for Human Rights*, 76 WASH. & LEE L. REV. 1167 (2019); *see also* Harwell Wells, *A Long View of Shareholder Power: From the Antebellum Corporation to the Twenty-First Century*, 67 FLA. L. REV. 1033 (2015); Roberta Romano, *Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. REG. 174 (2001).

[24] 17 CFR § 240.14a-8.

the proposing shareholder's minimum share ownership value and ownership duration.[26] Second, Rule 14a-8 lists reasons companies can exclude a proposal, such as if it is not a proper subject for shareholder proposals under applicable state corporation law or is irrelevant in relation to the company's size and business.[27]

Over the years, with changing socioeconomic settings, amid new regimes of regulatory leadership, these rules have been permitted to be interpreted in numerous ways.[28] Accordingly, the number and type of shareholder proposals has varied, both by kind of shareholder and kind of proposal.[29] Currently, the eligibility levels are set relatively low, which fails to screen out many proposals.[30]

On proposal topics, the pendulum has recently swung sharply towards social, political and environmental subjects, a swing accelerated by an SEC staff decision to require companies to include those the staff deems "significant," even if they have little or nothing to do with the company or its business and would not be material to investors.[31] Individuals and groups have used this change to pursue ends increasingly unrelated to corporate business.[32] Many proponents acknowledge as much, stressing that they buy minimal stakes in big companies to advance their missions regardless of the effects on a company's performance or shareholder value—an approach largely denounced[33] but sometimes encouraged.[34]

Data reflect the change: in the year before the SEC staff's reversal, the staff agreed with company requests to exclude proposals under the related Rule 14a-8 exclusion 40% of the time, but the next year that figure dropped to 23%.[35] The SEC staff's new approach correlates with increases in shareholder proposal submissions and ensuing votes.[36] The number of proposals

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[25] *See*, *e.g.*, John G. Matsusaka, Oguzhan Ozbas & Irene Yi, *Can Shareholder Proposals Hurt Shareholders? Evidence from Securities and Exchange Commission No-Action Letter Decisions*, 64 J. L. & ECON. 107, 125–26 (2021) (finding statistically significant positive returns associated with SEC's agreement to exclude shareholder proposal, supporting view that the SEC filters out proposals with negative value).

[26] 17 C.F.R. § 240.14a-8(b)(1).

[27] 17 C.F.R. § 240.14a-8(i)(1), (5), (10).

[28] *See* THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION, § 190:27 (2023).

[29] *See* James D. Cox & Randall S. Thomas, *The SEC's Shareholder Proposal Rule: Creating a Corporate Public Square*, 2021 COLUM. BUS. L. REV. 1147; A. A. Sommer, Jr., *Corporate Governance in the Nineties: Managers vs. Institutions*, 59 U. CIN L. REV. 357 (1990).

[30] Currently at least: $2,000 for three years, $15,000 for two years, or $25,000 for one year. 17 C.F.R. § 240.14a-8(b)(1).

[31] SEC Staff Legal Bulletin No. 14L (CF), U.S. SEC. & EXCH. COMM'N (Nov. 3, 2021). A pending lawsuit challenges whether the SEC and staff are acting impartially in opining upon what constitutes "significant" social matters. *See Nat'l Center for Public Policy Research v. SEC* (5th Cir. Case No. 23-60230, filed Apr. 28, 2023).

[32] *See* Jeff Green & Saijel Kishan*, Guns, Abortion and Race Heat Up Company Annual Meetings*, L.A. TIMES (June 8, 2022).

[33] *E.g.,* John H. Matheson & Vilena Nicolet, *Shareholder Democracy and Special Interest Governance*, 103 MINN. L. REV. 1649 (2019).

[34] *See* Lisa M. Fairfax, *Social Activism through Shareholder Activism*, 76 WASH. & LEE L. REV. 1129 (2019); DAVID WEBBER, THE RISE OF THE WORKING CLASS-SHAREHOLDER: LABOR'S LAST BEST WEAPON 45-151 (2018).

[35] Mark T. Uyeda, *Remarks at the Society for Corporate Governance 2023 National Conference*, U.S. SEC. & EXCH. COMM'N (June 21, 2013) (SEC Commissioner reporting based on SEC data).

[36] *See*, *e.g.*, James Nani & Lydia Beyoud, S*hareholders Up Climate, Social Demands After SEC Policy Shift*, BLOOMBERG L. (Apr. 4, 2022); Paul Verney, *SEC Allows Firms to Block Just 15% of E&S Proposals this Year*,

submitted to companies in 2023 increased 18% over 2021, rising to almost 1000, while the portion put to a vote increased 40%, exceeding 600 this year.[37] Social and environmental topics led the increases, up 52% in submissions and 125% in those put to a vote.[38]

Not coincidentally, support for shareholder proposals has declined sharply in the past two years, after rising for several years before that.[39] Comparing 2021 to 2023 among all proposals, the average percentage of shares voting in favor fell from 36% to 24% and the portion of proposals attracting majority support dove from 19% to 5%.[40] For social and environmental proposals, the average percentage of shares voting in favor dropped from 37% to 20% and the portion attracting a majority plummeted from 23% to 3%.[41]

Declining support is unsurprising, since proposals are increasingly unfocused on shareholder value, address topics not material to shareholders, and risk decreasing value as they distract managerial attention from running the business. The fading enthusiasm was probably reinforced by officials from many states who drew attention to the costs of special interest proposals, including by withdrawing investment funds from asset managers who supported the special interests.[42]

Despite such victories for investors, companies incur enormous expense, directly and indirectly, administering special interest proposals.[43]Although all shareholders pay the price, current practice permits a small number of proponents to dominate and game the system. One data point reveals the defects: this past proxy season, more than half of all proposals were submitted by just five parties.[44]

These special interest proponents have many legitimate routes to pursue their favored aims—from election campaigns and town halls to traditional advertising and social media and, for investment funds, divestment or screens—without impairing the interests or rights of others.[45]

RESPONSIBLE INVESTOR (Apr. 12, 2022); Suzanne McGee, *Shareholders Push an Array of ESG Proposals*, WALL ST. J. (Apr. 28, 2022).

[37] Uyeda, *supra*.

[38] *Id*.

[39] Kate Hilder, Mark Standen & Siobhan Doherty, *Institutional Investors Have Changed Their Tune on Supporting ESG Shareholder Proposals*, MINTER ELLISON (May 26, 2021); Jackie Cook, *How Fund Families Support ESG-Related Shareholder Proposals*, MORNINGSTAR (Feb. 12, 2020).

[40] Uyeda, *supra*.

[41] *Id*.

[42] *See* Stefan J. Padfield, *An Introduction to Anti-ESG Legislation*, 2023 TRANSACTIONS 292.

[43] The SEC estimates direct company costs per proposal is $150,000, plus untold managerial opportunity costs. Uyeda, *supra*. Hidden from view, social proposals commonly ask for reports, the publication of which creates more pressure and further costs for follow up as well as lawsuits—but not necessarily any actions to redress the challenged behavior. The upshot is a system of pressure, publicity, and litigation for moot ends all subsidized by America's investors.

[44] Uyeda, *supra* (based on data from Proxy Analytics LLC). In 2022, 10 proponents accounted for more than 60% of all proposals. *See* Sullivan & Cromwell LLP, *2022 Proxy Season Review: Part 1* (Aug. 8, 2022). The problem of a few proponents dominating the process dates back many years and is now acute. *See* Kobi Kastiel & Yaron Nili*, The Giant Shadow of Corporate Gadflies*, 94 USC L. REV. 569 (2021) (in 2018, five individuals accounted for nearly 40% of shareholder proposals submitted); *Comment Letter from Society for Governance to the SEC*, SEC File No. S7-20-22 (Sept. 13, 2022) ("For many years, approximately two-thirds of Rule 14a-8 proposals each year have come from less than a dozen proponents.").

[45] *See* Omari Scott Simmons, *Chancery's Greatest Decision: Historical Insights on Civil Rights and the Future of Shareholder Activism*, 76 WASH. & LEE L. REV. 1259 (2019).

But using Rule 14-8 for such ends impinges upon the interests and rights of targeted companies and their shareholders. Companies are expressing this concern, with directors opining that supporting these proposals would violate the fiduciary duties of company directors and officers as well as of asset managers.

Moreover, while proposals are presented as precatory, as state law requires, associated publicity can—and often does—skew board decisions in ways that are not in the best interests of a company or its shareholders.[46] Indeed, even nominally precatory proposals can become functionally binding because large index funds and powerful proxy advisors (discussed further below) announce that they will vote against directors whose boards do not implement them.[47] In this way, special interest groups leverage the corporate balloting process to amplify their power.

A final concern is that the foregoing statistics are only the visible part of the problem, as they count only those shareholder proposals that went to a vote. Many proposals are made and implemented without getting to a vote.[48] Facing rising pressure from misuse of the shareholder proposal process, more companies have been willing to negotiate settlements to get these proposals off the ballot. Through that backdoor route, the current state of the shareholder proposal rule is exerting a significant, if clandestine and unintended, influence on America.

The ability of a few parties to hijack the shareholder proposal process for their own purposes, imposing costs on public companies and other shareholders, underscores that the federal shareholder proposal Rule 14a-8 needs updating. Many repairs are possible, including heightening eligibility requirements or strengthening grounds for exclusion. This would include repealing the SEC staff's mandate requiring inclusion of social proposals as well as tightening rules concerning submission of repeat, duplicative or moot proposals.[49]

3. Index Fund Voting[50]

Public company share ownership today is dominated by institutions that hold stock on behalf of individuals, rather than by individuals themselves.[51] Most institutions, in turn, follow the modern practice of indexing rather than the traditional mode of stock picking. Indexers buy all stocks in a fully diversified market grouping, such as the S&P 500. They do not select stocks and therefore conduct little or no research on any company. This saves enormous costs while delivering individual fund clients the market return.

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[46] *See* Nickolay Gantchev & Mariassunta Giannetti, *The Costs and Benefits of Shareholder Democracy: Gadflies and Low-Cost Activism*, 34 REV. FIN. STUD. 5629 (2020) (finding that proposals by special interest proponents destroy corporate value if they pass).

[47] *See* Vanguard's Approach to Board Responsiveness (June 2023) ("When a board fails to respond to a proposal supported by a majority of its voting shareholders and the Vanguard-advised funds supported the proposal, the funds will generally vote against relevant members of the board); INSTITUTIONAL SHAREHOLDER SERVICES, U.S. PROXY VOTING GUIDELINES BENCHMARK POLICY RECOMMENDATIONS 12 (Nov. 19, 2020).

[48] *See* Rob Bauer *et a*l., *Who Withdraws Shareholder Proposals and Does It Matter? An Analysis of Sponsor Identity and Pay Practices*, 23 CORP. GOV. 472 (2015).

[49] The SEC has a pending rule proposal that would change the current levels of voting support a failed proposal would require to avoid being precluded in subsequent years.

[50] For my recent published views on this topic, see Lawrence A. Cunningham, *Why Mutual Fund Giants are Quietly Giving Voting Power Back to Individual Shareholders*, MARKETWATCH (Feb. 2022).

[51] *See* Amil Dasgupta, Vyacheslav Fos & Zacharias Sautner, *Institutional Investors and Corporate Governance*, 12 FOUNDATIONS & TRENDS CORP. FIN. 276 (2021).

So attractive is this method of managing other people's money that the volume of index funds has skyrocketed: in 1997, less than 8% of mutual funds were indexed, whereas today more than 40% are. Ingenious though it is, there is one gaping problem: in order to deliver the market return, the index fund business model must keep costs low, but the fund holds a huge number of shares carrying the right to vote at shareholder meetings.[52] Yet, despite conducting little or no investment research, the index fund industry still must determine how to vote.

For several years, many index funds resolved this problem by often voting in accordance with the board's recommendations, at least on topics not raising the specter of differing interests.[53] That solution was rational and consistent with the funds' fiduciary duties to individual clients to the extent that the directors on whom they would rely owe state law fiduciary duties to their companies and shareholders.

More recently, however, large index funds began promulgating guidelines espousing general views on topics such as director independence, board leadership, and shareholder rights—a practice leading to a one-size-fits-all formula that does not suit every company and often repudiates the flexibility state corporation law offers.[54] Smaller funds, which could not even afford such a formulaic effort, began to outsource the task by paying an external proxy advisor for voting recommendations and/or automatically voting with such recommendations, which likewise lean towards one-size-fits-all formulas. (The proxy advisor industry is discussed in the next section.)

Of late, in the era of proliferating social shareholder proposals, larger index funds have had to expand their voting guidelines to address a wide variety of social matters.[55] They now opine on everything from carbon emissions to workforce diversity and even argue that public company CEOs must speak publicly on pending political debates.[56] Yet the funds do not provide any evidence about the economic effects of their voting guidelines or decisions, nor do they consider the perils to companies resulting from such political involvement, while the empirical literature casts considerable doubt on whether such activities increase shareholder value.[57]

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[52] Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2020 (2019).

[53] *See* Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares*, 23 CARDOZO L. REV. 1419 (2002).

[54] Lawrence A. Cunningham, *Who Are Quality Shareholders and Why You Should Care*, 48 DEL. J. CORP. L. 1419, 1430-35 (2023).

[55] *See* Sandy Boss, *Investment Stewardship Proxy Voting U.S. Guidelines 2023*, HARV. L. FORUM CORP. GOV. (Jan. 18, 2023); Michal Barzuza, Quinn Curtis & David H. Webber, *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, 93 USC L. REV. 1243, 1244 (2020) ("With fee competition exhausted and returns irrelevant for index investors, signaling a commitment to social issues is one of the few dimensions on which index funds can differentiate themselves and avoid commoditization.").

[56] Larry Fink, *The Power of Capitalism*, BLACKROCK (2002); *see* Patrick Bolton *et al*., *Investor Ideology*, 137 J. FIN. ECON. 320 (2020).

[57] *See* Ulrich Atz, *et al., Does Sustainability Generate Better Financial Performance*? 13 J. SUSTAINABLE FIN. INV. 802 (2023) (meta review of ~1400 empirical studies 2015-2020 finding "the financial performance of ESG investing has on average been indistinguishable from conventional investing"); Rajna Gibson *et al*., *Do Responsible Investors Invest Responsibly*?, 6 REV. FIN. 1389 (2022) (U.S. firms that signed the United Nations' "Principles of Responsible Investing" do not on average receive higher ESG ratings and some receive worse); Aneesh Raghunandan & Shiva Rajgopal, *Do ESG Funds Make Stakeholder-Friendly Investments*?, 27 REV. ACCT. STUDS. 822 (2022) (mutual funds labeling themselves ESG invest in companies with worse records on compliance with labor and environmental laws); Samuel M. Hartzmark & Abigail B. Sussman, *Do Investors Value Sustainability*?, 74 J. FIN. 2789 (2019) ("evidence does not show that high-sustainability funds outperform low-sustainability funds").

The upshot has been public dissatisfaction with the voting of shares by index funds.[58] A startling op-ed by the index industry's legendary founder, John Bogle, shortly before his death warned of grave dangers for the country of the increasing concentration of power in the index fund industry.[59]

Index funds are struggling to adapt. The larger ones are seeking new ways to pass the vote back to their customers.[60] But such efforts are costly, undercut the business model, prohibitively so for smaller funds, may be difficult to administer, and cannot be relied upon. Proposals to help include returning to voting per the board's recommendation or providing an economic rationale when voting against a board's recommendation among others. Urgent Congressional action is needed.

4. Proxy Advisors[61]

The proxy advisor industry grew out of the 1980's shareholder rights movement.[62] Index funds, without the resources to conduct their own research, frequently turned to proxy advisors for voting recommendations. The solution was endorsed by the SEC in the early 2000s when it authorized index funds to meet their fiduciary duties to individual clients by relying on such proxy advisors, so long as certain conditions were met, including assurance that the proxy advisors' maintained sufficient systems to avoid conflicts of interest.[63]

The proxy advisor industry's influence has multiplied in tandem with index fund sector growth.[64] The power is amplified by the industry's limited competition: the two largest proxy advisor firms together command an estimated 97% market share.[65] Both such firms are for-profit businesses owned by private equity firms, one also majority-owned by a German company and the other until recently by two Canadian entities.

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[58] *See* Paul G. Mahoney & Julia D. Mahoney, *The New Separation of Ownership and Control: Institutional Investors and ESG*, 2021 COLUM. BUS. L. REV. 840; Sean Griffith & Dorothy Lund, *Conflicted Mutual Fund Voting in Corporate Law*, 99 B.U. L. REV. 1151 (2019); Bernard S. Sharfman, *Opportunism in the Shareholder Voting of the "Big Three" Investment Advisers to Index Funds*, 48 J. CORP. L. 1 (2022).

[59] *See* John C. Bogle, *Bogle Sounds a Warning on Index Funds*, WALL ST. J. (Nov. 29, 2018) ("Public policy cannot ignore this growing dominance, and consider its impact on the financial markets, corporate governance, and regulation"); *see also* Orla McCaffrey, *Charlie Munger Expects Index Funds to Change the World—and Not in a Good Way*, WALL ST. J. (Feb. 16, 2022) ("Warren Buffett's business partner says passive funds . . . wield too much power").

[60] *See* Vanguard, *Empowering Everyday Investors Through Proxy Voting Choice* (Feb. 1, 2023).

[61] For my recent published views on this topic, see Lawrence A. Cunningham, *SEC Mulls a Step Backward on Corporate-Governance Oversight*, NAT'L REV. (June 2022); Lawrence A. Cunningham, *Gensler Should Keep Clayton's Pragmatic Proxy Adviser Rules*, PENSIONS & INVESTMENTS (Feb. 2021).

[62] For example, Washington Analytics (now part of today's large proxy advisor, Glass Lewis) was founded in 1973 and Institutional Shareholder Services (today's other large proxy advisor) dates to 1985.

[63] *See Proxy Voting by Investment Advisers*, 68 FED. REG. 6585 (Jan. 31, 2003) (Final Rule) (codified in various sections of 17 C.F.R. Part 275); Inst. S'holder Servs., Inc., *SEC Staff No-Action Letter*, 2004 WL 2093360 (Sept. 15, 2004).

[64] *See* James R. Copland, David F. Larcker & Brian Tayan, *The Big Thumb on the Scale: An Overview of the Proxy Advisory Industry*, STAN. U. CLOSER LOOK SERIES (2018); Cindy R. Alexander *et al*., *Interim News and the Role of Proxy Voting Advice*, 23 REV. FIN. STUDS. 4419 (2010); Peter Iliev & Michelle Lowry, *Are Mutual Funds Active Voters?* 28 REV. FIN. STUDS. 446 (2015); Nadya Malenko & Yao Shen, *The Role of Proxy Advisor Firms: Evidence from a Regression-Discontinuity Design*, 29 REV. FIN. STUDS. 3394 (2016).

[65] Paul Rose, *Proxy Advisors and Market Power: A Review of Institutional Investor Robovoting*, HARV. L. FORUM CORP. GOV. (May 27, 2021).

This power is evident in how proxy advisor recommendations increasingly drive significant swings in many shareholder voting results.[66] Institutional investors are substantially more inclined to vote for proposals that advisors support than oppose—by margins of 64%-73% on directors in contested elections.[67]

The power grows as the number and reach of shareholder proposals expands, giving the advisors incentives to support such expansions.[68] Empirical evidence suggests that the upshot is corporate boards making choices that reduce shareholder value.[69] Additional evidence of the inordinate influence and dangers: many index funds now blindly rely upon proxy advisor recommendations—a dubious practice referred to as robovoting.[70]

Proxy advisor firms disclose little information about themselves, their operations or methods, other businesses they run or conflicts of interest, or rationales for their recommendations. What is known is that proxy advisors are not stockholders of the companies they make recommendations for or about, so they lack the "skin in the game" that shareholders maintain.[71] Neither state corporate law nor federal securities laws impose on proxy advisor firms fiduciary duties to public company shareholders, despite being paid to make influential recommendations with direct effects on public company shareholders.[72]

Proxy advisors not only sell recommendations to index funds on how to vote but also sell advice to issuers about how to receive better recommendations, presenting conflicts of interest.[73] However, the advisors furnish no details of such relationships to public company shareholders, making it difficult to assess the resulting conflicts of interest.[74]

While proxy advisors do not disclose details, the published information they do supply suggests that pricing power is limited by the economics of the index fund sector so budgets are tight and staffing is lean.[75] The firms rely heavily on automated technology, such as artificial intelligence, to scrape company websites for information. They use lengthy standardized

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[66] Copland, Larcker & Tayan*, supra.*

[67] *Id*.

[68] *See* Chester S. Spatt, *Proxy Advisory Firms, Governance, Market Failure and Regulation*, 10 REV. CORP. FIN. STUDS. 136 (2021); Andrey Melenko, *Creating Controversy in Proxy Voting Advice*, NBER WORKING PAPER 29036 (2021). While observers have long reported proxy advisor power to swing votes, *see* Robert D. Hershey Jr., *A Little Industry with a Lot of Sway on Proxy Votes*, N.Y. TIMES (June 18, 2006), and some said the influence was overstated, *see* Stephen Choi *et al., The Power of Proxy Advisors: Myth or Reality*?, 59 EMORY L.J. 869 (2010), the power inexorably intensifies as shareholder proposals expand in number and reach and incumbent advisors grow more ensconced.

[69] David F. Larcker *et al*., *Outsourcing Shareholder Voting to Proxy Firms*, 58 J. L. ECON. 173 (2015).

[70] *See* Paul Rose, *Robovoting and Proxy Vote Disclosure*, HARV. L. FORUM CORP. GOV. (Nov. 25, 2019); Timothy F. Doyle, *The Realities of Robo-Voting*, AM. COUNCIL ON CAPITAL FORMATION (2018).

[71] *See* Asaf Eckstein, *Skin in the Game for Credit Rating Agencies and Proxy Advisors: Reality Meets Theory*, 7 HARV. BUS. REV. 221 (2017) (making a cautious case in favor of requiring it).

[72] *See* Bernard S. Sharfman, *Now Is the Time to Designate Proxy Advisors as Fiduciaries under ERISA*, 25 STAN. J. L. BUS. FIN. 1 (2020). Proxy advisors may or may not also be registered under the Investment Advisers Act, 15 U.S.C. § 80b-1 *et seq*., which imposes fiduciary duties to adviser clients.

[73] Inst. S'holder Servs., Inc., *SEC Staff No-Action Letter*, 2004 WL 2093360 (Sept. 15, 2004).

[74] *See* Tao Li, *Outsourcing Corporate Governance: Conflicts of Interest Within the Proxy Advisory Industry*, 64 MGMT. SCI. 2473 (2018).

[75] *See* Bernard S. Sharfman, *Enhancing the Value of Voting Recommendations*, 87 TENN. L. REV. 691 (2020).

questionnaires for thousands of diverse companies and otherwise follow the large index funds in promulgating formulaic one-size-fits-all recommendations that do not suit every company.[76]

All these factors—absence of competition, fiduciary duty, regulation, budgets and formulas—results not only in recommendations contrary to investors' economic interest but to frequent and substantial mistakes. [77] The Society of Corporate Governance (the "Society"), the professional association of public company counsel and corporate governance professionals, has collated the proxy advisors' errors for more than a decade.

In 2010, for instance, the Society reported survey data of member companies that 65% of respondents said their companies had received a proxy advisor vote recommendation that was based on materially inaccurate or incomplete information.[78] The Society's senior leaders testified about such errors on several occasions, including in 2013 before this Committee and in 2018 before the Senate Banking Committee.[79] In 2018 and 2020 the Society filed comment letters detailing proxy advisor errors.[80]

In its 2020 letter, the Society listed 36 examples of research errors and material omissions it identified based on a survey completed by 134 of its public company members. The survey asked: "Are you aware of any factual errors, omissions of material facts, or errors in analysis in your proxy advisor recommendations with respect to your company in the past three years?" Fifty-six corporate members, or 42% of respondents, answered yes, and most gave specific examples.[81]

Notwithstanding such opacity, power, conflicts, and errors, both Congress and the SEC have been unsuccessful in their intermittent oversight efforts dating to at least 2010 to mitigate these problems.[82] In 2010, SEC Chair Mary Schapiro lamented that:

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[76] *See* Doron Levi & Anton Tsoy, *A Theory of One-Size-Fits-All Recommendations* (working paper 2020).

[77] *See* Kyle Isakower, *Proxy Woes: ACCF 2021 Proxy Season Analysis Shows Companies Still Reporting Errors at Similar Rate Despite Claims to the Contrary* (Dec. 15, 2021) (reporting study by the American Council on Capital Formation detailing errors in proxy advisor recommendations).

[78] *See Comment Letter from Society for Governance to the SEC*, SEC File No. S7-14-10 (Dec. 27, 2010).

[79] Darla C. Stuckey, Society of Corporate Governance Testimony, Examining the Market Power and Impact of Proxy Advisory Firms, U.S. House Financial Services, Subcommittee on Capital Markets (June 5, 2013); Darla C. Stuckey, Society of Corporate Governance Testimony, Corporate Governance Reform and Transparency Act of 2017 (115th Congress, 2017-18).

[80] *Comment Letter from Society for Governance to the SEC*, SEC File No. 4-725 (Nov, 9, 2018); *Comment Letter from Society for Governance to the SEC*, SEC File No. S7-22-19 (Feb. 3, 2020).

[81] To cull some categories for illustration:

Errors about Directors. Proxy advisors frequently make errors concerning company director nominees, sometimes with adverse consequences for their election and invariably reducing the number of votes they receive, including errors about current employment, number of outside boards, independence, committee memberships, retirement status, meeting attendance, and related-party transactions.

Errors about Compensation. Proxy advisors often make errors concerning executive compensation, which undoubtedly affects related shareholder voting results, including incorrect statements about benchmarking targets, errors describing and valuing equity compensation and performance-based restricted stock.

Errors about Voting and Proposals. Proxy advisors have made errors in stating the number of votes required to call a special meeting of shareholders, the number of votes required to pass shareholder resolutions on anti-takeover measures and in recommendations on shareholder proposals related to political activity and/or lobbying reporting.

Method Problems. Many of the proxy advisors' errors arise from relying upon outside sources, including inaccurate media stories, rather than on a company's proxy statement, audited financial statements or other formal reports issued by the company, including for GAAP data, shares outstanding, and business operations.

> Both companies and investors have raised concerns that proxy advisor[] firms may be subject to undisclosed conflicts of interest, may fail to conduct adequate research, or may base recommendations on erroneous or incomplete facts.[83]

In 2017, this House passed bipartisan legislation (on a 238-182 vote) led by Speaker Paul Ryan and Minority Leader Nancy Pelosi as H.R. 4015, the "Corporate Governance Reform and Transparency Act." It would have required proxy advisor firms to register with the SEC; have sufficient staff to support accurate voting recommendations; implement procedures allowing companies time to correct errors in voting recommendations before being released; and employ an ombudsman to address complaints about accuracy.[84]

In 2020, the SEC approved, after extensive public comment that included a public roundtable, a set of rules for proxy advisors tailored to address comments from them and their index fund clients, addressing if not solving issues of opacity, conflicts, and errors.[85] For example, the rules would have required proxy advisors to give companies access to proposed recommendations at or before the moment they were sent to customers and give them a way to read any company responses to the recommendations.[86] The rules also implicitly banned the practice of robovoting by instructing asset managers who engage proxy advisors also to consider any comments from companies responding to the recommendations.

In 2022, however, the SEC abruptly abandoned these rules in what participants and observers described as a whiplash or an about face.[87] To this day, proxy advisors issue recommendations without fact-checking them with the companies that are the subject of them. In explaining its turnabout, the SEC discounted the errors summarized above as not revealing "systemic inaccuracies in proxy voting advice" and diminished the significance of concerns about the proxy advisors' power, opacity, and conflicts.[88] Litigation is pending disputing the SEC's handling of this rulemaking.[89]

So, here we are, with a proxy advisor industry that has grown more rapidly and gained great power faster than legislative or regulatory action has been able to keep up with it. Yet thanks to the numerous efforts to provide oversight, a range of solutions is at hand and ready-made: register the proxy advisors with the SEC, require disclosure suitably adapted from that required of other similar organizations the SEC oversees, limit conflicts of interest and require related disclosure, compel disclosure of the economic rationale of recommendation for companies and their shareholders, require fact-checking of recommendations with companies, and otherwise assure that proxy advisors are acting in the best interests of the investors that Congress directed the SEC to protect. A further point: robovoting should be prohibited.

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[82] *See also* U.S. Government Accountability Office, *Corporate Shareholder Meetings: Issues Relating to Firms That Advise Institutional Investors on Proxy Voting*, GAO-07-765 (July 30, 2007).

[83] Chair Mary L. Schapiro, *Opening Statement at the SEC Open Meeting on Release No. 34-62495*, CONCEPT RELEASE ON THE U.S. PROXY SYSTEM, 114, 118 (July 2010).

[84] *See* H.R.4015, Corporate Governance Reform and Transparency Act of 2017 (115th Congress, 2017-18).

[85] *See Exemptions from the Proxy Rules for Proxy Voting Advice*, 85 FED. REG. 55082 (2020).

[86] *Id*., at 55112.

[87] *See* Hester Peirce, *U-Turn: Comments on Proxy Voting Advice* (Jul. 13, 2022).

[88] *See Proxy Voting Advice*, Exchange Act Release No. 34-95266 (Jul. 13, 2022).

[89] *See Nat'l Ass'n of Manufacturers v. SEC* (5th Cir. Case No. 22-51069, filed Jan. 20, 2023).

5. Conclusion

Securities markets and shareholder demographics have changed considerably over the past three decades and dramatically so in the past few years. While the SEC under successive administrations has tried to keep up, after such significant change given the age of our securities laws, there comes a time for Congressional action and guidance for the SEC. The time is now and your leadership is commendable to update federal securities laws to reflect these realities.

Principal areas of reform are refocusing the shareholder proposal rule on investors' economic interests, adopting a practical approach to index fund voting that aligns with the economic interests of ultimate fund beneficiaries, and enacting commonsense oversight of the proxy advisor industry to assure that it acts in the best economic interests of America's investors.

The corporate governance system, and Congress's and the SEC's role in supporting it, is critical to the protection of investors and has long served them and the country well. As the system has evolved, however, it has been hijacked by a small cohort of vocal special interest groups who have taken advantage of the rise of indexing investing and proxy advisors and seized upon Rule 14a-8 to advocate for favored causes. The regulatory framework has not caught up. That makes it a good time for Congress to legislative investor protection improvements.