

October 8, 2018

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

File Number 4-725

RE: Submission in advance of Staff Roundtable on the Proxy Process (Investment Advisers to Mutual Funds)

Submitted By: Bernard S. Sharfman\*

Dear Mr. Fields

This submission is in response to Chairman Clayton's July 30 press release announcing a staff roundtable on the proxy process and calling for submissions from interested parties. It refers in particular to two of the topics under consideration, Voting Process and Shareholder Proposals. Specifically, it requests the Securities and Exchange Commission ("SEC" or "Commission"), in whatever form it deems appropriate, to clarify that investment advisers to mutual funds must disclose, under the Proxy Vote Rule,<sup>1</sup> their policies and procedures:

- to avoid using their voting power at public companies opportunistically to obtain new business from activists such as public pension funds and investment funds associated with labor unions;
- to eliminate pressures to support the activism of its own shareholders at its portfolio companies; and
- to identify an actual link between support for a shareholder proposal under Rule 14a-8 and the enhancement of shareholder value before voting in favor of any such proposal.

## Introduction

According to the Release establishing the Proxy Voting Rule ("Release"),<sup>2</sup> an investment adviser "is a fiduciary that owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting."<sup>3</sup> This was the rationale behind the Proxy

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<sup>1</sup> 17 C.F.R. § 275.206(4)-6. The Proxy Voting Rule was promulgated under the Investment Advisers Act of 1940, 15 U.S.C. 80b-6.

<sup>2</sup> Proxy Voting by Investment Advisers, Investment Advisers Act Release No. IA-2106 (2003), <https://www.sec.gov/rules/final/ia-2106.htm>.

<sup>3</sup> *Id.*

Voting Rule requiring investment advisers, including mutual fund advisers, to create and disclose their proxy voting policies and procedures. However, the SEC and its staff have yet to clarify what these fiduciary duties mean for the largest mutual fund advisers now that they control an extraordinary amount of shareholder voting power at many of our largest public companies.<sup>4</sup> This phenomenon did not exist at the time the Proxy Voting Rule was implemented.<sup>5</sup>

This concentration of voting power creates significant value for an adviser if it can be traded for something that the adviser wants in return. For example, an adviser may use its voting power to support the activism of current and potential institutional clients in exchange for the ability to acquire more assets under management. Or, an adviser may use its voting power to support the activism of its own shareholders at the advisor's portfolio companies in exchange for those shareholders agreeing not to target the adviser itself for such activism. The result is that an adviser has not cast its delegated voting authority "*in a manner consistent with the best interest of its client*"<sup>6</sup> and has subrogated the "*client interests to its own*,"<sup>7</sup> a breach in its fiduciary duties to its mutual fund clients and its shareholders.

The Commission should provide clarification that mutual fund advisers must disclose, consistent with their fiduciary duties to act in the best interests of their mutual fund clients and their shareholders, how they will deal with these new conflicts in their voting policies. In addition, shareholder proposals are a prime area where this opportunistic use of an adviser's voting power may be in play. Therefore, the adviser's voting policy must also explain how voting on these proposals are linked to maximizing shareholder value.

Furthermore, the Commission should clarify that voting inconsistent with these new policies and procedures or omission of such policies and procedures will be considered a breach of the Proxy Voting Rule.<sup>8</sup> Such guidance should apply to any mutual fund adviser that is delegated voting authority. I urge the SEC to be diligent in enforcing breaches of the Proxy Voting Rule.

## Background

The Proxy Voting Rule requires mutual fund advisers, as registered investment advisers who have been delegated shareholder voting authority, to create and disclose their proxy **voting policies** and records:

If you are an investment adviser registered or required to be registered under section 203 of the Act ..., it is a fraudulent, deceptive, or manipulative act, practice or course of business within the meaning of section 206(4) of the Act ..., for you to exercise voting authority with respect to client securities, unless you:

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<sup>4</sup> Carmel Shenkar, Elke M. Heemskerk & Jan Fichtner, *The New Mandate Owners: Passive Asset Managers and the Decoupling of Corporate Ownership*, CPI ANTITRUST CHRON. 51 (Volume 3, June 2017), <https://www.competitionpolicyinternational.com/wp-content/uploads/2017/06/CPI-Shenkar-Heemskerk-Fichtner.pdf>. See also, Jan Fichtner, Eelke M. Heemskerk and Javier Garcia-Bernardo, *Hidden power of the Big Three? Passive index funds, re-concentration of corporate ownership, and new financial risk*, 19 BUS. & POL. 328.

<sup>5</sup> *Id.*

<sup>6</sup> Proxy Voting by Investment Advisers, Investment Advisers Act Release No. IA-2106.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

(a) Adopt and implement written policies and procedures that are reasonably designed to ensure that you vote client securities in the **best interest of clients**, which procedures must include how you address **material conflicts** that may arise between your interests and those of your clients;

(b) Disclose to clients how they may obtain information from you about how you voted with respect to their securities; and

(c) Describe to clients your proxy voting policies and procedures and, upon request, furnish a copy of the policies and procedures to the requesting client.<sup>9</sup>

This rule rests on two important premises. First, under the holding in *SEC v. Capital Gains Research Bureau, Inc.*,<sup>10</sup> the Investment Advisers Act of 1940 (Advisers Act) imposes a fiduciary duty on investment advisers, including mutual fund advisers.<sup>11</sup>

As stated in the Release, “Under the Advisers Act ... an adviser is a fiduciary that owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting.”<sup>12</sup> Moreover, “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.**”<sup>13</sup>

This fiduciary duty extends to the shareholders of mutual funds:

The investment adviser to a mutual fund is a fiduciary that owes the fund a duty of utmost good faith, and full and fair disclosure. This fiduciary duty extends to all functions undertaken on the fund's behalf, including the **voting of proxies** relating to the fund's portfolio securities. An investment adviser voting proxies on behalf of a fund, therefore, must do so in a manner consistent with the best interests of the fund and its shareholders.<sup>14</sup> (quotation marks omitted)

Second, the objective of this fiduciary duty is wealth maximization. According to the companion release, *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies*, “the amendments [regarding proxy voting disclosure] will provide better information to investors who wish to determine: ... whether their existing fund managers are

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<sup>9</sup> 17 C.F.R. § 275.206(4)-6.

<sup>10</sup> 375 U.S. 180 (1963).

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

<sup>12</sup> Proxy Voting by Investment Advisers, Investment Advisers Act Release No. IA-2106. This fiduciary approach was reaffirmed in Staff Legal Bulletin No. 20 (IM/CF) (June 30, 2014), <https://www.sec.gov/interps/legal/cfs1b20.htm> and in the recently released Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, <https://www.sec.gov/rules/proposed/2018/ia-4889.pdf>.

<sup>13</sup> Proxy Voting by Investment Advisers, Investment Advisers Act Release No. IA-2106.

<sup>14</sup> Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Investment Company Act Release No. 25922 (2003), <https://www.sec.gov/rules/final/33-8188.htm>.

*adequately maximizing the value of their shares.*”<sup>15</sup> This release also noted that “proxy voting decisions may play an important role in maximizing the value of a fund’s investments for its shareholders,” and can have “an enormous impact on the financial livelihood of millions of Americans.”<sup>16</sup> In sum, the requirement of shareholder wealth maximization does not stop with portfolio management, it also must be adhered to when a mutual fund adviser votes the shares it has been delegated.

This objective is also consistent with the premise that the overwhelming majority of investors, including retail investors, simply want to earn the highest risk adjusted financial return possible,<sup>17</sup> including when they vote or have votes cast by investment advisers. Moreover, I believe this desire to earn the highest risk adjusted financial return possible is also shared by the overwhelming number of socially motivated investors who align their investments based on their moral or social values,<sup>18</sup> even though they give up some risk-adjusted return in terms of portfolio diversification and may pay higher management fees for this customization. That is, these investors are willing to exclude certain stocks from their portfolios because they find them to be socially undesirable, but are still looking for the highest risk adjusted return possible given their investment constraints.

Finally, it must be noted that this objective is consistent with corporate law’s understanding of why shareholder voting adds value to corporate governance: “[w]hat legitimizes the stockholder vote as a decision-making mechanism is the premise that stockholders with economic ownership are expressing their collective view as to whether a particular course of action serves the corporate goal of stockholder wealth maximization.”<sup>19</sup>

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<sup>15</sup> *Id.* (Investment Advisers Act Release No. IA-2106 and Investment Company Act Release No. 25922 were published as companion pieces in the Federal Register. See 68 FED. REG. 6564 (February 7, 2003)).

<sup>16</sup> *Id.*

<sup>17</sup> Paul Brest, Ronald Gilson, and Mark Wolfson, *How Investors Can (and Can’t) Create Social Value*, STAN. SOC. INNOV. REV. (Dec. 8, 2016), [https://ssir.org/up\\_for\\_debate/article/how\\_investors\\_can\\_and\\_cant\\_create\\_social\\_value](https://ssir.org/up_for_debate/article/how_investors_can_and_cant_create_social_value); See also, George David Banks and Bernard Sharfman, *Standing Up for the Retail Investor*, Harvard Law School Forum on Corporate Governance and Financial Regulation (June 10, 2018), <https://corpgov.law.harvard.edu/2018/06/10/standing-up-for-the-retail-investor/>.

<sup>18</sup> According to Brest, Gilson, and Wolfson:

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

<sup>19</sup> *Kurz v. Holbrook*, 989 A.2d 140, 178 (Del. Ch. 2010) *aff’d* *Crown Emak Partners v. Kurz*, 992 A.2d 377 388-89 (Del. 2010) (*quoting* *Kurz* with approval).

## Types of Conflicts Identified in the Original Release and Enforcement Action

The Proxy Voting Rule was promulgated to address concerns that an investment adviser may vote its own preferences, not the preferences of its funds and their shareholders. If so, then an adviser would be in breach of its fiduciary duties and shareholder wealth maximization may not occur. In what fact patterns would this happen?

In the Release, the SEC focused on the concern that advisers would in some situations be reluctant to vote against management for fear that doing so would “threaten their ability to retain that company as a client for corporate retirement fund assets.”<sup>20</sup> As stated in the Release:

[I]n some situations the interests of a mutual fund’s shareholders may conflict with those of its investment adviser with respect to proxy voting. This may occur, for example, when a fund’s adviser also manages or seeks to manage the retirement plan assets of a company whose securities are held by the fund. In these situations, a fund’s adviser may have an incentive to support management recommendations to further its business interests.<sup>21</sup>

For example, in an op-ed piece in the Wall Street Journal, Todd Henderson and Dorothy Shapiro Lund<sup>22</sup> discuss how an activist hedge fund, acting with the support of the two leading proxy advisors, was allegedly impeded in moving forward on its proxy contest because several large mutual fund advisers balked at voting to support the hedge fund’s director nominees for fear of losing the company’s retirement fund business. This type of conflict of interest, a classic example of the agency costs that can be generated by mutual fund advisers, has been well documented and, according to Cvijanović, Dasgupta, and Zachariadis, appears to persist despite the implementation of the Proxy Voting Rule.<sup>23</sup>

Another type of conflict noted in the Release, and the one most relevant to the discussion below, is where “the adviser may also have business or personal relationships with other proponents of proxy proposals, participants in proxy contests, corporate directors or candidates for directorships.”<sup>24</sup> For example, such a conflict may exist where “the adviser may manage money for an employee group.”<sup>25</sup>

Such a conflict was described in the SEC’s enforcement case against INTECH.<sup>26</sup> Here, the registered investment adviser, INTECH Investment Management LLC, had initially voted its proxies based on an Institutional Shareholder Services recommendation platform that was purposely designed

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<sup>20</sup> M. Todd Henderson & Dorothy Shapiro Lund, *Index Funds Are Great for Investors, Risky for Corporate Governance*, WALL ST. J. (June 22, 2017), <https://www.wsj.com/articles/index-funds-are-great-for-investors-risky-for-corporate-governance-1498170623>.

<sup>21</sup> Proxy Voting by Investment Advisers, Investment Advisers Act Release No. IA-2106 (2003). *See also*, Lucian A. Bebchuk, Alma Cohen, and Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 90 (2017) (“[T]he agency problems of institutional investors can be expected to lead them to ... side excessively with corporate managers, ...”).

<sup>22</sup> Henderson and Lund, *supra* note 20.

<sup>23</sup> Dragana Cvijanović, Amil Dasgupta, and Konstantinos E. Zachariadis, *Ties That Bind: How Business Connections Affect Mutual Fund Activism*, 71 J. FIN. 2933 (2016).

<sup>24</sup> Proxy Voting by Investment Advisers, Investment Advisers Act Release No. IA-2106 (2003).

<sup>25</sup> *Id.*

<sup>26</sup> Order Instituting Administrative Cease-and-Desist Proceedings Pursuant to Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940, Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order, File No. 3-13463 (May 7, 2009), available at <http://www.sec.gov/litigation/admin/2009/ia-2872.pdf>.

to side with management. In 2003 to 2006, INTECH moved to a different ISS recommendation platform that followed the voting recommendations of the AFL-CIO. According to footnote 3 of the SEC's order instituting proceedings, such voting recommendations had the objective of promoting a "position that is consistent with the long-term economic best interests of plan members embodied in the principle of a worker-owner view of value."<sup>27</sup> Apparently, this approach was significantly different than the one taken in the original recommendation platform.

INTECH switched to this new platform in order "to retain and obtain business from existing and prospective union-affiliated clients."<sup>28</sup> Soon after, some of INTECH's original clients started making inquiries regarding the higher number of votes against management on shareholder proposals.

INTECH made the switch in voting platforms without having any written procedures or policies that addressed material potential conflicts between INTECH's interests in seeking more union-affiliated clients and those of its clients who did not favor the AFL-CIO. By doing so, it had subrogated its client interests to its own, a breach in its fiduciary duty of loyalty. Therefore, this was a clear violation of the Proxy Voting Rule. INTECH paid a civil penalty of \$300,000.<sup>29</sup>

### **The Changing World of Proxy Voting**

Of course, the world has changed since the Proxy Voting Rule first went into effect. Currently, an unprecedented concentration of voting power now resides in the hands of our largest mutual fund advisers. For example, BlackRock, Vanguard, and State Street Global Advisors (the Big Three) now control enormous amounts of proxy voting power without having any economic interest in the shares they vote. According to Shenkar, Heemskerk, and Fichtner, this concentration of voting power was and is being caused by a large shift from actively managed equity funds to equity index funds:

In contrast to the fragmented and sizeable group of actively managed mutual funds, the fast-growing index fund sector is highly concentrated. It is dominated by just three giant U.S. asset managers: BlackRock, Vanguard and State Street – what we call the "Big Three." Together they stand for a stunning 71 percent of the entire Exchange Traded Fund (ETF) market and manage over 90 percent of all Assets under Management ... in passive equity funds. As a consequence of this leading role in the market for passive investment, the Big Three have become dominant shareholders. Seen together, the Big Three are the largest single shareholder in almost 90 percent of all S&P 500 firms, including Apple, Microsoft, ExxonMobil, General Electric and Coca-Cola. Such concentration of corporate ownership is remarkable and may not have been seen since the days of the Gilded Age.<sup>30</sup>

This new concentration of voting power has its origin in the industry practice of centralizing the voting of mutual funds into the hands of their advisor's corporate governance department. In essence, not only would portfolio management be delegated to the mutual fund adviser, but also the voting of

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<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> For an excellent discussion of the INTECH settlement, see Ropes & Gray, SEC Brings Second Case Alleging Improper Proxy Voting by an Adviser (May 20, 2009), [www.ropesgray.com/sec-brings-second-case-alleging-improper-proxy-voting-by-an-adviser.pdf](http://www.ropesgray.com/sec-brings-second-case-alleging-improper-proxy-voting-by-an-adviser.pdf).

<sup>30</sup> See Shenkar, Elke M. Heemskerk & Jan Fichtner, *supra* note 4.

proxies. I refer to this as the “empty voting of mutual fund advisers.”<sup>31</sup> That is, they have the voting rights but not the economic interest in the underlying shares.

This low cost approach to proxy voting was innocuous enough when proxy voting was not concentrated. However, as the market share of equity index funds has grown, this empty voting has given rise to an *unintended* consequence.<sup>32</sup> The Big Three now control, without having any economic interest in the underlying shares, the voting rights associated with trillions of dollars worth of equity securities. For example, as of December 31, 2017, BlackRock had over \$6.3 trillion of assets under management, with almost \$3.4 trillion of those assets being equity securities.<sup>33</sup> This represents an astonishing amount of voting control. Therefore, at many public companies, the respective corporate governance departments of the Big Three, as well as other large mutual fund advisers, may now control the fate of a shareholder or management proposal, whether a nominated director receives a required majority of votes to remain on the board of directors, or if a proxy contest succeeds or fails.

### **Advisers Subrogating the Interests of Mutual Funds and Their Shareholders**

Such a concentration of power always brings with it the potential for abuse. It is easy to envision scenarios where this voting power can generate significant value for the advisor if it decided to vote in a certain way, whether or not it is in the best interests of its clients to do so. In essence, the large mutual fund adviser will be tempted to breach its fiduciary duties and monetize or take special advantage of the delegated voting power it has accumulated.

### **The Courting of Public Pension Fund Assets**

One scenario where a large mutual fund adviser may be tempted to monetize its newly found voting power is to vote in unison with public pension and union-related funds, such as on shareholder proposals these funds initiate or promote, if it will lead to bringing more assets under management. Public pension funds control approximately \$4.2 trillion in assets,<sup>34</sup> a prime target for a mutual fund adviser looking to increase the size of its equity index funds. Since the objective of an index fund is not to beat the market, but simply to match it, increasing profitability through increased assets under management is a critical business strategy for the adviser.

Public pension funds are leaders in the shareholder empowerment movement. This form of shareholder activism advocates shifting corporate decision-making authority to shareholders, and thus away from boards of directors and executive management, and arguably without regard to the impact on the value of a public company’s stock. That is, satisfaction with company performance does not factor into the decision to support a proposal that shifts decision making away from the board of directors. For example, consider their take-no-prisoners approach to dual class share structures even though these structures have been successfully used by companies such as Berkshire Hathaway,

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<sup>31</sup> Bernard S. Sharfman, *Mutual Fund Advisors’ “Empty Voting” Raises New Governance Issues*, COLUM. L. SCHOOL: BLUE SKY BLOG (July 3, 2017), <http://clsbluesky.law.columbia.edu/2017/07/03/mutual-fund-advisors-empty-voting-raises-new-governance-issues/>.

<sup>32</sup> Bernard S. Sharfman, *Dual Class Share Voting versus the “Empty Voting” of Mutual Fund Advisors’*, CONFERENCE BOARD CORPORATE GOVERNANCE BLOG (July 2, 2018), <https://www.conference-board.org/blog/postdetail.cfm?post=6812&blogin=8>.

<sup>33</sup> BlackRock, Inc., *BlackRock 2017 Annual Report*, Part I at 2, <http://ir.blackrock.com/Cache/1500109547.PDF?O=PDF&T=&Y=&D=&FID=1500109547&iid=4048287>.

<sup>34</sup> National Association of State Retirement Administrators, *Public Pension Fund Assets: Quarterly Update (Q1 2018)*, <https://www.nasra.org/content.asp?contentid=200>.

Facebook, and Alphabet (Google).<sup>35</sup> Such zealous advocacy should not be a surprise since dual class shares are an obvious threat to the movement's power. As I have previously observed, "the more public companies that utilize a dual-class share structure, the more controlled companies exist and the less power the movement has."<sup>36</sup> Or, as another example, the New York City Public Pension Funds' crusade to implement proxy access at all public companies without regard to an individual company's performance.<sup>37</sup>

Incidentally, based on their 2018 voting guidelines,<sup>38</sup> the Big Three unanimously support a standardized form of proxy access and equal voting rights. This should be no surprise as it is consistent with their own preferences for retaining or increasing their public pension and union-related funds business.

I cannot overstate the harm to mutual fund investors caused by the shareholder empowerment movement. It is a one-size-fits-all approach to the private ordering of corporate governance arrangements where enhancing shareholder value is purely a chance occurrence. However, the private ordering that results from shareholder empowerment should not be confused with our traditional understanding of private ordering. This understanding assumes that, "observed governance choices are the result of *value-maximizing* contracts between shareholders and management."<sup>39</sup> For example, it may or may not include dual class shares or proxy access. And that is the whole point of private ordering and why it has value, it "allows the internal affairs of *each* corporation to be tailored to its own attributes and qualities, including its personnel, culture, maturity as a business, and governance practices."<sup>40</sup> Private ordering that results from shareholder empowerment disregards what is wealth maximizing for shareholders at each company. I refer to this phenomenon as the "bastardization of private ordering" or "sub-optimal private ordering."

When a mutual fund adviser adopts voting policies that include sub-optimal private ordering, whether or not they are inspired by a desire to retain or increase assets under management, it is a breach of its fiduciary duty under the Proxy Voting Rule. That is, the breach is a result of a failure to

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<sup>35</sup> Bernard S. Sharfman, *A Private Ordering Defense of a Company's Right to Use Dual Class Share Structures in IPOs*, 63 VILL. L. REV. 1 (2018), <https://digitalcommons.law.villanova.edu/vlr/vol63/iss1/1/>.

<sup>36</sup> Bernard S. Sharfman, *Dual-class shares and the shareholder empowerment movement*, R Street Institute Blog (June 12, 2017), <https://www.rstreet.org/2017/06/12/dual-class-shares-and-the-shareholder-empowerment-movement/>.

<sup>37</sup> City of New York, Office of Comptroller, *Comptroller Stringer, NYC Funds: After Three Years of Advocacy, "Proxy Access" Now Close to a Market Standard* (Jan. 30, 2018), <https://comptroller.nyc.gov/newsroom/comptroller-stringer-nyc-funds-after-three-years-of-advocacy-proxy-access-now-close-to-a-market-standard/>.

<sup>38</sup> BlackRock, Inc., *Proxy voting guidelines for U.S. securities* (February 2018), <https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf>; State Street Global Advisors, *Proxy Voting and Engagement Guidelines North America (United States & Canada)* (March 2018), <https://www.ssga.com/investment-topics/environmental-social-governance/2018/03/Proxy-Voting-and-Engagement-Guidelines-NA-20180301.pdf>; Vanguard, *Vanguard's proxy voting guidelines*, <https://about.vanguard.com/investment-stewardship/policies-and-guidelines/>.

<sup>39</sup> David Larcker et al., *The Market Reaction to Corporate Governance Regulation*, 101 J. FIN. ECON. 431, 431 (2011).

<sup>40</sup> Troy A. Paredes, Comm'r, US Sec. & Exch. Comm'n, Statement at Open Meeting to Propose Amendments Regarding Facilitating Shareholder Director Nominations (May 20, 2009), *available at* <http://www.sec.gov/news/speech/2009/spch052009tap.htm>.



disclose how such voting policies adequately maximize the wealth of its mutual fund clients and their shareholders.<sup>41</sup>

In sum, consistent with the Proxy Voting Rule's requirement that mutual fund advisers vote their proxies in the *best interests* of their clients, mutual fund advisers who have obtained concentrated voting power due to the delegation of voting authority, must disclose in their voting policies the *procedures* they will use to eliminate the temptation to use their voting power to retain or acquire more public pension and union-related fund assets under management.

### **Appeasing the Mutual Fund Adviser's Own Shareholder Activists**

A mutual fund adviser may also utilize its delegated voting power to appease shareholder activists who attack the business decisions, procedures, and objectives of the adviser's management. For example, in early 2017, both BlackRock<sup>42</sup> and Vanguard (two of its equity funds received the proposals, 500 Index Fund and Total Stock Market Index Fund)<sup>43</sup> received shareholder resolutions from Walden Asset Management requesting a review of their proxy voting policies and practices related to climate change.<sup>44</sup> Yet, the clear intent of the proposals was not just to review, but to encourage the advisers to be a stronger supporter of climate change proposals. According to the language in both proposals:

Vanguard [BlackRock] is a prestigious member of the Principles for Responsible Investment (PRI) a global network of investors and asset owners representing more than \$62 trillion in assets. One of the Principles encourages investors to vote conscientiously on ESG issues.

Yet Vanguard [BlackRock] funds' publicly reported proxy voting records reveals [sic] consistent votes against all climate related resolutions (except the few supported by management), such as requests for enhanced disclosure or adoption of greenhouse gas reduction goals, even when independent experts advance a strong business and economic case for support.<sup>45</sup>

In sum, the submitted proposals were intended to dictate to both BlackRock and Vanguard how they were to fulfill their fiduciary duties under the Proxy Voting Rule.

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<sup>41</sup> See text associated with footnotes 15-19.

<sup>42</sup> Walden Asset Management, Review and report on ESG proxy voting (BLK, 2017 Resolution), [https://engagements.ceres.org/ceres\\_engagementdetailpage?recID=a0112000005OdxTAAS](https://engagements.ceres.org/ceres_engagementdetailpage?recID=a0112000005OdxTAAS).

<sup>43</sup> Vanguard Funds, Preliminary Proxy Statement (August 21, 2017), <https://www.sec.gov/Archives/edgar/data/34066/000093247117004594/pre14proxystatement.htm>.

<sup>44</sup> Rob Berridge, Ceres, Four Mutual Fund Giants Begin to Address Climate Change Risks in Proxy Votes: How About Your Funds? (Dec. 21, 2017), <https://www.ceres.org/news-center/blog/four-mutual-fund-giants-begin-address-climate-change-risks-proxy-votes-how-about>.

<sup>45</sup> Walden Asset Management, Review and report on ESG proxy voting (BLK, 2017 Resolution), [https://engagements.ceres.org/ceres\\_engagementdetailpage?recID=a0112000005OdxTAAS](https://engagements.ceres.org/ceres_engagementdetailpage?recID=a0112000005OdxTAAS); Vanguard Funds, Preliminary Proxy Statement (August 21, 2017), <https://www.sec.gov/Archives/edgar/data/34066/000093247117004594/pre14proxystatement.htm>.

It appears that the tactic worked. Walden Asset Management withdrew both proposals in return for commitments by the companies to address the request.<sup>46</sup> Moreover, both companies started to support 2-Degree Scenario Proposals, something neither company did prior to 2017.

Coincidental or not, subsequent to the agreement with Walden Asset Management, both companies had the exact same record on 2-Degree Scenario Proposals. In 2017, both BlackRock and Vanguard voted in favor of 2-Degree Scenario proposals at ExxonMobil and Occidental (both proposals received majority support<sup>47</sup>), while voting against 2-Degree Scenario proposals at twelve other companies.<sup>48</sup>

It is important to point out just how valuable the voting power of these two advisers are to climate change activists and why it should be expected that the Big Three will continue to use their power to maintain peace with climate change activists who are also shareholders. According to a 50/50 Climate Project report, if BlackRock would have voted 100% of their mutual fund shares in support of the twelve other 2-Degree Scenario proposals, even without the support of Vanguard, ten of the twelve rejected proposals would have received majority support.<sup>49</sup> If Vanguard would have done the same, even without the support of BlackRock, eight out of twelve additional proposals would have received majority support.<sup>50</sup>

In sum, this is another scenario where a mutual fund adviser may be tempted to trade its voting power for something that would be of value to it, no matter how it impinges on the fiduciary duties it owes to its mutual fund clients and their shareholders. Here, activists imbedded in the shareholder base of an adviser are telling the adviser how to go about implementing its fiduciary duty under the Investment Advisers Act of 1940 and the Proxy Voting Rule. Mutual fund advisers need to disclose how they will eliminate the pressures placed on them by their own shareholders when voting their proxies. Such pressures deserve the creation of a wall that needs to be disclosed pursuant to the Proxy Voting Rule.

### **Voting Policies on Shareholder Proposals and Wealth Maximization**

Shareholder proposals provide a significant opportunity for mutual fund advisers to abuse their voting power for purposes other than shareholder wealth maximization. In 2017, at least 911 shareholder proposals were submitted to public companies for voting at their annual meetings.<sup>51</sup> Of these, at least 502 went to a vote.<sup>52</sup>

Unfortunately, many of these proposals have nothing to do with shareholder wealth maximization and may ultimately end up having a negative impact. A recent study by Kalt and Turki found that the

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<sup>46</sup> Berridge, *supra* note 44.

<sup>47</sup> *Id.*

<sup>48</sup> Marka Peterson, Jim Baker, and Kimberly Gladman, *The 50/50 Climate Project, Asset Managers and Climate-Related Shareholder Proposals: Report on Key Climate Votes* at 14 and 19 (March 2018).

<sup>49</sup> *Id.* at 14.

<sup>50</sup> *Id.* at 19.

<sup>51</sup> E-mail from Sebastian V. Niles, Partner, Wachtell, Lipton, Rosen & Katz, to Bernard S. Sharfman (June 22, 2018).

<sup>52</sup> *Id.*

adoption of climate change resolutions “has no statistically significant impact on company returns one way or the other.”<sup>53</sup> They also found that this result should not be surprising:

[T]here is no general expectation that corporate managers have special abilities in predicting tastes, preferences, voting behavior, and/or institutional capabilities across a wide and varied number of independent political actors operating within independently acting nations across the globe. Under such conditions, resolutions that, for example, compel disclosure of outcomes under particular political scenarios (e.g., the political paths that might put the world on a trajectory to achieve a goal such as the “not more than 2 degrees temperature rise” goal that came out of the Paris climate accords in 2015) do not add materially to the information already available to investors from other sources. As such, they cannot be expected to add to shareholder value.<sup>54</sup>

Matsusaka, Ozbas, and Yi found that labor unions use shareholder proposals as bargaining chips to extract side payments from management.<sup>55</sup> Matsusaka, Ozbas, and Yi, in a separate paper, found that the stock market reacted positively when the SEC permitted shareholder proposals to be excluded.<sup>56</sup>

Moreover, it is not difficult to assume that shareholder proposals that deal with human rights, political contributions, lobbying disclosure, greenhouse gas emissions, climate change, etc. are most likely not submitted for purposes of shareholder wealth maximization. This is something that activists most likely understand from the get go. Instead, the submission of such proposals is to try and resolve issues of national and international importance through shareholder activism, not the political process.

This does not mean that such issues are not extremely important to all of us. However, submitting shareholder proposals is not the way to solve them. According to Kalt and Turki,

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<sup>53</sup> Joseph P. Kalt and Adel Turki et al., Compass Lexecon, *Political, Social, and Environmental Shareholder Resolutions: Do They Create or Destroy Shareholder Value?* (June 2018), <https://mainstreetinvestors.org/wp-content/uploads/2018/06/ESG-Paper-FINAL.pdf>.

<sup>54</sup> *Id.* at 3-4.

<sup>55</sup> John G. Matsusaka, Oguzhan Ozbas, and Irene Yi, *Opportunistic Proposals by Union Shareholders* (July 8, 2018), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2666064](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2666064). According to the authors,

We find that in contract expiration years compared to nonexpiration years, unions increase their proposal rate by one fifth, particularly proposals concerning executive compensation, while nonunion shareholders do not increase their proposal rate in expiration years. Union proposals made during expiration years are less likely to be supported by other shareholders or a leading proxy advisor; the market reacts negatively to union proposals in expiration years; and withdrawn union proposals are accompanied with higher wage settlements. *Id.*

<sup>56</sup> John G. Matsusaka, Oguzhan Ozbas, and Irene Yi, *Can Shareholder Proposals Hurt Shareholders? Evidence from SEC No-Action Letter Decisions* (June 2018), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2881408](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2881408). According to the authors,

We find that over the period 2007-2016, the market reacted positively when the SEC permitted exclusion. Investors appear to have been most skeptical about proposals related to corporate governance and proposals at high profit firms, suggesting that investors believe some proposals can hurt shareholders by disrupting companies that are already performing well. The evidence is compatible with the view that managerial resistance is based on a genuine concern that proposals can harm firm value. *Id.*

None of this is to say that we should not be extremely concerned about such issues as global climate change, human trafficking, cybersecurity, and the like. Effectively dealing with such problems, however, will require that wise public policy measures be taken across a wide swath of the world's nations. While frustration with slow progress on this front is understandably accompanied by the desire to "do something", doing something effective in such arenas is the task of our political institutions. Shareholder resolutions targeted at prominent corporations is an ineffectual substitute for sound policy making via the political institutions of democracy.<sup>57</sup>

This lack of connection between shareholder proposals and shareholder wealth maximization is an issue that all retail investors must be concerned about. Shareholder proposals, if implemented subsequent to a shareholder vote or prior to through the process of engagement, while perhaps not reducing shareholder wealth, may at best do nothing to enhance it. If so, then wealth maximizing opportunities may be foregone as finite company resources are devoted to responding to and subsequently implementing these proposals.

Therefore, mutual fund advisers must disclose in their voting policies the procedures they utilize to identify an actual link between support for a shareholder proposal and the enhancement of shareholder value. This is necessary to make sure that mutual fund advisers are complying with a primary objective of their fiduciary duties under the Proxy Voting Rule, "*adequately maximizing the value of their shares.*"<sup>58</sup>

## Conclusion

In *Transamerica Mortg. Advisors v. Lewis*,<sup>59</sup> the U.S. Supreme Court ruled that clients and their shareholders have no express or implied private right of action under Section 206 of the Investment Advisers Act of 1940. By extension, no private right of action exists under the Proxy Voting Rule. This makes it imperative that the Commission clarify the scope of an investment adviser's fiduciary duties under the Proxy Voting Rule as an integral part of the amendments it is considering to the proxy process.

According to Laby, "[b]y adopting rules and prosecuting enforcement actions, ... the SEC fills in the details of what is required by the fiduciary duties of loyalty and care, and brings uniformity to the industry."<sup>60</sup> Unfortunately, there has been too little guidance provided by the SEC since it implemented the Proxy Voting Rule in 2003. There has only been the INTECH enforcement action and a staff legal bulletin, a bulletin that focuses on proxy advisors and does not address the issue of

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<sup>57</sup> *Id.* at 4.

<sup>58</sup> Proxy Voting by Investment Advisers, Investment Advisers Act Release No. IA-2106 (2003). This fiduciary approach was reaffirmed in Staff Legal Bulletin No. 20 (IM/CF) (June 30, 2014), <https://www.sec.gov/interps/legal/cfslb20.htm> and the recently released Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, <https://www.sec.gov/rules/proposed/2018/ia-4889.pdf>.

<sup>59</sup> 444 U.S. 11 (1979).

<sup>60</sup> Arthur B. Laby, *The Fiduciary Structure of Investment Management Regulation*, forthcoming, RESEARCH HANDBOOK ON MUTUAL FUNDS (John D. Morley & William A. Birdthistle, eds.) (Elgar Publishing) (April 21, 2017), available at SSRN: <https://ssrn.com/abstract=2993429>

how proxy voting policy disclosures needs to be updated to conform to our current proxy voting environment.<sup>61</sup> An update to the process, as outlined in the July 30 announcement, is overdue.

In a proxy voting world where voting is dominated by a handful of extremely large investment advisers, the Commission should provide clarification that mutual fund advisers must disclose in their voting policies, consistent with the Proxy Voting Rule's requirement that they vote proxies in the best interests of their clients, the *procedures* they will use to deal with the temptation to use their voting power to retain or acquire more assets under management and to appease activists in their own shareholder base.

In addition, shareholder proposals are a prime area where this opportunistic use of an adviser's voting power may be in play. Therefore, mutual fund advisers must disclose the *procedures* they will use to identify the link between support for a shareholder proposal at a particular company and the enhancement of that company's shareholder value. This is necessary to make sure that that advisers are complying with a primary objective of their fiduciary duties under the Proxy Voting Rule, "*adequately maximizing the value of their shares.*"<sup>62</sup>

Finally, consistent with these new disclosures and procedures, the Commission should clarify that voting inconsistent with these new policies and procedures or omission of such policies and procedures will be considered a breach of the Proxy Voting Rule. I urge the SEC to be diligent in enforcing all breaches of the Proxy Voting Rule. While enforcement most clearly applies to the Big Three mutual fund advisers, it should also apply to any mutual fund adviser that has delegated voting authority.

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<sup>61</sup> SEC Divisions of Investment Management and Corporate Finance, *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms*, Staff Legal Bulletin No. 20 (IM/CF) (June 30, 2014), <https://www.sec.gov/interps/legal/cfslb20.htm>.

<sup>62</sup> Proxy Voting by Investment Advisers, Investment Advisers Act Release No. IA-2106 (2003).

Very truly yours,



Handwritten signature of Bernard S. Sharfman, consisting of a stylized 'B' and 'S' followed by a horizontal line.

Bernard S. Sharfman

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