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Corporate Governance Update: Proxy Voting and the Future of Corporations

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A significant debate has developed in recent months regarding the purpose and future of corporations, the primacy of shareholder interests, and the role of the regulatory environment. The outcome could have a lasting impact on public companies. A recently released framework for public discussion in the British Academy, "The Future of the Corporation: Towards Humane Business," centers around the view that the purpose of corporations is not simply to maximize shareholder value. The framework suggests further that corporations should specify their purposes, that some corporations with public and social functions should be required to align their purposes with social purposes, and that regulations should promote and even ensure the alignment of corporate with social purposes. This view is far removed from the general American view of the purpose of a corporation—*i.e.*, to maximize shareholder value—and the perceived purpose of the regulatory environment—*i.e.*, to facilitate corporations' efforts to maximize shareholder value and to protect shareholders from misconduct.

The common understanding of the purpose of a corporation appears to be evolving in parallel to that of the purpose of the shareholder franchise. The annual vote long has been seen as an opportunity for equity holders to express their view as to whether a given corporate action would maximize the financial value of their shares. Under an expanded view of corporate purpose, the shareholder vote would become a regular opportunity for shareholders to express their *values* rather than simply their opinion as to how best to maximize *value*. Using the latitude afforded by the Exchange Act Rule 14a-8 shareholder proposal process, it is already common for shareholder votes to address a wide array of social issues such as board composition and environmental concerns, which do not directly affect a

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company's financial performance during the time horizon of its strategic plan.

At the same time that shareholder votes are coming into focus as potential vehicles for social change, the proxy process is undergoing intense scrutiny by the SEC. There is an unprecedented consolidation of ownership in the U.S. equity market, with over 80 percent of the market value of the Russell 3000 and the S&P 500 now held by institutional investors. The upshot of this concentration is that a small number of governance experts and fund managers are making voting decisions that have enormous impact across the corporate landscape. In this context, proxy advisors have become increasingly important, and correspondingly controversial, components of the proxy process.

SEC Proxy Roundtable

The much-anticipated SEC staff roundtable on the proxy process that was held earlier this month included the perspectives of proxy advisors, issuers, investment firms, index funds, institutional investors, academics, and policymakers. All seemed to agree that, from a logistical standpoint, proxy advisors have become an essential component of the annual proxy season process. None of the panelists advocated for further regulation of proxy advisors. The general view of most panelists was that additional regulation likely would be burdensome and costly for the clients of proxy advisory services, which ultimately would increase the expense of the proxy process to the detriment of shareholders.

Panelist and former Senator Phil Gramm observed that institutional investors and investment advisors can and do pressure companies to pursue social agendas through proxy voting, while proxy advisors do the same with their highly influential voting recommendations. Senator Gramm highlighted the conflict that exists when funds have the authority to cast votes that potentially enhance their own reputation and marketability rather than maximizing the returns to individual investors. Proxy advisors with no fiduciary responsibilities have incentives that are even further removed from those of individual investors. His concern is that the social positions promulgated by institutional investors and proxy advisors are neither sufficiently popular with individual shareholders nor sufficiently value-maximizing to be enacted through legislative or executive action. Senator Gramm advocated for reducing the safe harbors available to those who vote or advise on voting shares of which they are not the beneficial owner, adding that it is the role of the SEC to protect investors from having their money used not in their own interests but to the advantage of investment advisors, index funds, and proxy advisors. In comments made at the roundtable, SEC Chair Jay Clayton emphasized the need for the SEC to protect the individual investor against suboptimal or blanket voting policies. He requested comments aimed at improving the quality of the voting decisions in each case for the benefit of the long-term Main Street investor.

Chairman Clayton and Senator Gramm represent the traditional view of the purpose of a corporation and the purpose of a shareholder vote. The competing vision of corporate purpose conceives of the corporation as a vehicle for long-term value creation, with "value" not described in purely financial terms but incorporating other elements of economic prosperity and social welfare. There is a view among some institutional investors that long-term economic value will be best achieved through the pursuit of certain types of social purposes alongside wealth maximization, such as environmental protection and gender diversity. But does that view represent and protect the interests of the individual shareholder? And will incorporating societal judgments regarding long-term economic value into corporate governance jeopardize the wealth-maximization function of corporations? If the pursuit of long-term economic value—however that concept may be defined by various market participants and regulators—is not financially beneficial to the individual shareholder, it is likely to result in the reduction of capital, productivity, and ultimately overall prosperity.

In the traditional paradigm, individual shareholders invest their money in the stock market in order to maximize their wealth. They realize their returns, and they use their earnings at their discretion. If they wish to pursue a social agenda, they may choose to make political donations, charitable gifts, or targeted investments in explicitly socially-oriented funds or companies. Investing in the stock market and using the proceeds for social change are two different activities. Under the competing new paradigm, the act of investing, even in broad index funds or companies without public or social purposes, would not be separable from agenda-driven activism, due to the pressure generated by powerful proxy voters. This may be unattractive and disadvantageous to the vast majority of investors who use index fund investing simply as a financial tool and have widely divergent social views, including perhaps the view that businesses should not adopt social agendas. Voting decisions aimed at wealth-maximization in the timeframe of a company's strategic plan are likely to be the best way that an investment advisor or fund, as an agent representing many thousands of shareholders, can come closest to representing the preferences of their retail investors or beneficiaries.

Legislative and Regulatory Activity

Legislative and regulatory actions are hovering in the wings as the curtain falls on 2018. On Capitol Hill, Senator Elizabeth Warren's Accountable Capitalism Act, introduced in August 2018, aims to federalize the largest U.S. corporations. There are also two bipartisan pieces of legislation in the works: the Corporate Governance Reform and Transparency Act (CGRTA), which was passed by the House in December of 2017 and was the subject of a June 2018 hearing in the Senate, and the Corporate Governance Fairness Act, which was introduced earlier this month in the Senate. Both of the bipartisan legislative efforts aim to regulate proxy advisors and hold them to higher standards of conduct.

On the regulatory front, just days before the SEC roundtable, the SEC withdrew two key no-action letters regarding proxy advisory firms. (Of note: The withdrawal of the Egan-Jones and ISS letters is a provision in the CGRTA.) This action may indicate that the current level of institutional investor reliance on proxy advisors will be unsustainable in a shifting regulatory environment, though the message is complicated by the fact that the SEC's Staff Legal Bulletin 20, which cites the two letters, was left in place. In any case, a theme to emerge from the roundtable was that, leaving aside the controversial topic of proxy voting recommendations, proxy advisors reduce costs for institutional investors in terms of research and workflow management. At this point, it may be that proxy advisors' role in the substantive and logistical task of making and implementing voting decisions throughout the proxy season has become too big to eliminate, absent some fundamental changes in the proxy voting process.

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In recent decades, the enduring value of corporations has been under assault from short-term investors such as hedge funds. Quarterly earnings pressure and the growing power of shareholder activists are two forces that have pushed executives toward maximizing very short-term profits at the expense of the company's longer-term interests and investors. A focus on short-term gains is often counterproductive to long-term value creation, as it hinders the capital investment that produces sustained economic prosperity. The rise of concentrated stock ownership in large, long-term investors has been beneficial insofar as it has helped to turn the tide against short-termism. To the extent that the false urgency of short-term economic interests is being displaced by productive collaboration among corporations, shareholders, and other stakeholders, this is a positive development. At the same time, it is important to tread carefully here to avoid turning corporations into vehicles for social engineering. Proponents of broadening the definition of corporate purpose as a defense against short-term profit-seeking should be wary of going too far in the other direction. A balanced approach, in which informed investors evaluate and support chief executives as they pursue wealth-maximization over the company's strategic timeframe, would be optimal.

The vision expressed in "The Future of the Corporation," which merges corporate economic purposes with social purposes, would enable regulators to enact social change on a scale that otherwise would require governmental action. Absent the federalization of corporate law in the United States, the diversity of state law will continue to give companies greater latitude to choose their own regulatory context. However, regulators are not the only powerful force in the current environment, and the enormous pressure that can be brought to bear by the collective ownership of institutional shareholders is a daunting prospect. A state-based system of corporate law and governance cannot protect corporations from institutional investors' agendas as effectively as it protects corporations from federal intervention. The best bulwark against overreach by institutions, proxy advisors, and other activists is a continued focus on the interests of the individual Main Street investor. As Chairman Clayton reminded the roundtable participants, the goal of proxy voting reform should be to get closer to the point at which each vote cast is a high-quality decision taken in the interests of the individual owner. Corporate law and regulation predicated on the long-term financial interests of shareholders has produced American economic success for generations. The current debate over social purposes, and the ramifications for the long-term financial interests of public company shareholders—particularly in the context of large-scale institutional proxy voting—deserve the attention of Main Street and institutional investors. An excellent result would be greater transparency and proxy process reforms that promote the interests of shareholders.