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The push towards corporate guidelines

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THE PUSH TOWARDS CORPORATE GUIDELINES

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Institutional investors bear an obligation and public expectation to be good stewards of their portfolio companies. Many commentators argue that the investors have failed to do so because they are not incentivized to make adequate investments in corporate governance. However, such criticism only examines institutional investors' efforts in actively engaging with the governance of their portfolio companies and ignored an important, passive governance tool—corporate guidelines. Those guidelines are published by the investors to articulate their stances on governance issues and justify their voting decisions in annual meetings. Corporate guidelines have become increasingly popular among not only the investors, but also parties who interact with the investors in shaping corporations' governance regimes, such as the corporations' managements and other shareholders, proxy advisory firms, and law firms. This paper examines how corporate guidelines are used by those entities and explains why they have been used more frequently.

For institutional investors, corporate guidelines serve as the best tool for balancing the investors' governance-related duties and the need for cost minimization. Creating and using the guidelines is less costly than active engagements, and unlike outsourcing voting decisions to proxy advisory firms, it is still regarded as a valid way to fulfill the investors' duties as corporate stewards. For managements,

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aligning governance policies with corporate guidelines signals their commitments to sound governance practices and helps them fend off challenges by activist shareholders. Activist shareholders, on the other hand, also cite corporate guidelines to support their proposals.

The rise of corporate guidelines, therefore, can be explained by more investors willing to supply corporate guidelines and more corporations, shareholders, and proxy advisory firms finding the guidelines useful in advancing their own interests.

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INTRODUCTION

In recent years, corporate scholars and policymakers have devoted a great deal of attention to large institutional investors. In particular, there exists a heated debate in the corporate world about the capabilities and incentives of institutional investors to invest in corporate stewardship—defined as monitoring, voting and engagement[1]—in their portfolio companies. The main focus is on mutual funds, which hold most of the assets of institutional investors.[2]

According to common wisdom, which finds support in theoretical and empirical studies, institutional investors are not active stewards because of three main reasons. First, managers of mutual funds have poor incentives to invest in active stewardship because of their compensation structure—a tiny fixed percentage of asset under fund's management, with no consideration of performance, and because of free-rider concerns. In addition, the stewardship budgets and personnel of mutual funds, including the three largest funds—BlackRock, State Street and Vanguard—are too small to allow them to invest in informed voting and engagements in the thousands of corporations in their portfolio.[3] Second, since mutual funds and other types of institutional investors (such as pension funds) have business ties with the corporations in which they invest, active intervention in those

[1] Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2029 (2019) (hereinafter Bebchuk & Hirst, *Index Funds*).

[2] Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, J. ECON. PERSP. 89, 94 (2017) (arguing that investment funds, including open-end mutual funds, closed-end mutual funds, exchange-traded funds, and other similar funds, "are the most category of institutional investors and represent most of the assets held by institutional investors").

[3] As recently documented by Bebchuk and Hirst, stewardship personnel of BlackRock, Vanguard and State Street stands at 45, 21, and 12 staff members respectively, a stark contrast with the huge number of companies globally (BlackRock, Vanguard and State Street invest in 11,246, 13,225, and 12,191 companies respectively) and in the U.S. (BlackRock, Vanguard and State Street invest in 3,765, 3,672, 3,117 companies respectively). Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2077.

corporations may lead to confrontations that jeopardize those ties. Third, and relatedly, managers of corporations wield political power, and confrontations with them may cause a political backlash against institutional investors. This concern is especially acute in light of the recent spate of criticism against the largest mutual funds, and the calls to enact additional regulations of their activities.[4]

Meanwhile, the emergence of passively managed funds—index mutual funds and exchange traded funds (ETF)—has become one of the heated topics in corporate scholarship today.[5] On the spot are the "Big Three"—BlackRock, Vanguard and Fidelity. According to the dominant view with respect to those funds' investment in corporate stewardship, the situation is even worse compared to the investment by active funds. This is because unlike active mutual funds that pick stocks, index funds are designed to replicate the return of a selected index (e.g., S&P 500), and minimize the tracking error with the lowest fees possible.[6] Put differently, investment in active stewardship is not aligned with the business model of passive funds. Considering the factors above, commentators have been urging the design and implementation of regulatory reforms of corporate stewardship.[7]

In contrast to the massive efforts in exploring active stewardship, little attention (if any at all) has been given to what I term "passive stewardship." This term reflects institutional investors' use of proxy voting guidelines that are drafted and published by them on an annual basis, and letters drafted by those investors providing insights into

[4] Section III.A.

[5] As recently observed, passive funds now control more than thirty percent of all U.S. assets, and if they "were to continue their present growth trajectory, they would own all listed stocks by 2030." Renaud de Planta, *The Hidden Dangers of Passive Investing*, FIN. TIMES (May 30, 2017), https://www.ft.com/content/15dd3552-3fad-11e7-82b6-896b95f30f58. *See also* Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721, 737–40 (2019) (estimating that within two decades, the Big Three can control 40% of the shares voted in S&P 500 companies).

[6] An index fund's tracking error is essentially the difference between the fund portfolio's returns and the benchmark index's return that it was designed to track. The lower the tracking error, the better is the index fund.

[7] Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2119-2122; *See also* Dorothy Shapiro Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 101 (2018).

their priorities, views and philosophy. This term also reflects principles, standards and general statements published by organizations and groups of institutional investors, such as the Council of Institutional Investors (CII) and the Institutional Stewardship Group (ISG) (collectively "corporate guidelines" or "investors' corporate guidelines").

Large institutional investors publish their corporate guidelines not only to inform their own voting at the shareholder meetings of their portfolio companies, but also to communicate with the management of those companies. Through corporate guidelines, institutional investors convey their priorities, views and philosophy regarding corporate governance and related issues, and communicate their expectations for their portfolio companies in those regards. These issues include boards and directors, audit-related issues, capital structure, mergers and asset sales, executive compensation, environmental and social issues, and shareholder rights and protections.

The growing use of corporate guidelines is due to various reasons. *First and foremost*, they allow institutional investors to strike a balance between their strict fiduciary duties, on the one hand, and their need to be cost-effective, on the other. For the side of investors' duties, it is important to understand that institutional investors are subject to legal and regulatory duties to vote in thousands of shareholder meetings in a way that reflects the best interests of their clients. This is a colossal burden. Relatedly, given their enormous power, institutional investors are expected to act as responsible “corporate citizens.”[8] Hence, they cannot disregard their stewardship duties. This is especially true given the harsh criticism directed toward institutional investors during the past few years, attacking investors for outsourcing their voting tasks to proxy advisory firms, moving towards the passive indexing strategy, and abandoning stewardship for the sake of lowering costs for their clients. This criticism has forced investors to declare that they devote resources to in-house analysis before voting, and to emphasize their willingness to invest more resources in stewardship.

As for the side of investors' cost-effectiveness, given that institutional investors face fierce competition, and active stewardship

[8] Sub-section III.A.1.

is very costly, institutional investors must be cost-effective. Using low-cost measures such as corporate guidelines helps them maintain cost-effectiveness. The rationale of cost-effectiveness would be even stronger considering that mutual funds have limited incentives to invest in stewardship in the first place for several interrelated reasons, such as their managers' compensation structure and free-rider problems. It is true that mutual funds may have some incentives to invest in stewardship. This is because they hold large stakes incorporations, which stand at approximately 5% or slightly more in almost all of the companies in the S&P 500.[9] This position increases the likelihood that their investment in stewardship will have influence and will not go in vain.[10] However, such incentives are usually overpowered by the disincentives.

The takeaway here, regarding the first reason for institutional investors' use of corporate guidelines, is that mutual funds cannot abandon their duties while they must keep their expenses low. Therefore, they maneuver by using a legitimate and cost-effective way to reflect their commitment to stewardship, and to signal that they take control over their voting tasks, i.e., they use corporate guidelines.

The second reason for the growing use of corporate guidelines is that the guidelines are considered a "soft" and less adversarial device that does not seek to dictate specific governance structures. Consequently, guidelines allow institutional investors to reduce the potential for confrontation with the managements of their portfolio companies, and thereby reducing the risks of losing business ties with those companies, and of a political backlash.

Third and finally, the use of corporate guidelines has become a common global phenomenon. Put shortly, stewardship codes and principles have become popular devices, adopted by the OECD, by many leading countries in the field of corporate governance, and by the largest institutional investors. This includes the principles developed in 2018 by the ISG, which is composed of the largest institutional investors in the U.S. and their international counterparts.

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[9] Bebchuk & Hirst, The Specter of the Giant Three, *supra* note 5, at 724.

[10] Marcel Kahan & Edward B. Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders* 5 (N.Y. Univ. Law & Econ., Research Paper No. 18-39, 2019)

Besides the above theories, this article provides the first empirical study that analyzes patterns of the use of corporate guidelines as a passive stewardship mechanism. To this end, I collected and reviewed the proxy statements published by the 500 corporations that constitute the S&P 500, as of December 10, 2019, in their DEF 14A forms. For each corporation in my sample, I collected information about whether the corporations' proxy statement includes references to investors' corporate guidelines, broken down by proposals submitted by corporations and shareholders at the corporation's annual meetings.

Such a reference to investors' corporate guidelines is made by corporations to communicate with their shareholders and other constituencies, and to express their commitment to their largest investors and to good corporate governance. Corporations also make the same reference when they respond to shareholder proposals submitted for voting at the annual shareholder meeting. In addition, leading law firms that advise corporations refer to institutional investors' corporate guidelines and urge corporations to review and pay close attention to those guidelines.[11] Lastly, even proxy advisory firms, which have become a major force in the corporate arena during the past two decades after an increasing number of institutional investors started to outsource their corporate governance duties, rely upon institutional investors' guidelines when they help investors to fulfill their voting tasks.

My analysis reveals that in 2019, 28 corporations made "explicit references" to investors' corporate guidelines (which constitute 5.6 percent of the corporations in the sample). 4 out of these 28 references were made by corporations in response to shareholder proposals. Interestingly, most of the explicit references were made by the largest corporations, where 9 out of 100 (9 percent) corporations included in the first tier of S&P 500 (meaning the hundred corporations with the largest market capitalization) made such a reference. In contrast, the analysis reveals that only 3 out of 100 corporations that constitute the last tier of S&P 500 made explicit references to investors'

[11] Section IV.

guidelines.[12] This finding reflects the intuition that larger corporations attract more attention from everyone—shareholders, media, academia, policymakers and also institutional investors. Being aware of this fact, the largest corporations are willing to signal their commitment to what institutional investors perceive as good corporate governance.

It should be emphasized that at this stage, the above statistics on explicit references do not capture the full importance of corporate guidelines. The goal of my empirical analysis here is to get a sense of the stand-alone and explicit use of institutional investors' guidelines, i.e., as a passive stewardship tool. However, corporate guidelines are not always used on its own and explicitly. Consider the situations where institutional investors and corporations interact through both the use of corporate guidelines and active engagement. Further analysis will find that frequently, proxy statements state that during engagements between corporations and their largest investors, the corporations got a feedback from the investors for their priorities, philosophy and expectations, and had taken this feedback into account. Additionally, the statistics do not include statements of corporations that revising their policies in response to investors' views[13] or sentiments.[14] This is because it is not clear from the proxy statements whether corporations have learned about investors' views or sentiments during an active dialogue with investors or by studying investors' guidelines alone.

[12] A side note: Within the second, third, fourth and fifth tiers—seven, five, four, and three Corporations, respectively, made such a reference. This means the most significant difference in making the references lays between companies with the largest market capitalization and those with the smallest market capitalization.

[13] *See*, *e.g.* , Merck & Co. (Schedule 14A) (April 8, 2019) ("[F]rom time to time, the Board revises the Policies of the Board in response to . . . the perspectives of our shareholders."); Southern Company (Schedule 14A) (April 5, 2019) (Southern Company described the "view" of "many stockholders," regarding certain governance arrangement).

[14] *See*, *e.g.*, Bristol-Myers (Schedule 14A) (2016) ("This year the Board also made it a priority to understand our shareholders' sentiments on the evolving environment regarding proxy access. After hearing the variety of opinions shared with us on this topic, our Board, in keeping with its commitment to governance best practices, adopted a proxy access shareholder right in February 2016.").

In order to avoid overly underestimating the power of corporate guidelines, the empirical analysis does a way through which corporate guidelines may shape corporations' governance regimes without being mentioned by these companies in their proxy statements. When a corporation designs its own guidelines or adopts a certain governance arrangement, it might say it did so in line with industry best practices, rather than explicitly referring to specific institutional investors' guidelines. Since corporate guidelines may initiate, accelerate and maintain an industry best practice, those guidelines may have influenced a corporation's governance regime although they were never explicitly mentioned. The empirical analysis shows that in addition to explicit references, 226 corporations (45.2 percent of the sample) declared that their board review the corporation's policies, frameworks and guidelines according to current and evolving best practices, or emphasized that corporation's governance guidelines are aligned with the best practices or that they are committed to the best practices.

By influencing industry best practices, corporate guidelines may create an even larger impact than expected. In addition to best practices themselves, corporations and shareholders refer to statistics regarding certain governance arrangements adopted (or not adopted) by corporations included in S&P 500, S&P 1500 or Fortune 100.[15] Shareholders used statistics regarding best practices to support their proposals in 42 proxy statements, where 17 such references were made in the proxy statements of the 100 largest companies in S&P 500; corporations used statistics regarding best practices in 30 proxy statements, where 28 references were made in response to shareholder proposals.

Not just corporations refer to investors' corporate guidelines. Shareholders that submitted proposals to the corporations have also relied upon the guidelines to support their proposals and to convince

[15] Such a reference includes, for example, a statement according to which "the terms of our proxy access By-law, including the re-nomination threshold, are consistent with the 67% of S&P 500 companies that have adopted proxy access"; or a statement according to which "[m]ore than 89% of the companies in the S&P 500 have adopted majority voting for uncontested elections, as have 67% of the S&P 1500."

corporations to make changes and adopt certain governance arrangements. As my empirical analysis reveals, 28 corporations (5.6 percent of the sample) received shareholder proposals that relied upon institutional investors' guidelines. The largest corporations are the most likely to receive these proposals: 14 out of the 100 (14 percent) corporations that constitute the first tier of S&P 500 were subject to such a proposal.[16] Similar as the previous statistics on references made by corporations themselves, this finding seems to align with the fact that larger corporations are subject to greater attention.

Summing up the number of explicit references made by corporations and shareholders, the analysis shows that the proxy statements of 51 corporations, meaning 10.2 percent of the sample, used investors' corporate guidelines. Among those 51 corporations, five of them included references made by both the corporations themselves and their shareholders.

In order to get a better picture regarding the use of investors' guidelines, I also analyzed proxy statements published in 2020 by corporations that constitute the S&P 500 list.[17] As of May 18, 2020, 408 corporations published their proxy statements: 38 of those proxy statements included explicit references to investors' corporate guidelines. Similar to the 2019 analysis, in the 2020 analysis, most of the references were made he largest corporations: 20 out of 84 (23.40 percent) statements were made by the corporations that constitute the first tier of S&P 500. The findings described above support the theoretical explanations for the growing power of corporate guidelines, as discussed earlier. Together, the theoretical and empirical findings, also shed a new light on the guidelines' effectiveness as a governance tool that supplements institutional investors' active tools, e.g., voting and engagements used by investors to monitor their portfolio companies.

[16] As for the second, third, fourth and fifth tiers, three, six, two and three corporations, respectively, were subject to a shareholder proposal that referred to investors' corporate guidelines.

[17] To be consistent with the 2019 analysis, I only examined corporations that are also included in the 2019 analysis, meaning corporations included in the S&P 500 list as of December 10, 2019.

In the last part of this paper, I discussed two major concerns about corporate guidelines. The first concern states that corporate guidelines are indeed used frequently, but they have no real impact on corporate governance because they are simply a window dressing. Investors publish the guidelines to pretend that they are committed to fulfil their fiduciary duties, while in reality they invest little in enforcing the guidelines. Corporations can just ignore the guidelines with no real consequences. Although I did not offer a systematic response to this concern, my analysis supported the view that using corporate guidelines for only symbolic purposes would create more costs than benefits, at least for large investors and companies that face heightened scrutiny from the public. My discussion also revealed the importance of active monitoring and enforcement to the effectiveness of corporate guidelines.

The second concern is that the reliance on corporate guidelines may lead to suboptimal corporate governance regimes because the guidelines are too generic and cannot account for all the individual variations among companies. However, such a concern may have been exaggerated because: (1) corporate guidelines usually reserve flexibility for managements to accommodate companies' individual characteristics; (2) combining corporate guidelines with active engagements allows investors to promptly intervene when their interests are threatened; and (3) there are common governance problems that can be effectively addressed by generic guidelines.

My responses to the two concerns also demonstrate that corporate guidelines are not completely passive, as they are the most effective when the investors implementing them also have some mechanisms of active engagements.

Structurally, the Article is organized as follows. In Part I, I will discuss the traditional focus on institutional investors' lack of participation in active stewardship. I will describe how scholarship has not given enough attention to the potential power of corporate guidelines. In part II, I will introduce the major characteristics of corporate guidelines, and the dynamic created between investors and their portfolio corporations by the guidelines. Part III analyzes the reasons behind the rise in uses of the guidelines. Part IV puts forward detailed evidence on the uses of corporate guidelines by corporations, shareholders, law firms, and proxy advisors. Lastly, Part V considers the limitations of corporate guidelines. A short conclusion will ensue.

I. The Focus on Institutional Investors' (Lack of) Participation in Active Stewardship

A. Institutional Investors' (Lack of) Activism

One of the most prominent phenomena of the past three or four decades in corporate law, is the emergence of institutional investors. Today, institutional investors own between seventy and eighty percent of public corporations' shares traded in the U.S. equity markets, and the largest institutional investors each holds approximately five to ten percent of a typical large public corporation.[18] As a report published by Sullivan & Cromwell LLP in 2019 reveals, "[A]s of December 2018, one of BlackRock, Vanguard or State Street was the largest shareholder in 438 of the S&P 500 companies, roughly eighty-eight percent, and collectively the three firms owned 18.7% of all shares in the S&P 500."[19]

Along with ownership and the power it confers comes great expectations—investors are supposed to play a prominent role in corporate governance. This role of institutional investors has attracted much attention in the corporate scholarship. However, institutional investors so far have not been able to fulfill such expectations. Two models that analyze investors' involvement in corporate governance can summarize the huge body of literature that has emerged on this topic during the past decades. Both models conclude that investors are not active monitors of corporations, but each of them has a slightly different perspective on investors.

According to the first model, institutional investors, especially mutual funds, are passive because of inadequate incentives and

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[18] Assaf Hamdani & Sharon Hannes, *The Future of Shareholder Activism*, 99 B.U. L. REV. 971, 973 (2019).

[19] Sullivan & Cromwell LLP, *Review and Analysis of 2018 U.S. Shareholder Activism*, 23, (March 14, 2019), https://www.sullcrom.com/files/upload/SC-Publication-SandC-MnA-2018-US-Shareholder-Activism-Analysis.pdf.

conflict of interests.[20] In short, corporate governance activism is very costly. Activism means targeting companies in which investors assume that intervention would potentially improve the company's share value, and take several actions to press the company to adopt investors' strategy. The actions may include proposing precatory or binding shareholder proposals, running 'vote no' campaigns against incumbent directors, and calling special meetings, etc. In certain cases, an activist shareholder may also initiate a lawsuit against the company, in order to obtain information from the company, or change its decisions.[21]

To get a sense of how costly activism is, Nickolay M. Gantchev found that a single activist campaign, ending in a proxy fight, and usually led by an activist hedge fund, has an average cost of $10.71 million.[22] Although this estimation refers to a costly campaign that ends with a contested vote,[23] other forms of activism are costly as well. High cost itself should not be an insurmountable barrier because theoretically, institutional investors can pass the cost to their clients by charging higher fees, but the problem here is that given regulatory barriers, mutual funds cannot charge performance-based fees, but only fees based on a fixed percentage of asset under management of the fund. Such an incentive structure therefore discourages managers of

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[20] Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1057–62 (2007).

[21] The underlying objective of activist campaigns is mainly to obtain seats on the board of the company. Also, as a recent report reveals, in past years, other "common underlying objectives of proxy contests related to business strategies, balance-sheet actions (such as returning cash to shareholders through dividends or share repurchases, which are often related to capital allocation strategies) and divestitures or other M&A actions (such as encouraging a sale of the company or opposing a merger)." Sullivan & Cromwell LLP, *supra* note 19, at 27.

[22] Nickolay Gantchev, *The Costs of Shareholder Activism: Evidence from a Sequential Decision Model*, 107 J. FIN. ECON. 610 (2013). *See also* Kahan & Rock, *Hedge Funds*, *supra* note 20, at 1050 ("All of this consumes significant resources, both in-house and from hiring outside advisors.")

[23] Activist campaigns may also end with a settlement between activists and the target company. *See* Lucian A. Bebchuk, Alon Brav Wei Jiang & Thomas Keusch, *Dancing with Activists*, J. FIN. ECON (forthcoming) (indicate that the incidence of such settlements has grown over the years).

mutual funds to be active.[24] I will elaborate this point further in Section III.A. below where I discuss the need of institutional investors to stay cost-efficient.

Moreover, managers of some types of institutional investors, such as pension funds and mutual funds, have business ties with public companies that distort their incentives to monitor these companies. As Bebchuk and Hirst explain, managers of large institutional funds believe that if they defer to the decisions of their portfolio companies' managements, they would have better chances to obtain business from those companies, such as 401(k) employer-sponsored retirement plans.[25] Such ties push institutional investors' managers to favor corporate officers and vote for the officers' proposals rather than shareholders' proposals.[26]

Lastly, managers of institutional investors may fear that a backlash would result from activism, and therefore choose to be significantly deferential to corporate officers. This means they are less willing to intervene with corporate officers' decision-making process and to confront the officers. The reason is that going against the officers may trigger opposition from the officers and "from parts of the public that are resistant to concentrations of financial power,"[27] in the hands of large institutional investors. Given the fact that corporate officers "control the massive resources of Main Street companies [provides them with] formidable foe in the political arena,"[28] opposition from corporate officers may lead to a political and regulatory backlash and a reduction of institutional investors' power. Therefore, institutional

[24] Kahan & Rock, *Hedge Funds*, *supra* note 20, at 1051.

[25] Bebchuk, Cohen & Hirst, *supra* note 2, at 101–103. Some of the company employee savings and retirement plans and other affiliates have retained institutional investors (such as BlackRock, State Street, etc.) to provide investment management, trustee, custodial, administrative and ancillary investment services.

[26] Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2060–2064. For empirical research that supports this argument, see Dragana Cvijanović, Amil Dasgupta & Konstantinos E. Zachariadis, *Ties that Bind: How Business Connections Affect Mutual Fund Activism*, 71 J. FIN. 2933, 2933 (2016); Gerald F. Davis & E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds*, 85 J. FIN. ECON. 552, 569 (2007).

[27] Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2070.

[28] Id., at 2069.

investors are not likely to choose an intervention strategy, even when it may enhance the value of their portfolio companies.[29]

According to the second model developed by Ronald J. Gilson and Jeffrey N. Gordon, although institutional investors are not proactive, they are not passive in the common sense. Rather, they are "rationally reticent," meaning they are "will[ing] to respond to proposals but are unlikely to [propose] them."[30] Put differently, institutional investors such as mutual funds are inactive in the sense that they are unlikely to intervene, except when other players, such as activist hedge funds, involve in shareholder activism.

Both models can explain why institutional investors grossly underinvest in corporate stewardship. As Lucian Bebchuk and Scott Hirst document, the big three have very small stewardship departments and their stewardship budgets are insignificant.[31] Specifically, Blackrock, Vanguard and State Street have stewardship teams composed of forty-five, twenty-one and twelve members respectively. At the same time, their portfolios (worldwide) include 11,246, 13,225 and 12,191 companies respectively. Given this data, the Big Three can only spend "very limited resources on stewardship."[32] Although it seems that the Big Three intend to increase their stewardship personnel,[33] the trend does not seem to be significant enough to change the picture.

Both models have one thing in common—they only focus on the active dimension of stewardship provided by institutional investors in companies in their portfolios and neglect the passive dimension.

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[29] Bebchuk & Hirst, Index Funds, *supra* note 1, at 2066–70.

[30] Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 887 (2013).

[31] Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2075–2080.

[32] *Id.* at 2079.

[33] *Id.* at 2075. *See also* Michelle Edkins, *BlackRock Investment Stewardship Engagement Priorities for 2019*, HARVARD L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Jan. 31, 2019), https://corpgov.law.harvard.edu/2019/01/31/blackrock-investment-stewardship-engagement-priorities-for-2019/ (reporting that today, Blackrock has an Investment Stewardship team comprised of approximately forty professionals operating across all regions).

B. Investors' Private Engagements

Before proceeding to analyze the passive dimension of stewardship, we should also pay attention to a special type of active stewardship—private engagements of large institutional investors with their portfolio companies. These "behind-the-scenes" engagements are considered to be a collaborative approach, in which institutional investors do not apply a one-sided approach and demand corporations to adopt certain changes. Instead, these engagements reflect an approach in which investors and their portfolio companies cooperate and understand each other.[34] In other words, such engagements are a more communicative and "non-confrontational"[35] means that allow investors to maintain a more "dynamic relationship" with companies' managements.[36] a As a recent brochure of BlackRock states, "[E]ngagement is an important mechanism to provide feedback or signal concerns about factors affecting long-term performance, not to tell companies what to do."[37]

In their recent article, Matthew J. Mallow and Jasmin Sethi, both senior directors at BlackRock, describe many interrelated forms of engagement including "holding direct conversations with companies, regulators, and issue experts; conducting educational outreach with the market; collaborating with other investors, companies, and advocates; convening summits to identify tipping points; soliciting shareholder proposals; and sponsoring academic and other intellectual analysis on the issues to increase market participant awareness."[38]

To complete the picture, commentators have also raised doubts regarding the effectiveness of private engagements as a form of

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[34] Matthew J. Mallow & Jasmin Sethi, *Engagement: The Missing Middle Approach in the Bebchuck–Strine Debate*, 12 N.Y.U. J.L. & BUS. 385, 390 (2016).

[35] *Id.* at 392.

[36] *Id.* at 390.

[37] *BlackRock Investment Stewardship: Protecting Our Clients' Assets for the Long-Term*, BLACKROCK 6 (2019), https://www.blackrock.com/corporate/literature/publication/blk-profile-of-blackrock-investment-stewardship-team-work.pdf [hereinafter BlackRock Investment Stewardship].

[38] *Id.* at 393. *See also* Lisa M. Fairfax, *Mandating Board-Shareholder Engagement?*, 3 U. ILL. L. REV. 821, 848 (2013).

corporate stewardship. As Bebchuk and Hirst point out, private, "behind-the-scenes" engagements are not a substitute for classic activism, because first, data provided in the public reports of largest institutional investors' reveals that investors engage privately with only a small number of their portfolio companies. Specifically, "[F]rom 2017 through 2019, the average proportion of portfolio companies with no engagement were 88.9% for BlackRock, 94.2% for Vanguard, and 94.5% for SSGA."[39] Second, since private engagements are non-confrontational, it is unlikely that institutional investors will force their portfolio companies to make changes involuntarily, which reduces the effectiveness of private engagements because companies can ignore the investors' expectations without being punished.[40]

C. Corporate Guidelines are Overlooked

Oddly, little research, if any at all, has been devoted to exploring the uses and the potential power of corporate guidelines. Some prominent scholars have shortly discussed the potential role played by guidelines. For example, in their article, Lucian Bebchuk and Scott Hirst acknowledge that investors can use general principles to monitor their portfolio companies, but argue, that monitoring "cannot be effectively carried out using general principles."[41] As they emphasize, monitoring requires a company-specific analysis regarding each and every company,[42] and this seem to be the consensus among scholars.[43]

[39] Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2086.

[40] *Id.* at 2088.

[41] *Id.* at 2083.

[42] *Id.* at 2084.

[43] *See, e.g.*, Kahan & Rock, *Let Shareholders Be Shareholders*, supra note 10, at 5 ("Type B issues involve market wide governance standards such as staggered boards, in-force poison pills, majority voting, board diversity. These issues are sometimes raised by shareholder proposals but the decisive influences are the proxy voting guidelines of the largest institutional investors and the voting recommendations by ISS and Glass Lewis, the two leading proxy advisers."). However, similar to Bebchuk and Hirst, Kahan and Rock qualifies their position by stating that "[t]he information that is material to a vote on any particular issue consists of some mix of issue-specific information [and] company-specific information . . ." *Id.* at 36. *See also* Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV.

Moreover, as John Coates explains, the current analysis of index providers' incentives regarding stewardship fails to "capture the real implications of indexing for U.S. corporate governance" because the analysis should but does not take into account the way index funds form and publish "policies" regarding various governance issues, and how these policies may influence corporate governance system in their portfolio companies.[44] Lastly, in their recent article, Edward Rock and Marcel Kahan explain how "run of the mill issues" "can be decided with reference to the voting guidelines," whereas more "significant issues" require "more specific attention" of the largest institutional investors.[45]

In a similar vein, scholars have recognized that large institutional investors are likely to enjoy the economies of scale derived from the fact that they invest in hundreds of companies, and are therefore incentivized to study corporate governance issues to take advantage of the insights common to all relevant companies.[46] However, beyond general recognition of the potential of corporate guidelines, a deeper study of their nature and cost-effectiveness is needed. This article aims to fill this void.

II. THE ESSENCE OF CORPORATE GUIDELINES

A. Corporate Guidelines—General Features

Traditionally guidelines on corporate governance are set by regulators, such as the Securities and Exchange Commission, and quasi regulators including stock exchanges, such as the NYSE and NASDAQ. These guidelines are a set of principles and practices that

767, 772 (2017) ("The firm-specific nature of the tradeoff between principal costs and agent costs is the reason that firms adopt a wide variety of governance structures . . .").

[44] John Coates, *The Future of Corporate Governance Part I: The Problem of Twelve* 15 (Harv. Pub. Law, Working Paper No. 19-07=, 2018).

[45] Kahan & Rock, *Let Shareholders Be Shareholders*, *supra* note 10, at 33.

[46] Kahan & Rock, *Let Shareholders Be Shareholders*, *supra* note 10; *See also* Jill E. Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17, 35 (2020) ("[T]he Big Three enjoy substantial economies of scale with respect to corporate governance and market-wide initiatives.").

aim to support and promote sound corporate governance, and accordingly, enhance corporate value.

Interestingly, today, corporations also design and adopt their own governance guidelines, which address various matters including requirements for director qualifications, board elections (including director majority voting policy), director responsibilities, lead independent director's role, directors' conflicts of interests, committees of the board, executives compensation, shareholders' communication with the board (e.g. shareholders' rights to proxy access and to call special meetings), performance evaluations of the board and its committees, review of the composition of the board and its committees, qualification of audit committee members, board diversity, and commitment to corporate social responsibility.

Corporations' guidelines establish a framework for governance of the board of directors and the management of the corporation. These guidelines are typically designed by the board, described in detail in the public reports of the corporations, and updated by the board periodically. As will be elaborated in the next section, corporations state their commitment to the guidelines compiled by large institutional investors and strive to align their guidelines with the investors'. Put differently, guidelines adopted by corporations are influenced by proxy voting guidelines published by large institutional investors.

Today, large institutional investors like BlackRock, Vanguard, Fidelity, and State Street[47] publish their own governance guidelines on an annual basis. In fact, mutual funds are subject to a duty to publish their guidelines since 2003, when the SEC adopted the Advisors Act Rule 206(4)-6 that requires mutual funds to disclose the policies and procedures they use to vote proxies relating to portfolio securities, and

[47] *Examining the Market Power and Impact of Proxy Advisory Firms: Hearing Before the* S. Comm*. on Capital Mkts. & Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 113th Cong. 17 (2013) [hereinafter Hearing before the House] (testimony of Lynn Turner, Manager Director, LitiNomics, Inc: "If you look at the Web sites of the largest public pension funds and the 15 largest money managers. . . you will find they all have their own custom designed proxy voting guidelines.").

to disclose their voting decisions in order to allow clients to see whether their practices are aligned with the guidelines.[48]

The guidelines are used to instruct the investors how to vote and communicate with their portfolio companies. As BlackRock recently stated, "voting guidelines are the benchmarking against which [they] assess a company's approach to corporate governance."[49] Relatedly, guidelines constitute a tool through which investors reflect their perspective on various corporate governance practices that can promote long-term financial performance, and thus show their vision and preferences to the corporations in which they invest.

Institutional investors do not differ significantly in their guidelines. Differences mainly exist in the form of how closely the investors will follow their guidelines. Some investors keep more flexibility within the guidelines, allowing them to diverge when necessary, while the other investors leave less room for discretion. Table 1 below illustrates this point by comparing the guideline of the largest institutional investors on majority/cumulative voting. The table is compiled based on the voting guidelines of BlackRock,[50] Vanguard,[51] State Street,[52] and T.RowePrice.[53]

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[48] *See* 17 C.F.R. § 275.206(4)-6 (2003). *See also* Hearing Before the House, *Id*., at 28 (providing explanation by the former Chairman of the SEC about the rule).

[49] *Protecting and Enhancing Our Clients' Assets for the Long Term*, BLACKROCK, https://www.blackrock.com/corporate/about-us/investment-stewardship#engagement-priorities. (last visited Dec. 24, 2019).

[50] *Proxy Voting Guidelines for U.S. Securities*, BLACKROCK (Jan. 2019), https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf [hereinafter: "BlackRock Guidelines"].

[51] *Vanguard Funds Proxy Voting Guidelines for U.S. Portfolio Companies*, Vanguard (April 1, 2019), https://about.vanguard.com/investment-stewardship/portfolio-company-resources/proxy_voting_guidelines.pdf.

[52] Rick Lacaille & Rakhi Kumar, *2019 Proxy Voting and Engagement Guidelines: North America*, HARV. L. SCH. FORUM. CORP. GOV. (Mar. 27, 2019), https://corpgov.law.harvard.edu/2019/03/27/2019-proxy-voting-and-engagement-guidelines-north-america/.

[53] *Proxy Voting Guidelines*, T.ROWEPRICE (2019), https://www.troweprice.com/content/dam/trowecorp/Pdfs/Proxy%20Voting%20Guidelines%20-%202019.pdf [hereinafter : "T.RowePrice Guidelines").

Table 1. An Illustrative Example of Guidelines Language

BlackRock	Vanguard	State Street	T.RowePrice
"We believe that a majority vote standard is in the best long-term interest of shareholders. . . As such, we will generally oppose proposals requesting the adoption of cumulative voting, which may disproportionately aggregate votes on certain issues or director candidates. . . BlackRock believes that directors should generally be elected by a majority of the shares voted and will normally support proposals seeking to introduce bylaws requiring a majority vote standard for director elections. Majority voting standards assist in ensuring that directors who are not broadly supported by shareholders are not elected to serve as their representatives. Some companies with a plurality	"Cumulative voting. A fund will vote for management proposals to eliminate cumulative voting and vote against management or shareholder proposals to adopt cumulative voting. Majority voting. If the company has plurality voting, a fund will vote for shareholder proposals requiring majority vote for election of directors. It will also vote for management proposals to implement majority voting for election of directors. A fund will vote against shareholder proposals requiring majority vote for election of directors if the company has a director resignation policy under which a nominee who fails to get a majority of	"Cumulative voting. We do not support cumulative voting structures for the election of directors." "Majority voting. We will generally support a majority vote standard based on votes cast for the election of directors. We will generally vote to support amendments to bylaws that would require simple majority of voting shares (i.e. shares cast) to pass or to repeal certain provisions."	"FOR proposals asking the Board to initiate the process to provide that director nominees be elected by the affirmative majority of votes cast at an annual meeting of shareholders. Resolutions should specify a carve-out for a plurality vote standard when there are more nominees than board seats."

voting standard have adopted a resignation policy for directors who do not receive support from at least a majority of votes cast. Where we believe that the company already has a sufficiently robust majority voting process in place, we may not support a shareholder proposal seeking an alternative mechanism."	votes cast is required to resign."		

When voting on certain issues, institutional investors may diverge from their own guidelines. Such a divergence is not automatically perceived as a breach of good corporate governance. However, at least some of the investors have an "align or explain" mechanism, meaning, when their voting behaviors in certain portfolio companies do not align with their guidelines and diverge from guidelines, they would explain the reason for the divergence. For example, T. Rowe Price has a Proxy Committee that develops its guidelines distributes the guidelines to portfolio managers. Ultimately, the portfolio managers decide how to vote on the proxy proposals of companies in their portfolios, but as T. Rowe Price's guidelines stress, "when portfolio managers cast votes that are counter to the Proxy Committee's guidelines, they are required to document their reasons in writing to the Proxy Committee."[54]

Lastly, guidelines designed by institutional investors typically reserve some degree of flexibility for the portfolio companies, by allowing them to take into account their individual characteristics when complying with the guidelines, as long as they execute the holistic attitude stipulated by the guidelines. Put differently,

[54] See T.RowePrice Guidelines, *supra* note 53, at 1.

institutional investors' guidelines do not seek to dictate specific governance structures, but rather defer to the structures chosen by corporations' boards of directors, as long as they align with the investors' philosophy.

An illustrative example is the guideline that requires the separation between the chairman of the board and the CEO. BlackRock's guideline allows its portfolio companies to choose between an independent chairman and a lead director that serve together with the chairman when the roles of the chairman and the CEO are combined.[55] Still in the same context, during the roundtable held by the SEC in 2018 on proxy process, Mrs. Rakhi Kumar, Senior Managing Director and Head of ESG Investment and Asset Stewardship at State Street, explained how some of the corporate governance issues are "gray" and require attention to specific details. As she stressed: "We realize it's not just as easy as flipping the role of a chair and CEO. We realize it has much more to it, such as the individual in place, the time commitment, the job description."[56]

The above example reflects the typical attitude of institutional investors to their own guidelines. As such, although at the first glance corporate guidelines designed by institutional investors may be seen as a rigid set of one-size-fits-all rules, they are actually relatively

[55] BlackRock Guidelines, *supra* note 50, at 6 ("We believe that independent leadership is important in the boardroom. In the U.S. there are two commonly accepted structures for independent board leadership: 1) an independent chairman; or 2) a lead independent director when the roles of chairman and CEO are combined. In the absence of a significant governance concern, we defer to boards to designate the most appropriate leadership structure to ensure adequate balance and independence. In the event that the board chooses a combined chair / CEO model, we generally support the designation of a lead independent director if they have the power to: 1) provide formal input into board meeting agendas; 2) call meetings of the independent directors; and 3) preside at meetings of independent directors. Furthermore, while we anticipate that most directors will be elected annually, we believe an element of continuity is important for this role for an extended period of time to provide appropriate leadership balance to the chair / CEO.").

[56] *See Round Table on the Proxy Process*, SEC 183 (July 30, 2018), https://www.sec.gov/files/proxy-round-table-transcript-111518.pdf [hereinafter SEC Roundtable-2018].

flexible principles that leave discretion for both the investors and managements of corporations.[57]

For these reasons, institutional investors' corporate guidelines are likely to attract little opposition from corporations, and thereby alleviate the concerns raised by Bebchuk and Hirst about the disincentives of investors to confront corporations' managers.[58] This means unlike active stewardship, institutional investors are not likely to underinvest in designing corporate guidelines because the guidelines won't harm the business ties between the managers of the investors and the portfolio companies or lead to other types of backlash.

B. Corporate Guidelines—The Potential Influence

In this part, I explain how corporate guidelines have omnipresent power and influence. As I have discussed in Part I.A, the research conducted so far by scholarship shows that institutional investors have limited pecuniary interest as well as budgets and personnel needed to influence governance regimes in their portfolio companies.[59] It therefore concludes that institutional investors' influence on corporate governance in their portfolio companies is limited.[60] In this part, I will argue that this view underestimates the influence of institutional investors on corporate governance it fails to capture the potential power of corporate guidelines.

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[57] *See, e.g.*, Vanguard, *Vanguard-Advised Funds Proxy Voting Policy*, SEC (October 1, 2019), https://www.sec.gov/Archives/edgar/data/932471/000093247119007334/sai069_102019.htm ("In evaluating proxy proposals . . . [W]e will give substantial weight to the recommendations of the company's board, absent guidelines or other specific facts that would support a vote against management."); BlackRock Guidelines, *supra* note 50, at 3 ("These Guidelines are not intended to limit the analysis of individual issues at specific companies and are not intended to provide a guide to how BlackRock will vote in every instance. . . . They are applied with discretion, taking into consideration the range of issues and facts specific to the company and the individual ballot item."); *Proxy Voting Guidelines*, FIDELITY 1 (Jan. 2020) ("Fidelity maintains the flexibility to vote individual proxies based on our assessment of each situation.").

[58] *See* the text accompanying note 27.

[59] *See infra* Part I.A.

[60] *Id.*

In subsection B.1, I will explain how, guidelines of the largest institutional investors have the potential to influence corporations before and after formal voting periods (in between shareholder meetings) due to their special nature. Relatedly, in subsection B.2, I will explain how this nature of guidelines allow both corporations and investors relying on them to avoid confrontation and shaming.

1. The Omnipresent Power of Corporate Guidelines

Skepticism regarding institutional investors' involvement in stewardship typically originates from statistics and numbers. For example, as mentioned before, Bebchuk and Hirst argue that the limited personnel and budgets of the Big Three cannot allow them to be good stewards in the huge number of corporations they invest in. Bebchuk and Hirst support their argument by citing that the number of companies with which the Big Three engage, according to their annual stewardship reports, only constitute between 5.5%–11% of their portfolio companies, and only 0.6%–2.3% of the companies experienced multiple engagements by the Big Three.[61] Bebchuk and Hirst also provide evidence on the frequency of the Big Three voting against say-on-pay proposals, showing that they rarely vote against the proposals initiated by managements. They argue that these findings indicate a nearly absolute deference of the Big Three to the managements of their portfolio companies.[62] Pro-management voting by index funds was documented also by other empirical studies.[63] While these findings are convincing, they do not capture the full story.

[61] Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2084–2088.

[62] *Id.* at 2091–2095.

[63] Ryan Bubb & Emiliano Catan, The Party Structure of Mutual Funds (Mar. 10, 2019) (unpublished manuscript) (on file with SSRN); Patrick Bolton, Tao Li, Enrichetta Ravina & Howard Rosenthal, *Investor Ideology* (European Corp. Governance Inst., Finance Working Paper No. 557/2018, 2019), https://ssrn.com/abstract=3119935. Interestingly, institutional investors themselves admit that they prefer engaging with their portfolio companies, over supporting shareholders proposals submitted to these companies. For example, Mr. Ray A. Cameron, Head of Investment Stewardship Team for the Americas Region at BlackRock, stated: "We prefer engagement, as we see shareholder proposals as a tool often of last resort, an avenue for accelerated change when needed. During our

The influence of investors' corporate guidelines tends to be underestimated because it is hard to identify and quantify, and because providing stewardship through the guidelines are often indistinguishable from the simple pro-management voting practice. Indeed, there are many cases where shareholders submit a proposal to a company asking its board to make a governance change and the institutional investors' voting decision is aligned with the board's recommendation to vote against the shareholder proposal. In such cases, the voting behavior of institutional investors is traditionally counted as pro-management voting, and thus the investors are perceived as if they haven't fulfilled their fiduciary duty to monitor their portfolio companies in an optimal manner. However, a closer look will reveal a more complex dynamic behind such voting pattern.

Analysis of the real power of the largest institutional investors shall not focus only on the dynamic between the investors and their portfolio companies in the formal voting process because changes in governance are also made by corporations in the period between annual meetings. Corporations may modify their governance guidelines during the year, not due to shareholders proposals, but based on analysis of corporate guidelines.

As some corporations' proxy statements reveal, corporations' governance guidelines are designed in advance of shareholder meeting, based board of directors' review of "governance guidelines published by institutional investors and proxy advisors," "stockholder

direct engagements with companies, we address the issues covered by many shareholder proposals that we believe to be material to the long-term value of the company. Where management demonstrates a willingness to address the material issues raised, and where we believe progress is being made, we will generally support the company and vote against the shareholder proposal." SEC Roundtable-2018, *supra* note 56, at 116, *See also Id.* at 118 ("Blackrock takes an engagement-first approach. And we find that even when we do not support shareholder proposals or some proposals, the conversations that we have with companies on related topics often lead to positive change without the use of what some might consider to be a blunt instrument."); Tim McLaughlin & Ross Kerber, *Index Funds Invest Trillions But Rarely Challenge Management*, REUTERS (October 8, 2019) (citing a statement of Michelle Edkins, head of corporate governance at BlackRock: "A vote against management is a sign of a failed engagement," Michelle Edkins, who oversees BlackRock's proxy voting, said in an interview.").

expectations," "proxy voting guidelines of [the company's] major stockholders," "Investor Stewardship Group's (ISG) Corporate Governance," "investor concerns," whether a certain standard has been "recognized by the Council of Institutional Investors as a market standard," "evolving governance best practices," "emerging best practices in corporate governance," and "prevailing practices among other U.S. companies."[64]

The above statements mean corporations do not ignore corporate guidelines of the largest institutional investors and proxy advisory firms, as well as industry's best practices. As the Investors Stewardship Group (ISG), an initiative formed by the largest institutional investors, emphasizes on its website: "Listed companies should recognize that some of their largest investors now stand together behind these principles."[65] The ISG's position reflects a threat that if corporations choose not to follow the principles perceived by investors to be good corporate governance, they should have good reasons; otherwise, they are exposed to sanctions from the investors in the form of, for example, the investors' decision to oppose reelection of directors; or the decision to support shareholder proposals. Such threat is credible despite the fact that institutional investors tend to vote with managements and are perceived as pro-managements.

As Mr. Brandon Rees, Deputy Director of Corporations and Capital Markets for the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) during the Roundtable held by the SEC in 2018: "Large institutional investors—the BlackRocks and State Streets and Vanguards of the world—do not need the shareholder proposal rule process to get attention of management or board of directors. There's not a corporate secretary or investors relations department in the country that would not return their call within 24 hours."[66]

Besides this general statement, as Mr. Gary Retelny, the President and CEO of the largest proxy advisory firm ISS recently emphasized

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[64] *See* Appendix A.

[65] *About the Investor Stewardship Group and the Framework for U.S. Stewardship and Governance*, INV'R STEWARDSHIP GRP., https://isgframework.org/ (last visited Feb. 2, 2020) [hereinafter ISG].

[66] SEC Roundtable-2018, supra note 56, at 150.

in the SEC's 2018 Roundtable, that where institutional investors "have their own custom policies that they have designed and that they want to implement with regards to" their portfolio companies, "[w]hat ISS does, essentially, is help them with the work flow . . . based on [investors'] own individual custom policies."[67] Relatedly, According to the recent empirical research conducted by Bebchuk and Hirst, the Big Three "have been very active in supporting [shareholders] proposals advocating governance changes favored by their governance principles."[68] Lastly, a report recently published by State Street, one of the prominent signatories of ISG, reveals that State Street's initial screen in March 2018 identified sixty-six S&P 500 companies that did not comply with ISG's governance principles. Subsequently, many of these companies improved their practices before their annual shareholder meetings or were able provide sufficient justification for their practices. State Street eventually voted against those who failed to do so.[69]

In conclusion, institutional investors' pro-management voting pattern during annual shareholder meetings does not necessarily mean that they blindly defer to managements' governance practices. It can also suggest that the investors are able to steer the managements to follow their guidelines before the annual meetings start, or secure the managements' promise that they will follow the guidelines soon after the upcoming meetings, thereby making it unnecessary to effectuate governance changes by voting against the managements.

2. Corporate Guidelines as a "Soft" Intervention that Avoids Confrontation and Shaming

Corporate guidelines, unlike active engagements, may allow corporations to avoid embarrassment and harm to their images. Simply put, at the moment that a shareholder proposal is submitted and

[67] Id., at 191-192. *See also* Id., at 192 ("87 percent of the shares that we execute votes for—vote as per their own custom policies.").

[68] Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2104.

[69] *See Stewardship Report 2018–19*, STATE STREET GLOBAL ADVISORS 59 (2019), https://www.ssga.com/investment-topics/environmental-social-governance/2019/09/annual-asset-stewardship-report-2018.pdf [hereinafter SSGA 2018-19].

requires that the board to implement a governance change, if the board subsequently recommend to the company's shareholder to vote "for" the shareholder proposal, it may be interpreted as if the board was unaware of and failed to make the fit and proper governance arrangement in advance. Such a dynamic may create an element of "shaming" against the board. In contrast, if the board chooses to propose a governance change by itself and support its proposal by referring to institutional investors' guidelines, the board is likely to signal that it is its commitment to good corporate governance, not external forces, that drives the proposed governance change. Such a proposal initiated by the board can even be made soon after the board refused to accept a shareholder proposal on the same governance issue.

To illustrate this dynamic, let's take the giant pharmaceutical company Allergan as an example. In its 2018 proxy statement, shareholders requested Allergan's Board to adopt a policy that would require the Chair of the Board, whenever possible, to be an independent director. To support their proposal, shareholders wrote that "number of institutional investors said that a strong, objective board leader can best provide the necessary oversight of management. Thus, the California Public Employees' Retirement System's Global Principles of Accountable Corporate Governance recommends that a company's board should be chaired by an independent director, as does the Council of Institutional Investors. An independent director serving as chairman can help ensure the functioning of an effective board."[70]

Allergan's Board of Directors recommended that the shareholders should vote against this shareholder proposal,[71] and at the annual meeting held on May 1, 2019, the proposal was rejected.[72] 101,019,176 shares voted "For" and 159,894,901 voted "Against".[73] Interestingly, at the time of the voting, the largest shareholders of Allergan were: Wellington Management Group with 24,934,153 (constitute 7.49%) of Allergan shares; BlackRock with 21,466,017

[70] Allergan PLC, Proxy Statement (Schedule 14A) (March 23, 2018).

[71] *Id.*

[72] Allergan PLC, Current Report (Form 8-K) (May 1, 2019).

[73] *Id.*

(constitute 6.45%) of Allergan shares; and Vanguard with 24,179,830 (constitute 7.27%) of Allergan shares.[74] Although their voting guidelines supported the separation of the Chairman and the CEO,[75] Wellington, BlackRock and Vanguard voted against the proposal,[76] which determined the results of the voting on the proposal.

However, subsequently in its 2019 proxy statement, Allergan's Board adopted the governance change that would require the Chair of the Board to be an independent director but phrased the change as its own initiative. It stated that "[T]he Board has also heard from many of our shareholders that they would value a policy requiring an independent Chair that the Board could phase in with the next CEO transition. Accordingly, the Board has adopted changes to its corporate governance guidelines and the Nominating and Corporate Governance Committee charter so that, phased in within a reasonable period of time in connection with the next CEO transition following the March 2019 adoption of the Corporate Governance Guidelines, the Chair of the Board shall be, whenever possible, an independent director."[77]

Another example is related to Booking Holding Company (the former Priceline Group Inc.). In the its 2015 proxy statement, the Board opposed a shareholder proposal concerning enhanced proxy access.[78] However, after the proposal was eventually approved at the annual meeting in 2015, the Board tried to describe this governance change as a result of its own effort to improve governance.[79] As the proxy statement of 2019 stated: "Our management and the Board of

[74] Allergan PLC, *Proxy Statement*, *supra* note 70.

[75] *Global Proxy Voting Guidelines*, WELLINGTON MANAGEMENT (December 5, 2018), https://www.wellington.com/en/wp-content/uploads/2017/08/global-proxy-voting-guidelines.pdf; BlackRock Guidelines, *supra* note 50, at 6; Vanguard, *Proxy Voting*, *supra* note 51.

[76] Advanced Series Trust, Annual Report of Proxy Voting Record of Registered Management Investment Company (Form N-PX) (August 28, 2019);; Vanguard Index Funds, Annual Report of Proxy Voting Record of Registered Management Investment Company (Form N-PX) (August 30, 2019)**Error! Hyperlink reference not valid.**.

[77] Allergan PLC, Proxy Statement (Schedule 14A) (March 22, 2019).

[78] The Priceline Group Inc., Proxy Statement (Schedule 14A) (April 22, 2015)**Error! Hyperlink reference not valid.**.

[79] The Priceline Group Inc., Current Report (Form 8-K) (June 4, 2015).

Directors regularly evaluate ways to improve the Company's corporate governance. The Board adopted the Proxy Access By-Laws in 2015. The Board's adoption of Proxy Access By-Laws demonstrates the Company's commitment to good corporate governance practices and responsiveness to stockholders. We adopted our current Proxy Access By-Laws after significant evaluation and deliberation by the Nominating and Corporate Governance Committee and the full Board of Directors and meaningful stockholder engagement. This thoughtful review included an analysis of best practices among other leading U.S. public companies and a review of the corporate governance policies of some of our largest stockholders."[80]

Such a dynamic may teach us that managements are not against governance changes per se but would oppose the changes proposed by shareholders in an adversarial manner. Unlike shareholder proposals, guidelines designed by institutional investors may allow both corporations and institutional investors an elegant way to avoid direct confrontation. At first, investors can support managements by voting against a shareholder proposal, even though the proposal is consistent with the investors' guidelines. Eventually, since managements understand that they have to align with the institutional investors' philosophy and expectations of governance to reflect their commitment to their largest investors and more generally, their awareness to good corporate governance, the managements are likely to adopt the substance of the shareholder proposal.

III. THE RISE OF CORPORATE GUIDELINES

This part of the article offers potential explanations for the rise of corporate guidelines from the supply side, i.e. for why corporate guidelines have become a more popular form of stewardship among institutional investors. Some of them are interrelated, and together, they shed light on the trend of the push towards standardization in corporate governance, and more specifically, the evolution of corporate guidelines.

[80] Booking Holdings Inc., Proxy Statement (Schedule 14A) (June 4, 2019).

A. The Need to Strike a Balance between Complying with Fiduciary Duties and Cost-Effectiveness

In this part I will explain how institutional investors' growing uses of corporate guidelines is the result of their need to balance between 1) their fiduciary duties to vote on a huge number of resolutions at shareholder meetings of their portfolio companies; and 2) their need to stay cost-effective. In this section I focus on three issues.

First, institutional investors are obliged to vote in the best interests of their clients as a part of their fiduciary duties. Relatedly, given their enormous power, these investors are expected to act as good stewards. *Second*, large investors are subject to a burden of voting in thousands of annual meetings every year. This enormous burden has push them to increasingly use the services of proxy advisory firms. Such reliance on advisory firms has drawn huge criticism that institutional investors outsource their duties owed to their clients instead of fulfilling them. Meanwhile, lots of mutual funds have moved towards the passive indexing strategy—a move that has portrayed them as passive stewards and attracted much attention and criticism from commentators and policymakers. Mutual funds have been forced to defend themselves, again, by emphasizing their willingness to devote more resources to corporate stewardship.[81] Unable to simply disregard the above criticism, institutional investors must show that they take control over their own duties. *Third*, institutional investors, mainly mutual funds, must remain cost-effective in order to achieve competitive advantages, in the market which substantially limits their incentives to invest in active stewardship. The combination of these elements, discussed below, has led to institutional investors' increasing reliance on corporate guidelines.

1. Compliance with Fiduciary Duties and Good Citizenship

Institutional investors owe fiduciary duties to their clients. According to the law and relevant regulations, institutional investors are required to vote their proxies in the best interests of their clients. At first, after the passage of the Employee Retirement Income Securities

[81] Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2034.

Act of 1974 (ERISA), the U.S. Department of Labor (DOL) began ordering private pension funds to act solely in the interests of their plan participants and beneficiaries. Subsequently, in 1988, the DOL released a letter, commonly known as the "Avon Letter," stating that "the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock."[82] In 2003, the SEC adopted a rule and amendments under the Investment Advisers Act of 1940 pertaining to mutual funds and investment advisers in order to encourage them to vote their proxies in the best interests of their shareholders.[83]

The SEC and the U.S. Congress have continued to reinforce institutional investors' duties in the following years. Just recently, in November 2018, in the statement announcing a roundtable on proxy process, Chairman Jay Clayton stated that "Shareholder engagement is a hallmark of our public capital markets."[84] In effect, it seems that pension funds, mutual funds and policymakers have interpreted the Investment Advisers Act of 1940 as requiring funds to vote at every shareholder meeting, on every matter. As the SEC Commissioner Elad L. Roisman recently stated, "it appears to be the default position of many advisers that they vote every proxy, for every company, in every fund's portfolio."[85]

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[82] *See* Letter from Allan lebowitz, Deputy Assistant Seely of the Pension Welfare Benefits Admin. at the U.S. Dep't of Labor, to Helmuth Fandl, Chairman of the Ret. Bd., Avon Products, Inc. (Feb. 23, 1988).

[83] *See* Proxy Voting, 17 C.F.R. § 275.206(4)-6 (2003).

[84] *See* SEC Roundtable-2018, *supra* note 56.

[85] Elad L. Roisman, Commissioner, Sec. & Exch. Comm., Keynote Remarks: ICI Mutual Funds and Investment Management Conference (March 18, 2019), (transcript available at https://www.sec.gov/news/speech/speech-roisman-031819#_ftnref10); *see also Examining the Market Power and Impact of Proxy Advisory Firms: Hearing Before the Subcomm. on Capital Mkts. & Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 113th Cong. 2 (2013) [hereinafter Hearing Before the House of Rep.] (providing a written testimony of Jeffrey D. Morgan, President & CEO of National Investor Relations Institute: "[M]utual fund and pension fund managers are required to vote all their shares on every matter . . . ."). *But see* Letter from the Inst. Inv'r, Serv., to Brent J. Fields, Secretary, the Sec. & Exch. Comm. (Nov. 7, 2018) (on file at https://www.issgovernance.com/file/publications/iss-roundtable-comment-

Beyond legal duties, institutional investors are also subject to reputational concerns. Simply put, due to their enormous power in influencing corporate governance (e.g. they have plenty of resources to invest in corporate stewardship and also enjoy economies of scale in this aspect), large investors are expected to act as good stewards,[86] and more metaphorically—as good corporate citizens.[87] These concerns incentivize the investors to act as responsible actors who promote better corporate governance since such a positive image is likely to improve the way they are perceived by policy makers, the media, etc.[88] This is especially important for large investors like BlackRock, Vanguard, and State Street, given the fact that during the past years, they are subject to a massive criticism against their market power, which has reduced competition and accordingly harmed consumers.[89] As Edward Rock and Marcel Kahan explain: "The best way to avoid regulation is to be

letter.pdf) (explaining that the regulation "does not . . . require investment advisers to vote every proxy, regardless of facts and circumstances").

[86] Bubb & Catan, *supra* note 63, at 28 ("Our main hypothesis for passive managers is that larger passive managers will invest more resources into voting due to economies of scale and because they face greater reputational risks. Put simply, the BlackRock's, Vanguard's, and State Street's of the world face more pressure to act as good stewards and can spread the costs of doing so across a wider asset base, than smaller passive managers.").

[87] *See, e.g.*, Proxy Advisory Firms Roundtable, SEC 74 (Dec. 5, 2013), https://www.sec.gov/spotlight/proxy-advisory-services/proxy-advisory-services-transcript.txt [hereinafter: SEC Roundtable-2013], in which Mr. Eric Komitee, General Counsel at Viking Global Investors, LP, Remarked, "I think investment advisers generally speaking have a duty of good corporate citizenship in the United States the same way ordinary citizens have a civic duty to vote in elections, you know, where the outcome is potentially important to corporate America and the companies in which they invest."

[88] *See* Kahan & Rock, *Let Shareholders Be Shareholders*, *supra* note 10, at 29.

[89] *See* Eric A. Posner, Fiona M. Scott Morton & E. Glen Weyl, *A Proposal to Limit the Anti-Competitive Power of Institutional Investors*, 81 ANTITRUST L. J. 669 (arguing that ownership concentration by the largest passive investors will undermine product market competition and calling to limit their power); Fiona Scott Morton & Herbert Hovenkamp, *Horizontal Shareholding and Antitrust Policy*, 127 YALE L.J. 1742 (2018) (holding the same position as the previous article); Asaf Eckstein, *The Virtue of Common Ownership in an Era of Corporate Compliance*, 105 IOWA L. REV. 507 (2020) (describing criticism against common ownership structure and the concentrated power of the largest institutional investors).

viewed by relevant audience as responsible stewards."[90] Moreover, reputation is critical to maintaining clientele, as the former Senator Phil Gramm stated during the Roundtable held by the SEC in 2018: "You're going to be relatively unaffected by the profitability of the company where you're casting those proxies. But you may very well be affected by the public perception of your actions, and therefore the marketability of your index."[91] Therefore, it should come with no surprise why the leaders of the largest institutional investors consistently emphasize their strong commitment to corporate stewardship.[92]

The upshot here, is that under the existing law and expectations from the public, institutional investors cannot renounce corporate stewardship in an absolute way. As I will show in the next parts of the Article, this toned to be a good corporate steward has increased institutional investors' reliance on corporate guidelines because they are considered a legitimate governance device, and at the same time allow the investors to stay cost-effective.

2. The Growing Burden on Institutional Investors, the Criticism against Outsourcing Their Fiduciary Duties, and the Need to Take Control Over Their Duties

Institutional investors are subject to a very burdensome governance task. During the last two decades, corporate law and regulations have significantly expanded the types of issues that require shareholder vote. For example, as the 2019 BlackRock Investment Stewardship report reflects, its investment stewardship team votes "at over 17,000 meetings a year."[93] As the 2019 Vanguard Investment Stewardship report reveals, "[i]n the 2019 proxy year, the Vanguard funds voted on 169,746 proposals at 18,961 company meetings across every major financial market."[94]

[90] Kahan & Rock, *Index Funds*, *supra* note 20, at 30.

[91] SEC Roundtable-2018, *supra* note 56, at 189.

[92] Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2084.

[93] BlackRock Investment Stewardship, *supra* note 37, at 13.

[94] Investment Stewardship: 2019 Annual Report, VANGUARD 8 (August 2019) https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019_investment_stewardship_annual_report.pdf.

The growing burden has pushed more and more investors to outsource their voting task to proxy advisory firms, in order to fulfil their fiduciary duties.[95] This trend has attracted much criticism and calls for legislative and regulatory intervention.[96] Large institutional investors were accused of violating their fiduciary duties, by blindly following the recommendations of proxy advisory firms, who operate without transparency and with conflict of interests. Public companies have also urged policymakers to take a stronger position on the proxy advisory industry. In response, the SEC as well as the U.S. Congress have investigated and debated the merits of proxy advisory regulation.

In 2010, the SEC issued a Concept Release that focused on the U.S. proxy system in general and on proxy advisors in particular.[97] The House of Representatives held a hearing on the matter in June, 2013,[98] and the SEC followed this hearing with a roundtable discussion in December, 2013.[99] At the same time, Commissioner Daniel M. Gallagher expressed "grave concerns" as to "whether investment advisers are indeed truly fulfilling their fiduciary duties when they rely on and follow recommendations from proxy advisory firms."[100] No rulemaking initiatives resulted from these discussions until June 30, 2014, when the Investment Management and Corporate Finance Divisions of the SEC issued a joint Legal Bulletin No. 20 (SLB-20), outlining the responsibilities of proxy advisors and institutional

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[95] Another reason for reliance on proxy advisor is the SEC interpretation that institutional investors could cleanse their conflict of interests they may have with their portfolio companies, by relying on voting policies developed by an independent, third-party agency—such as a proxy advisory firm. See Asaf Eckstein, *Great Expectations: The Peril of an Expectations Gap in Proxy Advisory Firm Regulation*, 40 DEL. J. CORP. L. 77 (2015).

[96] *Id*. *See also* Asaf Eckstein & Sharon Hannes, *A Long/Short Incentive Scheme for Proxy Advisory Firms*, 53 WAKE FOREST L. REV. 787 (2018).

[97] Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42,982, 43,011-12 (proposed July 14, 2010).

[98] Hearing before the House, supra note 47, at 2.

[99] SEC Roundtable-2013, *supra* note 87, at 41–42.

[100] Michael J. Segal, Trevor S. Norwitz & Sabastian V. Niles, *Wachtell Lipton discusses Commissioner Gallagher's Critiques of Proxy Advisory Firms*, THE CLS BLUE SKY BLOG (July 17, 2013), https://clsbluesky.law.columbia.edu/2013/07/17/wachtell-lipton-discusses-commissioner-gallaghers-critiques-of-proxy-advisory-firms/.

investors when casting proxy votes.[101] During these hearing and discussions, participants complained that institutional investors "sidestep their fiduciary obligations instead of actually fulfilling them themselves,"[102] that the SEC "effectively decoupled the voting decision from the fiduciary duty" by allowing institutional investors to exclusively rely on proxy advisors,[103] and that today, "investment managers vote automatically in line with a proxy advisory firm's recommendation, so-called robo-voting."[104] This debate shows no sign of fading. Just in 2018 the SEC initiated, again, a series of discussions on how to curb the power of proxy advisory firms. In November 2019, the SEC voted to propose amendments to its rules governing proxy advice.[105]

The outrage is not directed only towards proxy advisory firms, but also towards large institutional investors, and the way they fulfill their fiduciary duties has been under close scrutiny.[106] In response to the criticism, investors emphasize their commitment to enhance good governance in their portfolio companies. For example, BlackRock CEO Larry Fink has declared that BlackRock reaches its voting

[101] *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms*, SEC (June 30, 2014), https://www.sec.gov/interps/legal/cfslb20.htm [http://perma.cc/L7KN-MD8R] (providing a set of questions and answers summarizing investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms, as well as the availability and requirements of two exemptions to the federal proxy rules that are often relied upon by proxy advisory firms) [hereinafter SLB 20].

[102] Hearing before the House, *supra* note 47, at 19.

[103] *Id.*, at 29.

[104] SEC Roundtable-2018, *supra* note 56, at 191.

[105] SEC Proposes Rule Amendment to Improve Accuracy and Transparency of Proxy Voting Advice, SEC (Nov. 5, 2019), https://www.sec.gov/news/press-release/2019-231.

[106] In that regard, see Reena Aggarwal, Isil Erel & Laura Starks, *Influence of Public Opinion on Investor Voting and Proxy Advisors*, (Fisher College of Business, Working Paper No. WP 2014-03-12, 2015), https://ssrn.com/abstract=2447012 (analyzing how institutional investors' behaviors and voting are influenced by "the economic and social climate of public opinion").

decisions independently.[107] This declaration was accepted with satisfaction. For example, following this declaration, Martin Lipton of Wachtell, Lipton, Rosen & Katz, wrote to the firm's clients that "it is a helpful sign that a major institutional investor is willing to take a direct and pragmatic role in governance issues rather than outsourcing this responsibility to a proxy advisory firm or agitating for short-term results."[108]

So far, I described how the largest institutional investors have attracted much attention for the way they fulfil their duties. It would not be an exaggeration to say that the attention has skyrocketed with the growing use of index fund services provided by the Big Three. Index funds have become a major force in the investing arena and accordingly they have attracted huge attention. More and more scholars have started to explore these funds' incentives to be good stewards, and many of them criticize the funds for not having sufficient incentives.[109] Some scholars have made a step forward and called lawmakers to consider restricting the rights of index funds to vote at annual meetings of companies in which they invest.[110] The media has also warned against "[t]he [h]idden [d]angers of the [g]reat [i]ndex [f]und [t]akeover."[111] In response, leaders of index funds have emphasized that they are not passive with regard to engagements with

[107] Martin Lipton, *Disintermediating the Proxy Advisory Firms*, HARVARD L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Jan. 21, 2012), https://corpgov.law.harvard.edu/2012/01/21/disintermediating-the-proxy-advisory-firms/.

[108] Susanne Craig, *The Giant of Shareholders, Quietly Stirring*, THE N.Y. TIMES (May 18, 2013), https://www.nytimes.com/2013/05/19/business/blackrock-a-shareholding-giant-is-quietly-stirring.html.

[109] Kahan & Rock, *Let Shareholders Be Shareholders*, *supra* note 10; Bebchuk & Hirst, *Index Funds*, *supra* note 1; Davidson Heath, Daniele Macciocchi, Roni Michaeli & Matthew C. Ringgenberg, *Do Index Funds Monitor?* (European Corp. Governance Inst., Finance Working Paper No. 638/2019, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3259433.

[110] Lund, *supra* note 7.

[111] David McLaughlin & Annie Massa, *The Hidden Dangers of the Great Index Fund Takeover*, BLOOMBERG (Jan. 9, 2020), https://www.bloomberg.com/news/features/2020-01-09/the-hidden-dangers-of-the-great-index-fund-takeover.

their portfolio corporations.[112] Relatedly, they have stressed how they are committed to expand their stewardship teams' capabilities,[113] and intensify their stewardship efforts.[114] As an example of their increasing commitment, in recent years, mutual funds expressed their dissatisfaction from short-term vision of activist hedge funds,[115] and in letters they sent to CEOs of their portfolio companies, mutual fund leaders criticized the process of quick and private settlements between companies and activists= that has deprived their voice.[116]

The upshot here, is that during the years institutional investors have been subject to increasing burden because of their growing governance tasks, and they cannot relieve the burden by simply outsourcing these tasks or abandoning their duties. Therefore, subject to the huge costs coupled with the governance tasks, institutional investors seek a legitimate and cost-effective way to reflect their commitment to stewardship.

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[112] *See, e.g.*, Jennifer Thompson, *Index Tracking ETFs Deny Any 'Abdication' of Stewardship Role*, FINANCIAL TIMES (Feb. 5, 2018), https://www.ft.com/content/9c9743e0-e40c-11e7-a685-5634466a6915. *See also Viewpoint: The Investment Stewardship Ecosystem*, BLACKROCK 12 (July 2018), https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-investment-stewardship-ecosystem-july-2018.pdf.

[113] *See, e.g.*, *BlackRock Investment Stewardship 2018 Annual Report*, 2018 BLACKROCK 2 (declaring that BlackRock is "committed to doubling team size by 2020").

[114] *See, e.g.*, Madison Marriage, *BlackRock, Vanguard and State Street Bulk Up Governance Staff*, FIN. TIMES (Jan. 28, 2017), https://www.ft.com/content/657b243c-e492-11e6-9645-c9357a75844a; Press Release, BlackRock, BlackRock Releases 2020 Stewardship Priorities for Engaging with Public Companies (Mar. 18, 2020) (on file at https://www.blackrock.com/corporate/newsroom/press-releases/article/corporate-one/press-releases/stewardship-priorities); *Delivering on Our Commitment to Sustainability and Stewardship*, BLACKROCK, https://www.blackrock.com/corporate/about-us/investment-stewardship/our-commitment-to-stewardship (last visited May 16, 2020).

[115] For a discussion of long-term activism versus hedge fund activism, see Sharon Hannes, *Super Hedge Fund*, 40 DEL. J. CORP. L. 163, 189–199 (2015).

[116] John C. Coffee et al., *Activists Directors and Agency Costs: What Happens When an Activists Director Goes on the Board?*, 104 CORNELL L. REV. 381, 386 & n. 5, 436–7 & n. 95-97 (describing how BlackRock, State Street and Vanguard objected the procedure of such settlements).

3. Cost-Effectiveness and Limited Incentives to Invest in Active Stewardship

Corporate stewardship, defined as monitoring, voting and engagement,[117] is very costly, and is likely to raise investors' expenses without bringing much benefit, and accordingly harm their profitability. However, while institutional investors must stay cost-effective in comparison to their peers, it is hard to cut the costs incurred by corporate stewardship because as I explained above, they cannot ignore their fiduciary duties and cannot outsource fulfillment of the duties to proxy advisory companies without repercussions. Thus, institutional investors must find a mode of stewardship that has minimal cost while at the same time is perceived as legitimate by the public and regulators. Corporate guidelines emerge as a solution to the above dilemma.

Institutional investors, both active and passive, are profit maximizing players operating in competitive markets, so retaining existing clients (assets) and attracting new clients is one of their primary goals.

For active investors, especially mutual funds, their clients seek to get the highest profit possible. The profit equals the annual return achieved by the fund, minus the expenses incurred by the fund. Expenses include administrative costs and investment management fee paid to portfolio managers who perform research analysis to determine which securities the fund will pick. The investment management fee is often the biggest part of the fund's expenses.[118] The total cost of the fund, divided by the fund's total assets, is the Total Expense Ratio (TER). Investors, when considering whether to invest in a fund, give special attention to the TER.[119] This is because

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[117] Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2045.

[118] Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961, 1988 (2010).

[119] In that regard, it is very obvious how Vanguard highlights the fact that its expense ratio is the lowest in the industry. See *Why Ownership Matters*, VANGUARD, https://about.vanguard.com/what-sets-vanguard-apart/why-ownership-matters/ (last visited Jan. 22, 2020) ("No wonder Vanguard's average asset-weighted fund expense ratio in 2018 was 0.10%, less than one-fifth that of the 0.58% industry average (excluding Vanguard).").

expenses are deducted from the total assets of the mutual funds before the clients get their share. The lower the expense ratio is, the higher is the return for the clients. To illustrate, if the fund has an expense ratio of one percent, and the gross annual return is fifteen, then the net return to the clients is fourteen percent.[120] The upshot here, is that active mutual funds must be cost-effective to be able to compete with their peers. Given that active corporate stewardship is very costly, managers of mutual funds are likely to prefer using low-cost alternatives, such as corporate guidelines.

The preceding analysis is not merely theoretical. During hearings and discussions held along the years, investors stressed that they are likely to allocate their time and resources on choosing investments, rather than towards active engagement. In some sense, allocating resources to corporate stewardship is perceived by investors as an obstacle to fulfill their other responsibilities. This is illustrated by statements made by some institutional investors.[121]

As Eric Komitee, General Counsel at Viking Global Investors, LP, stressed during the Roundtable held by the SEC in 2013: “There are only so many hours in the year, and every hour spent evaluating proxies is potentially an hour spent not evaluating alternative investments that could go into the portfolio. It's an hour not spent evaluating counterparty risks and custodial issues and all the other aspects of an investment adviser's fiduciary duty that compete for, you know, the most scarce resource that everybody has, which is time.”[122] Similarly, at the Roundtable held by the SEC in November 2018, Scott Draeger, President and General Counsel of R.M. Davis Private Wealth Management, stated: “Over time, [voting] grew to be a huge responsibility. And the analysts really found that they were spending so much time focused on proxies that it left them with resources

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[120] *See* MARK MOBIUS, MUTUAL FUNDS: AN INTRODUCTION TO THE CORE CONCEPTS (2007). *See also* David John Marotta, *Know Your Fund Expense Ratios*, FORBES (Apr. 23, 2019) (“Low fund expense ratios are one of the best predictors of superior future returns. Lower fees and expenses leaves more money for investors.”)
[121] Although those statements were not made by the largest investors, probably because they do not want to be perceived as they are not fully committed to stewardship, it seems that those statements tell the real story.
[122] SEC Roundtable-2013, *supra* note 87, at 74.

lacking to do their day-to-day, typical investment work in the portfolio investments themselves."[123]

When speaking about passive investors, cost-effectiveness is even more crucial. The emergence of passively managed funds—index mutual funds and exchange traded funds (ETF)—is one of the most heated topic in corporate scholarship today.[124] Unlike active funds that pick stocks, index funds replicate the return of a selected index. The rationale behind index fund is, as the late Jack Bogle, index fund pioneer who founded Vanguard, put it: "Don't look for the needle in the haystack. Just buy the Haystack." As such, passive funds provide return to investors with lower costs of intermediation. Passive funds, dominated by the Big Three,[125] compete with active funds. Generally speaking, passive mutual funds charge ultra-low fees, and cost clients about 1/4–1/8 as much as comparable active mutual funds. This explains the "mass migration" from active to passive funds.[126] Passive funds also compete amongst themselves for the lowest tracking error performance, and for the lowest cost. In a definite way, Vanguard won "[t]he [f]ee [w]ar [that] [r]ages [o]n," with the lowest average fees and the largest market share.[127] The fee war has been so fierce that it continues to push the fee charged by both active and passive funds downward. As the Morningstar's Annual Fee Study reveals, the fee significantly decline over the years, with a decline of 6% in 2018.[128] So the bottom line here is that passive investors must be more

[123] SEC Roundtable-2018, *supra* note 56, at 185.

[124] *See supra* note 5.

[125] Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, *supra* note 5, at 723.

[126] According to the 2018 Morningstar Report, index funds have an average expense ratio of 0.15%, while actively managed funds charge 0.67% on average. Morningstar, Inc., *Morningstar's Annual Fee Study Finds That in 2018 Investors Paid Less to Own Funds Than Ever Before*, PR Newswire (April 30, 2019), https://www.prnewswire.com/news-releases/morningstars-annual-fee-study-finds-that-in-2018-investors-paid-less-to-own-funds-than-ever-before-300840661.html.

[127] Christine Idzelis, *Fee War Saved Investors Billions Last Year*, INSTITUTIONALINVESTOR (April 30, 2019), https://www.institutionalinvestor.com/article/b1f6gyxzqq4v43/Fee-War-Saved-Investors-Billions-Last-Year.

[128] Morningstar, Inc., *supra* note 126.

effective when it comes to costs than their active peers, which increases their disincentives to invest in active engagements.

At this point, one might argue that expenses caused by investment in stewardship, incurred by both active as well as passive investors, can be justified because stewardship may improve the funds' performance. Specifically, the investment in stewardship may increase the value of the Asset under Management (AUM) of a fund's portfolio and given that investment advisers charge fees equal to a percentage of the AUM, they may have the incentive to invest in stewardship. As I will shortly explain below, such an argument suffers limitations because the incentive structure of managers in most institutional investors discourage them from engaging in active stewardship. Moreover, it is unclear how sensitive are mutual funds' clients to the funds' performance.

For both active and passive funds, an incentive problem discourages investment managers from investing in active engagement. Even if investment managers have improved the value of their portfolio by investing in stewardship, they typically would capture only a tiny fraction of the increase in value. Specifically, active investors capture around 0.79 percent of the improvement in the value of the position whereas passive investors capture only 0.12 percent.[129] Such a fraction "would generally be insufficient to induce the level of stewardship investment that would best serve the interests of beneficial investors."[130]

Moreover, under the current regulatory regime, investment managers are not allowed to charge the expenses of stewardship as a part of the fees paid by its investors, so they bear the full costs of stewardship.[131] One may further argue that investment advisers may have indirect incentives to invest in stewardship in order to enhance funds' performance and thereby attract flows of new assets to the fund, which will increase their fees. However, as empirical studies have shown, the effect of funds' performance on flows is complex and not

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[129] *Id.* at 97.
[130] *Id.*; Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2056.
[131] Bebchuk, Cohen & Hirst, *supra* note 2, at 96.

linear,[132] which means performance may not be perceived as having much instrumental value of boosting flows.

To complete the picture, in contrast to Bebchuk, Edward Rock and Marcel Kahan stress that the most important incentive for index funds' advisers to invest in stewardship is the size of their holdings. Although the rate charged by equity index funds is very low (the average in 2017 was 0.09%), given that passive index funds have the largest positions in companies, the incentive of passive funds' managers to invest in stewardship are likely to be high.[133]

Lastly, Bebchuk and Hirst also point out a free-rider problem that discourages index funds' managers from investing in stewardship. The investment of a certain fund in stewardship would not improve the fund's performance relative to other funds. This is because if a fund succeeded in enhancing the value of a portfolio company through investment in stewardship, the increase in value would be captured by all other investors of that company and rival index funds that track the

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[132] *Compare* Erik R. Sirri & Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 J. FIN. 1589, 1598 (1998) (providing empirical evidence showing that asset flows respond strongly to prior superior performance, but are much less sensitive to past poor performance: "For top performers . . . performance is associated with economically and statistically significant inflows. For other funds, performance is positively associated with flows, but this relationship is statistically weak. . . [For] the poorest performers . . . there is virtually no relationship between historical performance and flows."), Judith Chevalier & Glenn Ellison, *Risk Taking by Mutual Funds as a Response to Incentives*, 105 J. POL. ECON. 1167, 1169 (1997) (finding that there are "significant nonlinearities in the relationship, with the overall sensitivity of the relationship and its shape being dependent on the age of the fund in question."), and Jill E. Fisch, *supra* note 118, at 1994 ("Investors fail to respond to chronic poor performance by withdrawing their funds, allowing some of the worst performing mutual funds to survive."), with Jonathan Lewellen & Katharina Lewellen, I*nstitutional Investors and Corporate Governance: The Incentive to be Engaged* (Tuck Sch. Of Bus., Working Paper No. 3265761, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3265761 (providing empirical evidence of how institutional investors gain an extra sum of money in annual management fees from both changes in the AUM (direct incentives) and future flow of assets (indirect incentives) and finding that flow of assets is typically sensitive to performance when speaking about the largest institutional investors, and thereby concluding that the investors do have incentives to invest in stewardship).

[133] Kahan & Rock, *Let Shareholders Be Shareholders*, *supra* note 10, at 13–20.

same index.[134] Bebchuk and Hirst thereby conclude that active involvement in their portfolio companies "would not result in a superior performance that could enable the manager to attract funds currently invested with rival investment managers."[135] Therefore, index funds may have even less incentive to invest in stewardship than active funds, and this is supported by empirical evidence.[136]

Summing up, maintaining cost-effectiveness is critical to institutional investors, especially passive index investors, which translates to their need to take a more modest approach of stewardship by relying upon corporate guidelines.[137]

B. Soft Device that Reduces Risk of Confrontation

The second explanation of why institutional investors are likely to heavily rely on corporate guidelines is that these investors have additional considerations beyond those of good stewardship. Recall that institutional investors prefer not to directly confront with managements of corporations, both because managements have strong political power and thus confrontation with managements may trigger a regulatory backlash, and because institutional investors have business ties with the corporations they invest in.[138]

As I explained earlier in Part II.B.2. above, unlike active engagement, corporate guidelines are considered as a "soft" device that allows institutional investors to enforce their governance

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[134] Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2047. *See also* Bebchuk, Cohen & Hirst, *supra* note 2, at 96–97. Note that even if a rival index fund does not invest in this particular portfolio company, it can still benefit from the increase in the company's value as long as it tracks the same index, because such an increase would raise the value of the index.

[135] Bebchuk, Cohen & Hirst, *supra* note 2, at 98.

[136] *See* Heath et al., *supra* note 109 (supporting Bebchuk and Hirst's thesis and finding that index funds vote with managements more frequently than active funds and are more likely to defer to managements).

[137] Interestingly, mutual funds may also maintain cost-effectiveness by using other methods. For example, their ownership in corporations operating within similar geographies and industries enables them to monitor common threats faced by those companies at lower costs, by applying more formulaic models. *See* Eckstein, *The Virtue of Common Ownership*, supra note 89.

[138] *See* Sub-section I.A.

principles in a non-confrontational and flexible way. Since guidelines do not aim to force corporations to accept a specific arrangement, they are less likely to create a clash between institutional investors and managements. Relatedly, corporate guidelines designed by institutional investors may give managements an elegant way adopt governance changes without embarrassment. By referring to the guidelines when proposing its own initiative to improve governance, corporations' boards can signal that they have kept their shareholders' interests in mind and are actively seeking governance changes that are fit and appropriate. This would allow corporations to align with best practices demanded by the institutional investors through the back door and prevent a direct confrontation between the corporations and the investors in the front door.

C. Standardization in Corporate Law—A Global Phenomenon

In this part I suggest another explanation to the rise of corporate guidelines. In his recent article, John Coates analyzes how three mega-trends have reshaped corporate governance. One of these trends is globalization.[139] The growing power of institutional investors' guidelines should be seen as an integral part of a global push towards standardization. This subsection, while not offering an exhaustive discussion, points to some of the major phases of this trend.

To begin with, in May 1999, members of the Economic Co-operation and Development (OECD) voted unanimously to endorse the OECD Principles of Corporate Governance. Since their endorsement, the Principles have been recognized as the basic governance standards for companies and investors around the world. Some EU jurisdictions, such as the UK and Germany, have also adopted corporate governance codes, in the form of "comply or explain," which means the codes are not legally binding, but once a corporation decides not to comply with them, it should explain the reasons for noncompliance.[140] Similar codes were adopted by other

[139] Coates, *supra* note 44.

[140] John Armour, Luca Enriques, Henry Hansmann & Reinier Kraakman, *The Basic Governance Structure: The Interests of Shareholders as a Class, in* THE ANATOMY

countries, such as Japan (that adopted a stewardship code in 2014) and Hong Kong (that adopted principles of responsible ownership in 2016).[141]

In 2003, the International Corporate Governance Network (ICGN), led by investors that are responsible today for assets under management in excess of thirty-four trillion dollars, published its first set of governance principles in order "to promote effective standards of corporate governance and investor stewardship."[142]ICGN's governance principles were updated in 2013 and in 2017, and they deal with various aspects in corporate governance such as the Board's leadership and independence (including the need for an independent Chair and the role of the lead independent director), and the aspects related to the Board's composition (including diversity and directors' tenure).[143]

In 2006, the United Nations Principles for Responsible Investment (PRI) was first launched. sixty-three investment companies with $6.5 trillion in assets under management (AUM) signed a commitment to incorporate Environmental, Social and Governance (ESG) principles into their investment decisions. By 2018, the number of signatories had increased to 1,715 and represented 81.7 trillion dollars in AUM.[144] PRI's principles put special emphasis on ESG issues, seeking to promote better ESG in companies in which the signatories invest and appropriate disclosure on ESG issues in those companies.[145]

OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 63 (3rd ed., 2017).

[141] Glenn Booraem, *What We Do. How We Do It. Why It Matters: Vanguard's Investment Stewardship Commentary*, HARV. L. SCH. FORUM. CORP. GOV. (May 1, 2019), https://corpgov.law.harvard.edu/2019/05/01/what-we-do-how-we-do-it-why-it-matters-vanguards-investment-stewardship-commentary/.

[142] *About*, INT'L CORP. GOVERNANCE GRP., https://www.icgn.org/about (last visited Jan. 12, 2020).

[143] *Global Governance Principles*, INT'L CORP. GOVERNANCE GRP. (2017), http://icgn.flpbks.com/icgn_global_governance_principles/ICGN_Global_Governance_Principles.pdf.

[144] Robert G. Eccles & Svetlana Klimenko, *The Investor Revolution*, HARV. BUS. REV. (May 2019), https://hbr.org/2019/05/the-investor-revolution.

[145] PRINCIPLES FOR RESPONSIBLE INVESTMENT, https://www.unpri.org/ (last visited Jan. 14, 2019).

The push towards standardized corporate governance on the global level received another boost after the 2008 financial crisis occurred, leading to a growing number of stewardship codes, principles and guidelines adopted by many countries around the world.[146]

Recently, sixty of the largest institutional investors in the U.S. and their international counterparts gathered and formed the Investor Stewardship Group (ISG). Together, these investors have combined assets in excess of 31 trillion dollars in the U.S. equity markets.[147] The ISG developed six principles that went into effect on January 1, 2018.[148] These principles are perceived by the ISG as "fundamental to good corporate governance at U.S. listed companies,"[149] and as "minimum standards in the market," i.e. their "minimum" expectations on corporate governance from corporations they invest in.[150] Although these principles are not mandatory, companies have difficulty to ignore them because they are usually backed by the investors' credible threat to detect and punish non-compliance.[151] For example, recall that after State Street, one of the most prominent signatories of the ISG, reported that it identified sixty-six S&P 500 companies that failed to comply with the ISG's governance principles, many of these companies eventually modified their practices based on the ISG's principles before their annual shareholder meetings, or provided sufficient explanations for their non-compliance. Those who

[146] *Q&A on Stewardship Codes*, ERNST & YOUNG (August 2017), https://www.ey.com/Publication/vwLUAssets/ey-stewardship-codes-august-2017/$FILE/ey-stewardship-codes-august-2017.pdf.

[147] ISG, *supra* note 65.

[148] *Id.*

[149] *Id.*

[150] Andrew Letts, *Engaging with Rakhi Kumar of State Street Global Advisor*, PJT CAMBERVIEW (May 9, 2018), https://pjtpartners.com/pjtcamberview/engaging-with-rakhi-kumar-of-state-street-global-advisors.

[151] Rick Lacaille & Rakhi Kumar, *2019 Proxy Voting and Engagement Guidelines: North America*, HARV. L. SCH. FORUM. CORP. GOV. (Mar. 27, 2019), https://corpgov.law.harvard.edu/2019/03/27/2019-proxy-voting-and-engagement-guidelines-north-america/ ("as a founding member of the Investor Stewardship Group ('ISG'), we proactively monitor companies' adherence to the Corporate Governance Principles for US listed companies.").

did neither suffered the opposition of State Street in the voting process.[152]

To summarize, all of the global developments described in this section can be seen as an accelerating force that has been pushing institutional investors towards standardization, and more specifically, towards relying upon proxy voting guidelines.[153]

IV. INSTITUTIONAL INVESTORS' GUIDELINES—EVIDENCE

In the previous section I analyzed the importance of corporate guidelines. While doing so, I focused on the nature of corporate guidelines and the potential supply-side explanations for the rise of guidelines, i.e. the explanations for why corporate guidelines become a favorable instrument created by investors and groups of investors to participate in corporate governance. In this section, I will provide evidence—collected from the proxy statements of the S&P 500 companies—regarding the potential power, i.e. demand-side influence, of corporate guidelines. To do so, I will analyze the ways major players other than the investors in the corporate governance arena—corporations, shareholders, legal advisors and proxy advisors—use corporate guidelines. Specifically, I will show how corporations use corporate guidelines to reflect their commitment to their largest investors and to oppose shareholders proposals, how shareholders base their proposals on the corporate guidelines to support their positions, and how legal advisor refer to the guidelines to warn their corporate clients. Next, I will demonstrate how corporations and shareholders make frequent uses of what they term "best practices," which may be created and maintained by corporate guidelines. Finally, I will discuss proxy advisors' use of corporate guidelines and how investors are involved in the formulation of proxy

[152] *See* text accompanying *supra* note 69.

[153] In a post published in 2019, Glenn Booraem, a Principal and an Investment Stewardship Officer at Vanguard, acknowledged that events described above (the adoption of the U.K. Governance Code, the United Nations Principles for Responsible Investment, the Japan Stewardship Code, the Hong Kong Principles for Responsible Ownership; and the establishment of the ISG), "reinforced the need for stronger governance practices and continue to influence the evolution of corporate governance." Booraem, *supra* note 141.

advisors' own guidelines. Before moving to discuss how the different players interact with corporate guidelines, I will first explain the methodology for the empirical study of the uses of corporate guidelines and summarize the findings.

A. Empirical Research—Sample and Methodology

In order to analyze how corporate guidelines are used by major players in corporate governance, I analyzed the proxy statements published by corporations in the form of DEF 14A (Schedule 14A). My dataset contains proxy statements published in 2019, by the 500 corporations that constitute the S&P 500 list, as of December 10, 2019. For each corporation in my sample, I collected information about whether the corporation' proxy statement includes explicit references—made by both corporation and shareholders—to guidelines of institutional investors and organizations represent these investors, such as CII or the ISG".

The empirical analysis shows that in 2019, 28 corporations made explicit references to corporate guidelines (which constitute 5.6 percent of the corporations in the sample). Most of the references were made by the largest corporations, where 9 out of the 100 (9 percent) corporations included in the first tier of the S&P 500 (meaning the hundred corporations with the largest market capitalization) made such references. Smaller corporations made fewer references: within the second, third, fourth and fifth tiers of the S&P 500, 7, 5, 4, and 3 corporations, respectively, made such references. Interestingly, 4 out of the 28 explicit references mentioned above were made by corporations in response to shareholder proposals.

It should be emphasized that at this stage, the statistics do not capture the full power of corporate guidelines because they only include references made independent of other interactions between corporations and their investors, and in an explicit manner to the guidelines. For example, the statistics do not include frequently-made declarations in proxy statements, according to which during engagements between corporations and their largest investors, the corporations have received feedback from investors on their priorities and expectations and have considered the feedback in formulating corporate governance policies.

Also, the statistics does not include the statements according to which corporations have revised their policies in response to their investors' views[154] or sentiments.[155] This is because it is not clear from the proxy statements whether corporations have learned about investors' views or sentiments during an active dialogue with the investors, by studying corporate guidelines, or both.

In order to not overly underestimate the power of corporate guidelines, my analysis does cover a way that corporate guidelines may exert influence on investors' portfolio corporations without being mentioned by these companies. A corporation may cite rationales other than following corporate guidelines published by specific investors, such as aligning with industry best practices, when it designs its own guidelines or adopts a certain governance arrangement. However, since corporate guidelines may initiate, accelerate and maintain an industry best practice, the corporations' governance regime may still be influenced by corporate guidelines although it does not intentionally conform to those guidelines. The empirical analysis shows that in addition to explicit references to corporate guidelines, 226 corporations (45.2 percent of the sample) declared that their boards reviewed corporation's policies, frameworks and guidelines according to current and evolving best practices, or emphasized that corporation's governance guidelines were aligned with the best practices or that they were committed to the best practices.

Corporate guidelines' influence generated through shaping best practices may create a derivative effect. Corporations and shareholders refer to statistics regarding certain governance arrangements adopted (or not adopted) by corporations included in S&P 500, S&P 1500 or Fortune 100.[156] Shareholders used statistics regarding best practices to support their proposals in 42 proxy statements, where 17 of such references were made in the statements of the 100 largest companies. Corporations made references to statistics regarding best practices in

[154] *See, e.g.*, Merck & Co., *supra* note 13.
[155] *See, e.g.*, Bristol-Myers, *supra* note 14.
[156] *See supra* note 15.

30 proxy statements, where 28 of them were made in response to shareholder proposal.

Not just corporations made explicit references to corporate guidelines. Shareholders that submitted proposals to their corporations have also relied upon the guidelines to support their proposals and to attempt to convince corporations to make changes and adopt certain governance arrangements. As the analysis reveals, 28 corporations (5.6 percent of the sample) received shareholder proposals that relied upon corporate guidelines. Most of the references were included in the proposals submitted to the largest corporations, where 14 out of the 100 (14 percent) corporations that constitute the first tier of the S&P 500 were subject to such shareholder proposals. As for the second, third, fourth and fifth tiers, of the S&P 500—3, 6, and 3 corporations, respectively, were subject to such shareholder proposals.

The fact that more frequent uses of explicit references to corporate guidelines—by both corporations and shareholders that targeted these corporations—occur in the proxy statements of the largest corporations comports with our intuitions. The largest corporations attract much more attention than the smaller ones—from the media, practitioners, academia, policymakers, shareholders and other corporations.

Furthermore, in five cases, the same proxy statement includes references made by both the corporation and its shareholders. Thus, in total, an explicit reference to corporate guidelines is made in 51 proxy statements, 10.2 percent of the sample.

In order to get a better picture regarding the uses of corporate guidelines, I also analyzed proxy statements published in 2020 by corporations in the S&P 500.[157] As of May 18, 2020, 408 corporations published their proxy statements: 38 of those proxy statements included explicit references to investors' corporate guidelines. Similar to the 2019 analysis, in the 2020 analysis, most of the references were made he largest corporations: 20 out of 84 (23.40 percent) statements were made by the corporations that constitute the first tier of S&P 500.

[157] *See supra* note 17.

Table 2 presents summary statistics on information in the above categories. Note that references to corporate guidelines and best practices on executive compensation issues are excluded from the dataset because every proxy statement makes such references and they are trivial.

Table 2. The Way Corporations and Shareholders Make Use of Guidelines and Best Practices – in 2019

	Number of corporations that made a reference[158](number of corporations that made a reference in response to shareholder proposal)	*Number of corporations that were subject to a shareholder proposal that made a reference*
1) Explicit reference to investors' guidelines	28 (4 in response) [5.6%]	28 [5.6%]
2) Statement according to which the board reviewed its policies / guidelines according to current and evolving best practices or a statement according to which company's guidelines were	226 (31 in response) [45.2%]	-

[158] This column counts the number of proxy statements that refer to each of the categories appeared in the first column of the table. It is worth noting, however, that a single proxy statement sometimes refers to a certain category more than once.

aligned with best practices		
3) Reference to statistics regarding industry best practices	30 (28 in response) [6%]	42 [8.4%]

B. Guidelines as a Device Used by Corporations

Corporations declare their commitment to their shareholders and communicate actively with institutional investors, to express that their governance practices conform with the investors' expectations and defend their practices against adverse shareholder proposals. Some corporations provide exact figures regarding their engagement with institutional investors. Some describe how the extensive outreach with shareholders has led their boards to fully evaluate and consider certain governance issues and implement changes regarding those issues.

The purpose is clear—to satisfy investors, especially large institutional investors, by signaling corporations' commitment to existing and potential investors. Some corporations invest special efforts to impress investors. For example, Delta Air Lines, stated in its 2019 Annual Meeting Proxy Statement, that "[i]n 2018, Delta was named as a 'Most Honored Company' by the financial journal Institutional Investor, which ranked Delta's investor relations effort number 1 in the airline category."[159] Similarly, Honeywell International Inc. described in detail all of the recent awards it received from institutional investors (most honored company, leadership award, best investor relations, etc.).[160] Similar statements appear in proxy statements of other leading companies.[161]

Another means to express corporations' commitment to large institutional investors is to explain how corporations' guidelines and the guidelines established by institutional investors are aligned. Among leading corporations that declare how they consider guidelines

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[159] Delta Air Lines, Inc., Proxy Statement (Schedule 14A) (May 10, 2019).
[160] Honeywell Int'l Inc., Proxy Statement (Schedule 14A) (March 14, 2019).
[161] See, e.g., Merck & Co., supra note 13, at 27.

and standards of institutional investors are Bank of America,[162] and Saleforce.com.[163] Corporations also refer to the governance guidelines designed by the ISG and the CII, including the largest players such as BlackRock, State Street, T. Rowe Price, Vanguard, etc.[164] For example, UnitedHealth Group made such references when responding to a shareholder proposal to amend its proxy access bylaw provisions.[165] My research also reveals that corporations are making growing uses of the ISG's guidelines as a reference point. Among

[162] Bank of America Corp., Proxy Statement (Schedule 14A) (March 13, 2019) ("Through our Corporate Governance Committee, the Board regularly reviews and closely monitors stockholders' views on the appropriate number of public company boards on which directors may serve. The Committee considers: the proxy voting guidelines of our major stockholders . . .").

[163] Salesforce.com, inc., Proxy Statement (Schedule 14A) (April 25, 2019) ("[T]he Board of Directors also recognizes that many investors and others now view supermajority voting provisions as unduly limiting the Board of Directors' accountability to stockholders or stockholder participation in the corporate governance of the Company.").

[164] *Associate Members*, COUNCIL OF INST. INV'R, https://www.cii.org/associate_members (last visited Jan. 19, 2020).

[165] UnitedHealth Group Inc., Proxy Statement (Schedule 14A) (April 19, 2019) ("The 20 shareholder aggregation limit we adopted has been adopted by almost all U.S. listed companies implementing proxy access (approximately 93% as of December 31, 2018), and has been recognized by the Council of Institutional Investors as a market standard.").

leading corporations are Procter & Gamble,[166] Intel,[167] IBM,[168] Target,[169] and Gilead Sciences.[170]

It may come with no surprise that today corporations disclose the level of their commitment to institutional investors' guidelines. In fact, institutional investors encourage companies to proactively disclose

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[166] The Protcter & Gamble Co., Proxy Statement (Schedule 14A) (August 23, 2019) https://www.sec.gov/Archives/edgar/data/80424/000119312519227275/d738651d def14a.htm ("We have evaluated the Company's governance practices against the Corporate Governance Principles published by the Investor Stewardship Group ('ISG'), a collective of some of the largest U.S.-based institutional investors and global asset managers, and found they were highly consistent. P&G's strong corporate governance policies and practices are disclosed throughout this proxy statement, but the following table highlights some of the key ways that P&G's governance practices are consistent with ISG's Corporate Governance Principles.") The Proxy Statement also lists "Policies consistent with the Investor Stewardship Group's Corporate Governance Principles" and "Signatory to Commonsense Corporate Governance Principles 2.0" as "Corporate Governance Principles." *Id.*)

[167] Intel Corp., Proxy Statement (Schedule 14A) (2019) ("These guidelines, which investors may find on our website at *www.intel.com/governance*, along with our other corporate governance practices, compare favorably under the Investor Stewardship Group's (ISG) Corporate Governance Framework for U.S. Listed Companies, as shown in the table below.").

[168] International Business Machines Corp., Proxy Statement (Schedule 14A) (March 11, 2019) ("And this year, IBM became a signatory of the Commonsense Principles 2.0 and endorsed the Investor Stewardship Group's corporate governance principles."). The Proxy Statement further states: "Most recently, the Company has been on the forefront of strong governance practices as a signatory to the Commonsense Principles 2.0, bringing the company and investor viewpoints on critical governance matters together. The Company also endorses the Investor Stewardship Group's principles on corporate governance to promote strong governance practices." *Id.*

[169] Target Corp., Proxy Statement (Schedule 14A) (April 29, 2019)("For your convenience, we organized the corporate governance highlights listed above so you can see how our corporate governance practices compare favorably with the corporate governance principles developed by the Investor Stewardship Group (ISG), which includes some of the largest institutional investors and global asset managers and advocates for best practices in corporate governance.").

[170] Gilead Sciences, Inc., Proxy Statement (Schedule 14A) (March 25, 2019) ("We believe our strong corporate governance structures align with these ISG principles.").

their compliance with their principles.[171] As State Street revealed in its Stewardship Report in 2019: "In instances of non-compliance when companies cannot explain the nuances of their governance structure effectively, either publicly or through engagement, we may vote against the independent board leader." [172] In this regard, it is worth noting that State Street has a structured, built-in process, to monitor divergences from its guidelines based on their portfolio companies' disclosures. As State Street reveals, its stewardship activities are directly monitored by the State Street Global Advisors Investment Committee (IC) composed of several subcommittees. One of them, the Proxy Review Committee, "provides day-to-day oversight of the Stewardship Team, including approving departures from proxy voting guidelines."[173] Like State Street, other large institutional investors also detect and address from their guidelines and best practices.[174]

To be clear, so far, I have explained how references to corporate guidelines allow corporations to deliver to the investors and other constituencies (such as policymakers and media) a strong message of commitment to strong corporate governance. But other than achieving the signaling effect, corporations may make such references to support their initiatives of making certain governance changes.

Furthermore, corporations sometimes refer to investors' guidelines in response to shareholder proposals.[175] While doing so, corporations

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[171] Rick Lacaille & Rakhi Kumar, *2019 Proxy Voting and Engagement Guidelines: North America*, HARV. L. SCH. FORUM. CORP. GOV. (March 27, 2019), https://corpgov.law.harvard.edu/2019/03/27/2019-proxy-voting-and-engagement-guidelines-north-america/.

[172] *Id.*

[173] SSGA 2018-19, *supra* note 69, at 22. *See also* Edward B. Rock, *Institutional Investors in Corporate Governance*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 363 (Jeffrey N. Gordon & Wolf-Georg Ringe, eds., 2015).

[174] Guido Ferrarini & Maria Cristina Ungureanu, *Executive Remuneration*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 334, 354 (Jeffrey N. Gordon & Wolf-Georg Ringe, eds., 2015) ("In anticipation of the 2014 proxy season, Vanguard sent letters to approximately US 350 companies to proactively engage with them on governance issues. The letters are tailored to the individual companies and identify governance practices at the companies that Vanguard believes are not in line with what the asset manager views as best practices.").

[175] *See*, *e.g.*, Booking Holdings Inc., Proxy Statement, *supra* note 80**Error! Hyperlink reference not valid.**(declaring, in response to a shareholder proposal to

are aware of the fact that since the large institutional investors hold shares in the corporation, quite often ranging between 7%–10%, shareholders are likely to support their proposal with a statement regarding large investors' guidelines to force a corporation to agree to adjust its policy.

When facing a shareholder proposal that uses institutional investors' guidelines to convince the corporation to adopt certain policies, the board of this corporation has two options—to recommend the shareholders to vote "for" or "against" the proposal. When choosing to recommend against the proposal, as what happens most of the times, the board cannot just provide its bottom line, and it has to support its recommendation. This dynamic frequently force corporations to start a dialogue with institutional investors, when choose to divert from their guidelines.

Lastly, as I will explain in section IV.E. below, in many cases, corporations refer to industry best practices, especially when responding to a shareholder proposal. In this regard, it is important to understand that when corporations refer to best practices, they are essentially indirectly referring to corporate guidelines because the best practices are strongly influenced by the guidelines.

C. Guidelines as a Device Used to Support Shareholder Proposals

Some shareholders increasingly use institutional investors' guidelines as a part of their proposals submitted to the corporation to be voted on at shareholder meetings. These shareholders are often activist hedge funds that have significant incentives to invest in activism (in comparison to mutual funds),[176] or corporate gadflies that

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enhance proxy access, that: "We adopted our current Proxy Access By-Laws after significant evaluation and deliberation by the Nominating and Corporate Governance Committee and the full Board of Directors and meaningful stockholder engagement. This thoughtful review included . . . a review of the corporate governance policies of some of our largest stockholders.")

[176] Zohar Goshen & Sharon Hannes, *The Death of Corporate Law*, 94 N.Y. U. L. REV. 263, 283–5 (describing the role played by hedge funds during the past years). *See also* Hamdani & Hannes, *supra* note 18; Kahan & Rock, *Hedge Funds*, *supra* note 20.

are becoming dominant players over the past years.[177] Guidelines are being used by these players as a tool to convince corporations to follow certain practices. Usually, shareholders also include information regarding the way large institutional investors voted on the matter in their proposals.[178]

My dataset provides many examples of direct and specific references made by shareholder proposals to large institutional investors' guidelines. For example, shareholders referred to the guidelines when they called Apple to improve proxy access;[179] when they asked Amazon to reduce the ownership threshold for calling special shareholder meeting;[180] when they asked Alphabet (Google) to elect directors by a majority vote;[181] and when they required

[177] Kobi Kastiel & Yaron Nili, *The Giant Shadow of Corporate Gadflies* (Univ. of Wisconsin Studies, Research Paper No. 1523, 2020) (discussing the growing importance of corporate gadflies). *See also* James R. Copland, *Frequent Fliers: Shareholder Activism by Corporate Gadflies*, PROXYMONITOR (2014), https://www.proxymonitor.org/Forms/2014Finding5.aspx (providing evidence regarding gadflies dominance); Steven Davidoff Solomon, *Grappling with the Cost of Corporate Gadflies*, N.Y. TIMES (Aug. 19, 2014), https://dealbook.nytimes.com/2014/08/19/grappling-with-the-cost-of-corporate-gadflies/?mtrref=www.google.com&gwh=A39F4B83C27A2E8E2D06901656D5DC2A&gwt=pay&assetType=REGIWALL (providing similar evidence).

[178] *See*, *e.g.*, Facebook, Inc., Proxy Statement (Schedule 14A) (April 12, 2019) (including shareholder proposal to use majority voting for director elections, which states that: “Among our Company's largest shareholders: T. Rowe Price Associates and BlackRock both voted FOR 88.9% of shareholder proposals on this topic. SSgA Funds Management voted FOR 100% of such proposals.”).

[179] Apple Inc., Proxy Statement (Schedule 14A) (Jan. 8, 2019)(“BlackRock’s 2018 Proxy Voting Guidelines included the following: ‘In general, we support market-standardized proxy access proposals, which allow a shareholder (or group of up to 20 shareholders) holding three percent of a company’s outstanding shares for at least three years the right to nominate the greater of up to two directors or 20% of the board.’”).

[180] Amazon.Com, Inc., Proxy Statement (Schedule 14A) (April 11, 2019) , (“Large funds such as Vanguard, TIAA-CREF, BlackRock and SSgA Funds Management, Inc. (State Street) support the right of shareholders to call special meetings.”).

[181] Alphabet Inc., Proxy Statement (Schedule 14A) (April 30, 2019) (“BlackRock’s proxy voting guidelines include the following: ‘Majority voting standards assist in ensuring that directors who are not broadly supported by shareholders are not elected to serve as their representatives.’ Among our Company’s largest shareholders: T. Rowe Price Associates and BlackRock both voted FOR 88.9% of

ExxonMobil to separate the roles of the Chairman and the CEO.[182] Frequently, it is the same group of shareholders—known as "corporate gadflies"—who include references to institutional investors' guidelines in their proposals.[183]

These finding may shed light on a recent study conducted by Ian R. Appel, Todd A. Gormley and Donald B. Klein, in which they found that passive investors affect corporate governance of companies in which they invest.[184] They discuss possible mechanisms by which passive investors may influence governance, which includes “facilitating activism by other, non-passive investors.”[185] They assume that a “threat” of activism by others may be enough to enhance governance, and that such a threat is likely to increase when the “concentration of passive institutions’ ownership stakes” increases.[186]

Furthermore, as my research reveals, shareholders also refer to the guidelines issued by the Council for Institutional Investors (CII). Such references were made, for example, by the shareholders who submitted proposals to the Board of Amazon regarding the vote-counting practice;[187] by shareholders who submitted proposals to the Board of Facebook in order to give each share an equal vote,[188] and to separate

shareholder proposals on this topic. SSgA Funds Management voted FOR 100% of such proposals.”).

182 Exxon Mobil Corp., Proxy Statement (Schedule 14A) (April 11, 2019) (“Numerous institutional investors recommend separation of these two roles. For example, California’s Public Employee Retirement System’s Principles & Guidelines encourage separation, even with a lead director in place.”).

183 This group includes Mr. John Chevedden, Mr. James McRitchie, and Mr. Kenneth Steiner.

184 Ian R. Appel, Todd A. Gormley & Donald B. Klein, *Passive Investors, Not Passive Owners*, 121 J. FIN. ECON. 111 (2016) (finding that increased ownership by passive funds in companies is associated with increased percentage of independent directors, removal of takeover defenses, and lower percentage of dual class share structures.)

185 *Id.* at 128.

186 *Id.*

187 Amazon.Com, Inc., Proxy Statement, *supra* note 180 (“Policy 3.7 of the Council of Institutional Investors (CII, ‘The Voice of Corporate Governance’) declares that ‘abstentions should be counted only for purposes of a quorum’ (emphasis added)”).

188 Facebook, Inc., Proxy Statement, *supra* note 178(“The Council for Institutional Investors (CII) recommends a seven year phase-out of dual class share offerings.

the roles of the Chairman and the CEO;[189] by a shareholder asked the board of JPMorgan to adopt a cumulative voting;[190] and by shareholders who submitted proposals to the Board of AT&T to modify proxy access requirements.[191]

Lastly, shareholders may also rely on governance guidelines provided by institutional investors through other channels. For example, shareholders have referred to the annual letter sent by BlackRock Chairman and CEO Larry Fink to corporations in which BlackRock invests and their senior managements. Boeing's shareholders did so when they urged the Compensation Committee of the Board of Directors to adjust financial performance metrics to exclude the impact of share repurchases when determining the amount or vesting of any senior executive incentive compensation grant or award.[192] Similarly, Gilead Sciences' shareholders requested that the

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The International Corporate Governance Network supports CII's recommendation 'to require to a time-based sunset clause for dual class shares to revert to a traditional one-share/one-vote structure no more than seven years after a company's IPO date.").

189 *Id.* ("The Council of Institutional Investors argues: Having an independent chair helps the board carry out its primary duty— to monitor the management of the company on behalf of its shareowners. A CEO who also serves as chair can exert excessive influence on the board and its agenda, weakening the board's oversight of management. Separating the chair and CEO positions reduces this conflict, and an independent chair provides the clearest separation of power between the CEO and the rest of the board.").

190 JPMorgan Chase & Co., DEF 14A, https://www.sec.gov/Archives/edgar/data/19617/000119312519098338/d695908d def14a.htm, at 90.

191 AT&T Inc., Proxy Statement (Schedule 14A) (March 12, 2018) (""*Proxy Access: Best Practices 2017* (http://www.cii.org/files/publications/misc/Proxy_Access_2017 FINAL.pdf) by the Council of Institutional Investors (CII), notes that 'while proxy access has gained broad acceptance, some adopting companies have included, or are considering including, provisions that could significantly impair shareholders' ability to use it.' The report 'highlights the best practices CII recommends for implementing proxy access.").

192 The Boeing Co., Proxy Statement (Schedule 14A) (March 15, 2019) ("Large stock buybacks send 'a discouraging message about a company's ability to use its resources wisely and develop a coherent plan to create value over the long term,'

Board issue a report describing how Gilead plans to allocate tax savings as a result of the Tax Cuts and Jobs Act.[193] Institutional investors other than BlackRock use annual letters to communicate with managements of their portfolio companies as well. In fact, "[i]t has become customary, over the last few years, for companies and other stakeholders to await annual letters from large institutional investors that provide insight into investor views."[194]

Before moving forward, and just in order to complete the picture, besides corporate guidelines, shareholders may also support their proposals by citing guidelines drafted by other individuals and

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Laurence Fink, chairman and CEO of Blackrock, wrote in an April 14, 2015 letter to S&P 500 Index companies.").

[193] Gilead Sciences, Inc., Proxy Statement, *supra* note 170 **Error! Hyperlink reference not valid.**("Larry Fink, CEO of BlackRock recently stated: 'Companies have not been explicit enough about their long-term strategies. In the United States, for example, companies should explain to investors how the significant changes to tax law fit into their long-term strategy. What will you do with increased after-tax cash flow, and how will you use it to create long-term value? This is a particularly critical moment for companies to explain their long-term plans to investors.'").

[194] Pamela L. Marcogliese et al., *Synthesizing the Messages from BlackRock, State Street, and T. Rowe Price*, HARVARD L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Feb. 28, 2019), https://corpgov.law.harvard.edu/2019/02/28/synthesizing-the-messages-from-blackrock-state-street-and-t-rowe-price/.

entities—such as index providers;[195] professional and academic opinion leaders;[196] and policymakers.[197]

D. Guidelines Are Being Used by Legal Advisors and Other Professionals

In order to better understand the push towards corporate guidelines, and in order to have a more complete picture of the dynamic they create, it is worth examining the way law firms treat them when they advise their corporate clients. Today, the best U.S. big law firms study institutional investors' philosophy, expectations, and

[195] For example, when John Chevedden submitted to UPS a proposal for equal voting rights for each shareholder, he emphasized that "[l]ast year, S&P Dow Jones Indices said that companies with multiple classes of shares would be barred from entering its flagship S&P 500 index." United Parcel Service, Inc., Proxy Statement (Schedule 14A) (Mar. 15, 2019). More generally, in this context it is useful to refer to Scott Hirst & Kobi Kastiel, *Corporate Governance by Index Exclusion*, 99 B.U. L. REV. 1229 (2019) (describe how index providers constitute another source of corporate governance rules).

[196] For example, a proposal submitted to the Board of Netflix, Inc., by activist shareholder John Chevedden, which recommended removing the requirement of Supermajority vote, referred to Professor Lucian Bebchuk and his colleagues' position against Supermajority vote. Netflix, Inc., Proxy Statement (Schedule 14A) (Apr. 23, 2019). Also, references to this article were made by Chevedden when he targeted Norfolk Southern Corp.; Firstenergy Corp.; Twitter, Inc.; Skyworks Solutions, Inc.; Leidos Holdings, Inc.. Similar references were made by James McRitchie when he targeted BlackRock, Inc.; and by other shareholder when they targeted Discovery Inc.

[197] For example, a proposal submitted by Chevedden to Anthem, Inc. to eliminate the classified board structure, emphasized that "Arthur Levitt, former Chairman of the Securities and Exchange Commission said, 'In my view it's best for the investor if the entire board is elected once a year. Without annual election of each director shareholders have far less control over who represents them.'" Anthem, Inc., Proxy Statement (Schedule 14A) (Mar. 29, 2019). Similarly, a shareholder proposal submitted to the Board of Walt Disney Company requested the company to report on cyber security and data privacy, emphasized that "[i]n September 2017, the Co-Director of the SEC's Enforcement Division announced creation of a 'Cyber Unit' stating, 'Cyber-related threats and misconduct are among the greatest risks facing investors and the securities industry.'" It also added that "[p]rior to becoming Chairman of the SEC, Jay Clayton wrote, 'cyber-threats are among the most urgent risk to America's economic and national security and the personal safety of its citizens.'" The Walt Disney Co., Proxy Statement (Schedule 14A) (Jan. 11, 2019).

vision through the analysis of their proxy voting guidelines, letters, and public statements.

Law firms are well aware of the fact that it is necessary for their corporate clients to have the support of large institutional investors when asking shareholders to vote for proposals initiated by the management, and when asking them to vote against shareholder proposals adverse to management recommendations. As explained before, each large institutional investor typically holds between five to ten percent of the shares of a public corporation. Together, they frequently constitute a solid block of shares which can tip the scale in any voting process. As I explained before in Section IV.B., complying with institutional investors' guidelines is a necessary condition to win the investors' support. Therefore, law firms frequently advise their clients to pay attention to and follow the guidelines.

One illustrative example is a memorandum sent by Davis Polk to their client, stressing that "[o]ne thing to note—as influential as these proxy advisory firms' voting guidelines are, it is just as, if not more, important to review the voting guidelines of the company's actual institutional shareholders."[198] Another example is a statement made by Martin Lipton, the founding partner of Wachtell, Lipton, Rosen & Katz, that emphasized:

> Major institutional investors, including BlackRock, Fidelity, State Street and Vanguard have established significant proxy departments that make decisions independent of ISS and warrant careful attention. It is important for a company to know the voting policies and guidelines of its major investors, who the key decision-makers and point-persons are and how best to reach them. It is possible to mount a strong defense against an activist attack supported by ISS and gain the support of the major institutional shareholders.[199]

[198] *Client Memorandum, A Say-on-Pay Update – Plus Strategies for Responding to a Negative Recommendation by a Proxy Advisory Firm*, DAVISPOLK (Nov. 29, 2018), https://www.davispolk.com/files/2018-11-29-a_say-on-pay_update_plus_strategies.pdf.

[199] Martin Lipton, *Dealing with Activists Hedge Funds and Other Activist Investors*, HARV. L. SCH. FORUM. CORP. GOV. (Jan. 25, 2019),

Other leading law firms also closely follow large institutional investors' evolving perspectives and views.[200]

Other professionals in the corporate field use institutional investors' corporate guidelines as a reference point. For example, in October 2014, the Business Roundtable, an association of the CEOs of leading U.S. corporations, released a proposed voting policy on "Independent Chair Shareholder Proposals (U.S.)."[201] This policy referred to the perspectives of BlackRock and State Street on the matter.[202] Similarly, in its annual corporate directors survey published in 2019, PwC described new developments in the policies of State Street and BlackRock regarding gender diversity.[203]

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https://corpgov.law.harvard.edu/2020/01/20/dealing-with-activist-hedge-funds-and-other-activist-investors-3/.

[200] *See, e.g.*, *\Purpose, Culture and Long-Term Value—Not Just a Headline*, KIRKLAND & ELLIS (Feb. 11, 2019), https://www.kirkland.com/-/media/publications/governance-update/2019/02/kirkland-governance-update--feb-2019_final.pdf (stating that letters sent by "two of the world's largest long-term 'passive' investors [(BlackRock and State Street)] offer a powerful counterpoint to the seemingly never-ending short-term oriented agitation from activist hedge funds."); *BlackRock Publishes Updated Proxy Voting Guidelines*, WHITE & CASE (Feb. 21, 2018), https://www.whitecase.com/publications/alert/blackrock-publishes-updated-proxy-voting-guidelines; *Proxy Access—Now a Mainstream Governance Practice*, SIDLEY AUSTIN 6–8 (Feb. 1, 2018), https://www.sidley.com/-/media/update-pdfs/2018/02/20180201-corporate-governance-report.pdf (describing in detail institutional investors' policy to support proxy access [including policies of BlackRock, CalPERS, Fidelity, State Street T. Rowe Price, and Vanguard); Richard J. Grossman & Demetrius A. Warrick, *Shareholder Activism Trends in the 2019 Proxy Season*, SKADDEN (April 23, 2019), https://www.skadden.com/insights/publications/2019/04/quarterly-insights/shareholder-activism-trends-in-the-2019-proxy; Marc S. Gerber, *US Corporate Governance Turning Up the Heat*. SKADDEN (Jan. 17, 2019), https://www.skadden.com/insights/publications/2019/01/2019-insights/us-corporate-governance-turning-up-the-heat (describing BlackRock's perspective regarding ESG issues).

[201] Business Roundtable, *2015 Proposed Voting Policy on "Independent Chair Shareholder Proposals (U.S.)"*, INSTITUTIONAL S'HOLDERS. SERVS. (October 29, 2014), https://www.issgovernance.com/file/policy/Business_Roundtable.pdf.

[202] *Id.* at 2–3.

[203] *The Collegiality Conundrum: Finding Balance in the Boardroom*, PWC 14 (2019), https://www.pwc.com/us/en/services/governance-insights-

This sub-section described a special dynamic, in which guidelines of institutional investors may influence corporate managements' decision-making through attracting the attention of corporate professionals.

E. Best Practices

As explained in section IV.A above, in addition to explicit references to corporate guidelines, corporations may cite industry best practices to support their adoption of certain governance arrangements. Since corporate guidelines may initiate, accelerate and maintain industry best practices, corporate guidelines may exert influence on corporations' governance regimes through the corporations' reliance on the best practices.

The empirical analysis shows that almost half of the S&P 500 corporations declared that their boards reviewed corporation's policies, frameworks and guidelines according to current and evolving best practices, or emphasized that corporation's governance guidelines were aligned with the best practices or that they are committed to best practices. Relatedly, both corporations and shareholders referred to statistics regarding best practices and corporations made the references mainly in response to shareholder proposals.

Such references are made as a tool to convince corporations to adopt certain governance arrangements. For example, a shareholder of Facebook who submitted a proposal that called the Board to elect directors by a majority vote, supported his proposal by stating that "[m]ore than 89% of the companies in the S&P 500 have adopted majority voting for uncontested elections, as have 67% of the S&P 1500 . . . ."[204] A shareholder of Alphabet (Google) supported his proposal by exactly the same statement.[205] Similar use of best practices was done by shareholders with regard to other governance issues as well. For example, a shareholder of Pfizer supported his proposal to separate the role of the Chairman and the CEO, by stating that "[as of

center/assets/pwc-2019-annual-corporate-directors-survey-full-report-v2.pdf.pdf [hereinafter *The Collegiality Conundrum*].

[204] Facebook, Inc., Proxy Statement, *supra* note 178.

[205] Alphabet Inc., Proxy Statement, *supra* note 181.

March 2017] 58% of S&P 1,500 firms separate these two positions and the number of companies separating these roles is growing."[206] Similar proposals and statements were made by shareholders of other companies as well.[207]

In response to shareholder proposals that make such references, corporations also make similar references. For example, the Board of JPMorgan Chase & Co.'s response to a shareholder proposal on enhancing shareholder proxy access emphasized that "[t]he Firm's proxy access By-law is aligned with current best practices and with prevailing practices among other U.S. companies." The Board added that "[b]ased on a review of the Corporate Governance & Executive Compensation Survey 2018 by Shearman & Sterling, the terms of our proxy access By-law, including the re-nomination threshold, are consistent with the 67% of S&P 500 companies that have adopted proxy access."[208]

F. Extension—Proxy Advisors' Reliance on Corporate Guidelines and Investors Involvement in Designing Proxy Advisors' Guidelines

Proxy advisors are considered as central players in corporate governance. During the past two decades, institutional investors have increasingly relied on proxy advisory firms, and many believe that institutional investors have outsourced their proxy voting and corporate governance decisions to proxy advisory firms. The leading proxy advisory firms—Institutional Shareholder Services ("ISS") and Glass, Lewis & Co. ("Glass Lewis"), which together account for ninety-seven percent of the industry—have been called "de facto

[206] Pfizer Inc., Proxy Statement (Schedule 14A) (Mar. 14, 2019).

[207] *See*, *e.g.*, AbbVie Inc., Proxy Statement (Schedule 14A) (Mar. 22, 2019) ("As of October 2018, 50% of the S&P 500 have separated the role of Chair and CEO. Furthermore, 31% of S&P 500 firms have an independent chair."). Although the example above includes accurate statistics, in some cases, shareholder proposals only mention the names of leading corporations in the cases in which a requested governance arrangement was adopted.

[208] JPMorgan Chase & Co., Proxy Statement, *supra* note 190.

corporate governance regulators,"[209] and "de facto arbiters of U.S. corporate governance."[210] In some cases, proxy advisors effectively controlled the vote of fifty percent of a corporation's total shares outstanding.[211]

Similar to mutual funds, proxy advisory firms also lack capabilities and resources needed to research each company about which they provide voting advice or execute voting on behalf of their clients, i.e., institutional investors. For example, in June 2017, the ISS reported that its "Global Research team [located in the ISS' offices in Europe, North America, Asia, and Australia] consisted of approximately 460 analysts, including approximately 270 research analysts and 190 data analysts."[212] As Glass Lewis reports, it has around "380 employees worldwide, more than half of whom are dedicated to research."[213] These numbers are overshadowed by the enormous coverage proxy advisors are supposed to provide. As ISS currently reports, it "covers approximately 44,000 meetings in 115 countries yearly . . . working closely with clients to execute more than 10.2 million ballots representing 4.2 trillion shares."[214] Similarly, Glass Lewis reports that it covers "[M]ore than 20,000 meetings each year, across approximately 100 global markets."[215]

In light of proxy advisors' lack of optimal capabilities to make an informed voting decision on each resolution submitted to a vote at every shareholder meeting, it is interesting to see that proxy advisors themselves rely on corporate guidelines to cope with their limited

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[209] Letter from Wachtell, Lipton, Rosen & Katz, to Elizabeth M. Murphy, Sec'y, SEC 6 (Oct. 19, 2010), http://www.sec.gov/comments/s7-14-10/s71410-129.pdf.

[210] Hearing before the House, *supra* note 47, at 2. For an overview of the evolution of the proxy advisory industry, see Eckstein & Hannes, *supra note* 96.

[211] Eckstein & Hannes, *supra note* 96, at 110.

[212] *Due Diligence Compliance Package*, INSTITUTIONAL S'HOLDER. SERVS. (Nov. 2017), https://www.issgovernance.com/file/duediligence/Due-Diligence-Package-November-2017.pdf.

[213] *About Us*, GLASS LEWIS, https://www.glasslewis.com/company-overview/ (last visited May 18, 2020).

[214] *About ISS*, INSTITUTIONAL S'HOLDER. SERVS., https://www.issgovernance.com/about/about-iss/ (last visited May 18, 2020).

[215] *About Us*, GLASS LEWIS, https://www.glasslewis.com/company-overview/ (last visited May 18, 2020).

capacities. In the Roundtable on proxy process held by the SEC in November 2018, Mr. Gary Retelny, the President and the CEO of the ISS, explained that "[W]hat ISS does, essentially, is help [institutional investors] with the work flow . . . in actually executing those votes, based on [investors'] own individual custom policies."[216] Ms. Katherine Rabin, who served as the CEO of Glass Lewis, made a similar statement.[217]Relatedly, proxy advisors' lack of capabilities may shed light on their reliance on their own guidelines, which has attracted much criticism. Critics have attacked proxy advisors for their "one-size fits all" approach.[218]

Interestingly, institutional investors not just design their own guidelines, but also involved in the process in which proxy advisory firms develop their voting guidelines. A look at the development process of ISS guidelines can illustrate such an involvement. This process includes four major phases: 1) Survey—when ISS invites institutional investors, corporate issuers and corporate governance organizations to respond to a survey regarding selected policy positions; 2) Roundtable—ISS holds a roundtable to discuss with investors and issuers means to promote corporate guidelines; 3) Comments—ISS publishes draft guidelines and gets feedbacks from investors and issuers; and 4) Final Guidelines—ISS publishes the final version of its guidelines for the subsequent proxy season.[219]

As reported by the ISS, it received inputs from 121 institutional investors and 382 corporate issuers for its 2017 Governance Principles Survey;[220]107 responses from institutional investors and 469

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[216] SEC Roundtable 2018, *supra* note 56, at 192.

[217] Id., at 193: ". . . at the end of the day, what we're doing is executing votes in accordance with the specific instructions of our clients. Whatever policy it is, it's their policy."

[218] Eckstein & Hannes, *supra* note 96, at 110.

[219] James R. Copland, David F. Larcker & Brian Tayan, *The Big Thumb on the Scale: An Overview of the Proxy Advisory Industry* (Stanford Univ. Graduate Sch. of Bus., Research Paper No. 18-27, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3188174

[220] *2017–2018 Global Policy Survey: Summary of Results*, INSTITUTIONAL S'HOLDER. SERVS. (Sep. 25, 2017), https://www.issgovernance.com/file/policy/2017-2018-iss-policy-survey-results-report.pdf.

responses from corporations for its 2018 Survey;[221] and 128 responses from investors and 227 responses from corporate executives in its 2019 Survey that covered issues such as Board Gender Diversity, Director Overboarding, Combined CEO and Chair, Capital structure (including multi-class shares), etc.[222] These data indicate that both institutional investors and corporations have strong interest in proxy advisors' guidelines.[223] Similarly, although Glass Lewis, the other leading proxy advisory firm, does not disclose the process for designing its guidelines, its process also includes inputs from institutional investors and corporations.[224]

V. LIMITATIONS OF THE USES OF CORPORATE GUIDELINES

This part considers limitations and concerns regarding the uses of corporate guidelines. Section A addresses the concern that corporate guidelines are only a window dressing, i.e., they are used by corporations to show that they have tried to satisfy demands from policymakers, shareholders and other constituencies, and by institutional investors to show that they have fulfilled their fiduciary duties related to corporate governance, while they have not necessarily done so in practice. Thus, the guidelines do not play a normative role and do not have any real influence on corporate governance. Put differently, according to such a claim, there is a gap between

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[221] *2018 Governance Principles Survey: Summary of Results*, INSTITUTIONAL S'HOLDER. SERVS. (Sep. 18, 2018), https://www.issgovernance.com/file/policy/2018-2019-iss-policy-survey-results-report.pdf.

[222] *2019 Global Policy Survey: Summary of Results*, INSTITUTIONAL S'HOLDER. SERVS. (September 11, 2019), https://www.issgovernance.com/file/policy/2019-2020-iss-policy-survey-results-report.pdf.

[223] *See* David F. Larcker, Allan L. McCall, & Brian Tayan, *The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions*, STANFORD GRADUATE SCH. BUS. (March 2012) ("During the 2011 proxy season, 72.0 percent of companies reviewed the policies of a proxy advisory firm or engaged with a proxy advisory firm to receive feedback and guidance on their proposed executive compensation plan.").

[224] Courteney Keatinge & Kern McPherson, *2020 Policy Guidelines—United States*, HARV. L. SCH. FORUM. CORP. GOV. (Nov. 13, 2019), https://corpgov.law.harvard.edu/2019/11/13/2020-policy-guidelines-united-states/.

corporations' rhetoric that they rely on corporate guidelines and how they treat the guidelines in reality. Section B discusses the claim that guidelines are too generic to accommodate the individual characteristics of each corporation.

A. Guidelines as a Window Dressing?

The crux of the first concern is that corporate guidelines are more like a publicity tool than a factor determining corporate governance. According to this argument, corporate guidelines only serve a "symbolic" function.[225] Put differently, corporate guidelines may be used as a mechanism to conceal and legitimize—i.e. to "camouflage"— both corporations and institutional investors' low-level of commitment to corporate governance.[226]

The concern described above stems from the fact that the real power of corporate guidelines is less observable, measurable and visible. Even when the influence of these guidelines can be traced, it is hard to separate the influence of the guidelines used independently, from the influence the guidelines combined with other factors. For example, when a shareholder submitted a proposal to a corporation, urging it to adopt a certain governance arrangement, it may be this proposal itself, or the media coverage of the proposal, that attracted the attention of the board and pushed the board to consider the requisite governance modification. In this process, the board may have also reviewed its institutional investors' guidelines. However, what led to the eventual modification might be the proposal and not the guidelines. Relatedly, as explained in previous parts of the article, institutional investors engage with their portfolio companies behind the scenes. Therefore, it is hard to figure out exactly what is the

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[225] Marcel Kahan & Edward Rock, *Symbolic Corporate Governance Politics*, 94 B.U.L. REV. 1997, 2042 (2014) ("[W]e should be open to the possibility that corporate governance politics, like politics generally, may serve a 'mythological' or 'symbolic' function separate and apart from these more instrumental and practical uses.").

[226] The "Camouflate" term was coined by Bebchuk and Fried in their discussion of executive compensation. LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004).

dynamic of each engagement and what is the role played by the investors' guidelines in comparison to their active engagements.

Comparing the costs and benefits for investors and corporations to use corporate guidelines in different ways may shed light on the guidelines' true influences. For the investors, the costs of using their guidelines as mere camouflage include reputational loss and potential legal challenges if their actions are exposed, and potential losses to their investments caused by bad governance in their portfolio companies. The benefit is lower costs of monitoring and enforcing corporations' and fund managers' compliance with the guidelines. If the benefit outweighed the costs, we would expect to see the investors ignoring significant violations of their guidelines, or not investing enough resources in monitoring potential violations, vice versa. Although this paper did not cover the magnitude of the costs and benefits, it provided evidence in Section IV.B that at least for large funds like State Street and Vanguard, the costs may exceed the benefits. Both State Street and Vanguard have systems in place to monitor and enforce their portfolio companies' compliance with their guidelines. Also, Section II.A mentioned that some investors, while giving their portfolio managers the flexibility to breach their guidelines, still require the managers to "align or explain."

As for the corporations, the costs include loss incurred by their investors' enforcement actions and reputational loss if their noncompliance is discovered. The companies may benefit from breaching the guidelines if doing so allows the managements to pursue better alternative governance regimes. Thus, the outcome of the corporations' cost and benefit analysis depends at least partially on the existence of a credible enforcement threat, i.e., whether corporations believe that violating the guidelines would invoke their investors' adverse response.[227] Such responses may include exiting from a portfolio corporation (in the case of actively managed funds), voting against a resolution offered by the corporation's management, supporting a shareholder proposal against the current governance

[227] In this regard it is interesting to refer to Guy Halfteck, *Legislative Threats*, 61 STAN. L. REV. 629, 637 (2008) (explaining about the "credibility condition," within the context of legislative threat).

regime, or even voting against the reelection of directors who refused to comply with the guidelines without a sufficient explanation. Noncompliance may not always incur more costs than benefits, but my empirical analysis has shown that this is the case at least for the largest companies. Those companies made the most references to corporate guidelines in their proxy statements to demonstrate their compliance.

In short, corporate guidelines are certainly effective among large investors and corporations. This finding is consistent with the assumption that large investors and corporations are subject to heightened attention from policymakers, media, practitioners and activists because such attention implies that the probability of getting caught is higher. This assumption is supported by a recent study showing how corporate gadflies target mainly larger companies.[228] Lastly, the above cost and benefit analysis shows that the effectiveness of corporate guidelines hinges on the enforcement. In other words, corporate guidelines are not a completely passive instrument because they are more effective when complemented by active stewardship.

B. One Size Does Not Fit All

The second limitation of corporate guidelines is that they are formulated as generic models, and in corporate governance, it is commonly agreed that one size does not fit all. Intuitively, it is undesirable that corporations with different characteristics adopt the same set of governance mechanisms and arrangements. Corporate governance must take into account the structure of the corporation, the industry in which it operates, and the dynamic between shareholders and managers. Many commentators, as Zohar Goshen and Richard Squire, are against using a one-size-fits-all approach to corporate governance.[229] From this point of view, guidelines are not efficient in enhancing good corporate governance. While this limitation should be acknowledged, it should be read together with the following clarifications.

[228] Kastiel & Nili, *supra* note 177.

[229] Goshen & Squire, *supra* note 43, at 774.

First, although at the first glance corporate guidelines may be seen as a rigid set of one-size-fits-all rules, as I illustrated in Section II.A, corporate guidelines reserve some flexibility and discretion for both investors and their portfolio companies. This can be learned from language in the guidelines and institutional investors' declarations that they do not aim to force specific arrangements on companies.

Second, this article in no way suggests that corporate guidelines can replace active engagement, but it does suggest that a mix of the above two types of stewardship can be more effective than active engagement alone under certain circumstances. In other words, even if guidelines standing alone are not the most efficient tool of corporate stewardship because of the one-size-fit-all issue, it can still be an essential part of a hybrid tool that is the most efficient. As discussed earlier, the largest institutional investors cannot afford to actively engage with all of their portfolio corporations. Thus, they are forced to prioritize. As Bebchuk and Hirst recognize in their article, investors may allocate their resources to portfolio companies that are of current interest. For example, investors may focus on "companies that are targets of hedge fund activists," or "companies that have been afflicted by scandals."[230] The concern is that such an asymmetrical allocation of resources may cause investors to ignore the majority of their portfolio companies, and make investors more responsive rather than preventive. In other words, investors will not be able to "reveal the presence of substantial problems before they become clearly apparent."[231] Thus, purely active engagement for an institutional investor means a complete failure to fulfill its stewardship duties in the portfolio companies that it does not actively engage with.

On the other hand, using guidelines to complement active engagement reduces although does not eliminate the gap between the optimal and the real level of investors' stewardship in the companies that the investors do not actively engage with. Assuming corporate guidelines can have real impact on corporate governance, although generic governance models are not perfect, they may still be able to address some substantial problems in many companies. This is

[230] Bebchuk & Hirst, Index Funds, *supra* note 1, at 2080.
[231] *Id.* at 2082.

because certain governance issues are common to all, or at least a large number of corporations, and thus can be addressed by the same guidelines. For example, the Harvard Law School's Shareholder Rights Project (SRP), a clinical program led by Bebchuk, advocated for declassification of board and eventually led to a dramatic decline in the number of staggered boards in large corporations in the US.[232] There are plenty of similar examples. Poison Pill has experienced a sharp decline due to the fundamental objection of proxy advisory firms. Voting in shareholder meeting has experienced a significant shift from plurality to majority voting.[233] Bebchuk and Hirst acknowledge that investors can use "some generally applicable insights."[234] In conclusion, criticizing corporate guidelines for lack of efficiency when used alone is misplaced. The guidelines are not meant to be used alone in the first place. The combination of active engagement and corporate guidelines, considering the constraints faced by institutional investors, is the optimal form of stewardship compared to other alternatives, such as purely active engagement.

CONCLUSION

Institutional investors, while often the largest shareholders in their portfolio companies, seem to have little incentive to actively shape the companies' corporate governance regimes. There are two common explanations for this phenomenon: (1) active engagements are too costly because initiating an activist campaign is expensive and may disrupt the complex business relationships between investors and their portfolio companies; and (2) the investors are "rationally reticent" and

[232] Lucian Bebchuk, Scott Hirst & June Rhee, *Towards the Declassification of S&P 500 Boards*, 3 HARV. BUS. L. REV. 157 (2013). *See also* Steven Davidoff Solomon, *The Case Against Staggered Boards*, N.Y. TIMES (Mar. 20, 2012), https://dealbook.nytimes.com/2012/03/20/the-case-against-staggered-boards/ (explaining how the Harvard SRP "has succeeded in getting about a third of all the S.&P. 500 companies that had a staggered board to eliminate it").

[233] Stephen Choi, Jill E. Fisch, Marcel Kahan & Edward B. Rock, *Does Majority Voting Improve Board Accountability?*, 83 U. CHI. L. REV. 1119 (2016); Lucian Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 702 (2007) ("[G]iven the clear and widely accepted flaws of plurality voting, majority voting should be the default arrangement.").

[234] Bebchuk & Hirst, Index Funds, *supra* note 1, at 2082.

thus will only respond to others' shareholder proposals instead of submitting their own. Institutional investors draw criticism for underinvesting in corporate governance because of their lack of activism. However, such criticism is incomplete because it ignores the power of a passive corporate governance instrument used by the investors—corporate guidelines. In this paper, I have explained the growing popularity of corporate guidelines through the lenses of investors, corporations, shareholders, and other stakeholders in corporate governance.

Corporate guidelines, a set of sound principles and practices in corporate governance, are published by institutional investors to instruct their portfolio managers on voting decisions. Given institutional investors' large holdings in their portfolio companies, their voting decisions can have significant impacts on the governance policies in those companies. However, some argue that such influences are left unused because of investors' pro-management voting patterns. Therefore, they conclude that corporate guidelines have little power of changing companies' existing governance regimes. I responded to this concern by pointing out that corporate guidelines can alter the managements' governance policies prior to voting, and thus determining the influence of corporate guidelines by only observing voting practices is improper. In short, studying corporate guidelines is not meaningless and it requires a broader scope than just focusing on the most observable voting patterns.

Investors have three main motivations to use corporate guidelines to involve in their portfolio companies' corporate governance. First, using corporate guidelines allows institutional investors to balance the need to fulfill their fiduciary duties and the need to stay cost-effective. On the one hand, institutional investors have the obligation to vote in the best interests of their clients, which implies that their voting decisions should aim to effect sound governance policies. Moreover, given their enormous influences over their portfolio companies, these investors are expected by the public to act as good stewards. On the other hand, institutional investors bear the burden of voting in thousands of annual meetings while facing the pressure to cut costs to be competitive. A variety of incentive issues, such as the free-rider problem, further diminish the value of investing in corporate governance to the investors. Outsourcing voting decisions to proxy advisory firms, though less costly, may backfire as it is often perceived by regulators and the public as evading, not fulfilling, the investors' fiduciary duties. In contrast, active engagements are often too expensive. Thus, suffering from none of the above two problems, corporate guidelines have emerged as the favorite governance tool.

Second, institutional investors prefer not to incur direct confrontations with managements of their portfolio companies because such confrontations may trigger regulatory backlashes and jeopardize the business ties between the investors and the companies. Corporate guidelines are less likely to create direct conflicts compared to activist campaigns because they allow the managements to respond to the investors' demands proactively, thereby preserving their images. Furthermore, corporate guidelines typically reserve some degree of flexibility for the managements, by allowing them to consider individual companies' characteristics as long as they follow the general principles stipulated by the guidelines.

Third, the development of corporate guidelines is a part of the global push towards the standardization of corporate law. Large institutional investors across the world form organizations, such as the ISG, and publish standardized corporate guidelines through those entities. Such guidelines is even more powerful in effecting the governance policies preferred by the investors and thus are relied upon more frequently.

Corporations are not only passive targets that corporate guidelines are directed to influence, but also active users of those guidelines. The empirical study in this paper has shown that in 2019, 5.6% of the S&P 500 companies made explicit references to corporate guidelines in their proxy statements to signal their commitments to sound corporate governance principles and support their governance policies or their responses to shareholder proposals. Moreover, industry best practices, which are heavily influenced by corporate guidelines, are mentioned by 45.2% of the companies for the same reasons.

Other parties whose interests are tied to corporate governance also rely on corporate guidelines. Activist shareholders cite the guidelines to make their proposals more convincing. Proxy advisory firms, who bear an even heavier burden to vote than institutional investors, also rely on pooling corporate guidelines and inputs from various investors to inform their voting decisions.

The structure of my explanation of the emergence of corporate guidelines resembles a supply and demand model. On the supply side, institutional investors have strong incentives to create and use corporate guidelines. On the demand side, corporations, shareholders, proxy advisory firms, and law firms all rely on the guidelines to maintain their governance-related interests. It is the shifts on both sides that lead to the rise of corporate guidelines.