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Law, Politics and Markets of Corporate Governance:
Institutional Investors' Influence

by

Stephen Davis Carniglia

A dissertation submitted in partial satisfaction of the

requirements for the degree of

Doctor of Philosophy

in

Jurisprudence and Social Policy

in the

Graduate Division

of the

University of California, Berkeley

Committee in charge:

Professor Robert A. Kagan, Chair

Professor Robert Cooter

Professor Malcolm Feeley

Professor David Vogel

Spring 2013

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Abstract

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Doctor of Philosophy in Jurisprudence and Social Policy

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Professor Robert A. Kagan, Chair

This dissertation research project examines the role of institutional investors in influencing the corporate governance rules applicable to U.S. public companies, through an interview study of institutional investors and their expert corporate governance advisers, as well as a detailed review of the comments submitted to the SEC in connection with a proposal to regulate the proxy advisory firms which advise institutional investors. The key issue continues to be the “agency problem” identified by Berle and Means in the 1930’s: the tendency of management to serve their own interests rather than investors’ interests.

Despite a long-standing debate over whether corporate law evolves to serve managers or investors, there is substantial evidence that the resulting legal environment has permitted corporate governance rules which tend to entrench management and increase its discretionary powers. This has led to significant increases in management compensation, which has led to behavior intended to protect management and enhance compensation. A long history of political and legal involvement by business and management interests has served to protect the status quo in most cases. Dispersed shareholders have been at a disadvantage in corporate governance because of the collective action problem; their individual interests are small compared to those of corporate managers.

The growth of *institutional* ownership of U.S. corporate shares led many commentators to predict that these new shareholders would have the resources and influence to counter management interests, curb excesses, and reform corporate governance. While they have had some success, institutional investors have not been as influential as expected and executive compensation has grown substantially at the same time as institutional ownership increased.

This research shows that institutional investors want important changes in corporate governance, especially in aligning management's interests with shareholders', but they have failed to match management's actions in coordination, lobbying, political contributions, litigation, and public relations. It found evidence that institutional investors barely use their vast economic power to influence corporate governance. It found that a significant impediment is a striking mismatch in personality traits and motivation of corporate governance professionals compared to corporate managers, although proxy advisory firms provide an unheralded role in coordinating institutional corporate governance efforts and positions. It concludes that the agency problem is unlikely to be solved without significant increases in institutional investors' political resources and coordination, and without a new mobilizing force.

Acknowledgments

I have come to this project by an unusual path, which in some ways gave me an unfair advantage and in others made it unusually challenging. I entered the Jurisprudence and Social Policy PhD. Program after retiring from a rich, rewarding and very lucky career in law, accounting and business. My years at the predecessors of PricewaterhouseCoopers and KPMG, where I was a national Professional Practice Partner, the national Tax-Oriented Investment Partner, and Partner-in-Charge of the Northern California Real Estate, Hospitality and Construction Practice, gave me the opportunity to learn from a large number of partners and clients, including many of the Wall Street firms and many institutional investors. I had the opportunity to attend more than one hundred public company board meetings, as well as to be a “pilot project” for the integration of audit, tax and consulting services to a single industry. I am appreciative to all of these firms and individuals who gave me an extraordinarily broad education in business.

When I left the professional world and the “gate-keeper” role, I chose to join a small boutique real estate investment banking firm that was led by three of the smartest, most creative and committedly ethical people I have ever encountered in business, Doug Abbey, Bob Burke and Hamid Moghadam. I am proud to have been their partner as we made two significant business transitions, into being a successful and highly-respected investment adviser to institutional investors (including over one hundred of the best and most sought-after institutional clients), and then to the creation of public real estate investment trust which later became the largest warehouse company in the world, Prologis. The experience of being the Chief Financial Officer, General Counsel, Chairman of the Management Committee and Vice Chairman of the Investment Committee was the most exhilarating of my business career, and I thank Doug, Bob and Hamid for the extraordinarily deep education they gave me in their industry and the world of institutional investors.

So I came to my topic knowing a great deal about it. My initial instinct was to stay away from what I knew, but I eventually found myself drawn to the challenge of doing academic research to create documentation of the views and actions of these notoriously secretive institutional investors in an area that I did not know much about: their activities in corporate governance reform. It has been a challenge to distinguish between what I know and what I can provide evidence to support. Where I might have failed in this, please be assured that the conclusions in this dissertation are consistent with my observations and experience in dealing with institutional investors, corporate boards and senior management. And while many people had great impact on the development of the ideas, research and presentation of this dissertation, any errors are solely my own.

Robert A. Kagan, the chair of my committee, has been the rock (and the hard place) of my project. He has been devastatingly critical, demanding, thorough and deeply involved in my work. He has also worked incredibly hard to learn my subject, to ask the right questions, to challenge my logic, to guide my presentation, to support me and to protect me from myself. If this work is any good, it is thanks to Bob.

Malcolm Feeley was my advisor as a student through my Qualifying Exams. He coached me through the program and through the decisions about my topic, including how to re-design my research when my subjects were too unresponsive for me to continue my original quantitative approach.

Bob Cooter is an economist who is really a philosopher. Bob's own quest to find new places to apply economic thinking, especially for the good of society, was a guide for the large measure of economic thinking which is embedded throughout this project.

David Vogel, at the Haas School of Business and the Political Science department, was my "outside" member. The irony is that my topic has as much to do with his work as a leading scholar on business and politics, as it does with any other member of my committee. His work probably had the greatest influence on mine, despite our relatively limited time together.

I also want to thank the many other people who helped me in this project, including Nelson Polsby (still with me in spirit), Bruce Cain (now heading the U.C. Washington, D.C. program), Jesse Fried (now at Harvard Law School), Kristin Luker (who taught me all I know about interviewing), Jim Hawley (at St. Mary's Fiduciary Capitalism program) and John Cioffi (at UC Riverside's political science department).

I must acknowledge three "un-nameable" figures in institutional investor corporate governance who spent many hours talking to me about the field, the players, the key ideas, and how to make contact. They helped me reach the many corporate governance specialists and expert advisers who spoke to me, both on and off the record. All of these people were critical to being able to do my research and I thank them for their candor and ideas.

I want to thank my parents, both graduates of U.C. Berkeley and both still alive, though quite elderly, for their love, encouragement and models of good living. My father, who earned his PhD in Chemistry here almost sixty years ago, was an inspiration for this endeavor and as a teacher.

Finally, I want to dedicate this work to my wife and the love of my life, Claire Baker, and to my wonderful daughter, Allison, both of whom helped, sacrificed, suffered, supported and made fun of me in this project.

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Chapter 1.

Introduction

The broad topic of this project is the public and private regulation of the internal management of business entities, specifically U.S. corporations whose common equity securities are listed for public trading on a U.S. securities exchange.¹ Historically, this was the portion of corporate law dealing with the rights, powers and responsibilities of shareholders, directors and managers. Since about 1990, this subject has come to be known as corporate governance. David Larcker and Brian Tayan said: “We define corporate governance as the collection of control mechanisms that an organization adopts to prevent or dissuade potentially self-interested managers from engaging in activities detrimental to the welfare of shareholders and stakeholders.” (Larcker 2011a) This project uses a somewhat broader definition, say “The external laws, rules and regulations, and the internal charter provisions, bylaws, and practices which govern the relationships of shareholders, directors and managers.” But the core issues are well-described by the Larcker and Tayan definition above.²

The specific topic of this project is the actions of institutional investors, who together own a majority of almost all U.S. public companies, in trying to influence both the external rules and the internal decisions of corporate governance. Institutional investors have been surprisingly passive in the use of their resources and power as shareholders on behalf of the interests of their beneficiaries. This project looks at how corporate governance rules are made and how management and shareholder interests are represented in the process, to try to understand the apparent weakness of institutional investors.

The boundaries of this project must be somewhat imprecise because of the wide range of definitions applied by the many people who have studied various aspects of the problems presented in corporate governance.³ This study focuses on U.S. public corporations, although many U.S. corporations earn the preponderance of their revenues and profits overseas. This project

¹ And are, by definition, subject to the Securities Act of 1933, the Securities Exchange Act of 1934 and regulation by the U.S. Securities Exchange Commission.

² It should be noted early on that these issues relate only to decisions about corporate management, compensation and financial structure, not how the corporation conducts its other business operations. This project covers who decides and how they decide, but not what they decide about other issues. For instance, corporate dividend policy would be included, but (absent a conflict of interest) what advertising agency they use would not. Thus, this project does not consider issues that are customarily included in “corporate social responsibility,” including the treatment of labor, suppliers, neighborhoods and the environment.

³ Academic interest in corporate governance has “mushroomed” lately. There were roughly 3,500 items indexed under “Corporate Governance” on SSRN in 2006; this increased to over 9,000 in July, 2012.

excludes the whole field of international corporate governance, despite the fact that foreign domicile, foreign operations and globalization introduce important challenges in corporate governance. Many of the issues and problems raised in this study relate generally to “big business” or to “great wealth,” not just to public corporations, but this study excludes a large number of powerful and influential private businesses, such as Bechtel or Cargill or the Koch Brothers’ enterprises. In focusing on corporations, it excludes a rainbow of newly-invented forms of common interest businesses, such as limited liability companies and publicly-traded partnerships and business trusts holding tranches of defined income streams.⁴ As will be seen, the governance of traditional U.S. public corporations is challenging enough.

U.S. public corporations have a great impact on all of our lives, including our food, shelter, clothing, transportation, education, information, protection, entertainment, healthcare, employment, income, savings, investment, retirement, and burial. They have served our physical, material and economic needs well and their importance has continued to grow. Most companies have performed effectively and efficiently and honestly. We rely on public corporations almost as much as we rely on government.

On the other hand, few observers would deny that corporate governance failures are far from infrequent. Corporate governance failures occur when the rules of corporate governance permit, or fail to prevent, or create incentives for, decisions by corporate boards or senior management which lead to intentional behavior which is not in the best interests of the corporation or its shareholders. This isn’t to suggest that mistakes of judgment are corporate governance failures, but most corporate governance failures involve some element of mistake. The key element is that the mistake was enabled by a failure of the corporate governance rules (or a breach of them). For instance, a failure to invest in new technology needed to meet new competition could be a mere mistake, but would be a corporate governance failure if the decision was made in order to increase the current income on which bonuses are calculated.

Corporate governance failures can have a great impact on all of our lives, not just on the shareholders and directors and managers who are directly involved. Corporate governance failures led to a round of financial institution failures in the 1980’s and 1990’s, including Penn Square Bank, Centennial Savings, Drexel Burnham, Executive Life, Lincoln Savings, and American Savings.⁵ This wave of failures was repeated a few years later in the so-called “dot.com bust” in the early 2000’s, when Enron, WorldCom,

⁴ Typically found in so-called “securitization” transactions.

⁵ The common theme here is that deregulation of financial institutions and reliance on market regulation led to short-term risk-taking by management which resulted in the failure of the corporations and huge financial losses to shareholders, depositors and large numbers of others who did business with these corporations.

Long Term Capital Management,⁶ Tyco, Adelphia, Global Crossing, HealthSouth, ImClone, Qwest and many others failed.⁷ These were followed even more quickly by the financial crisis and “great recession” of 2008, with the failures of AIG, Citigroup, Lehmann Brothers, Bear Stearns, Merrill Lynch, Wachovia, IndyMac, Washington Mutual, Countrywide, Fannie Mae, Freddie Mac, and MF Global.⁸ All of these businesses were intentionally undercapitalized⁹ and most of them knowingly engaged in transactions which abused their customers and squandered their reputations, all driven by misalignments of managers’ interests that led them to take risks that were not in the corporations’ or the shareholders’ interests.¹⁰ Managers lost the bonuses and incentives they might have earned; the rest of us lost jobs, savings, retirement, security and trust.¹¹

Along with these highly visible failures, there have been less visible corporate governance failures which both betray shareholders’ interests and undermine other elements of our society. The steady growth of management compensation, in relative terms and as a percentage of corporate returns, has concentrated enormous wealth in the hands of managers.¹² John Coffee argues that the threat of hostile takeovers and the advent of incentive compensation increased managers’ focus on short-term earnings and stock price. He notes that equity compensation of CEOs grew from 5% of their total compensation in 1990 to 60% in 1999, and stock options grew from 5% of shares outstanding to 15% during the same period. He notes that this created a strong incentive for earnings management and acceleration. Incentive pay also led to management pressure on the outside “gatekeepers” who audit, rate, analyze and certify corporate performance, who too often failed to prevent manipulation by management. For example, Coffee points out that FirstCall reported that the ratio of “buy” to “sell” analyst recommendations rose from 6 to 1 in the early 1990s to 100 to 1 by 2000. (Coffee 2004)

⁶ Perhaps the least honestly named business of all time, given their huge short-term speculation in currency and interest rate futures and derivatives.

⁷ The common theme here is that technology was creating a “new paradigm” where profitability didn’t matter because unlimited growth was going to create huge wealth, and, again, short-term risk-taking by management resulted in the failure of the corporations and huge financial losses to everyone involved.

⁸ Once again, the common theme is that short-term risk-taking by management of these venerable U.S. corporations, some of them over a century old, caused them to collapse.

⁹ The term “undercapitalized” is generally understood to mean that the entity has inadequate equity capitalization, usually through the substitution of debt as a means to increase current earnings on the remaining equity. This decreases the entity’s resources and reserves available to withstand unexpected problems.

¹⁰ See the Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States (2011), which specifically mentions corporate governance and risk management failures as causes.

¹¹ See Huffington (2003) for a relatively short list of “Who’s Been Indicted?”

¹² This represents a corporate governance failure in the sense that boards have failed to act to control compensation levels. See further discussion in Chapter 3.

This contributed to the high level of income inequality in the U.S. Joseph Stiglitz points out that income inequality is having a major impact on our society and that it is getting worse. The richest 1% captured 93% of income increases in 2010, primarily through corporate profits and managerial compensation. (Stiglitz 2012)

Most of the problems and issues of corporate governance trace to a weakness identified by Adolph Berle and Gardiner Means in a landmark 1932 book.¹³ As owners began to rely on managers to run their companies, managers' personal motivations began to interfere with their faithful representation of the owners' interests. Managers' personal motivations can lead to business decisions which are primarily intended to protect and enrich managers, instead of maximizing the long-term value of the company. The authors were concerned that this would lead to unlimited managerial power and that management interests could ultimately become more powerful than the state. This tendency is generally referred to as "agency cost" or the "agency problem." (Berle 1932)

Good corporate governance has the potential to be very valuable for society. The U.S. has profited immensely from the worldwide recognition that our securities markets, and corporate governance created protections for investors which insured that they would receive the profits to which they were entitled. The recent failures of corporate governance have led to much "hand-wringing" about "The Endangered Public Company" because they have led to fewer new public companies, an emphasis on private equity and declining financial performance. (Economist 2012) But much of our modern economy runs on trust and the efficient use of capital depends on it. Society and the beneficiaries of investments have a strong interest in insuring that corporate management faithfully pursues investors' interests rather than permitting management to make decisions which injure them.

In the era of deregulation in the 1980's, management successfully advocated for the reduction of both direct regulation of corporate governance and the reduction of private rights of action. Law and Economics scholars advocated for "private ordering"¹⁴ to regulate corporate conduct, arguing that corporate takeovers and market valuations would provide the discipline for managers to behave in the best interests of shareholders. But management reacted to takeovers by adopting very effective anti-takeover devices that had the ancillary effect of entrenching management. The 1990's began with considerable enthusiasm for the idea that the growing importance of institutional investors would lead to their acting as private corporate governance regulators. They were thought to have the interest, the resources

¹³ Discussed more extensively in Chapter 5.

¹⁴ Private ordering is the idea of relying upon actions of private parties to arrange their affairs and transactions, instead of public laws, regulations and decisions of government.

and the power to force management to act in shareholders' interests. But they have evidently failed to do so. (Cheffins 2012)

The obvious question is why not? This project studies the interaction of two types of large institutions: U.S. public corporations and the institutional investors which invest in them. At its core is a survey and interview study of institutional investors' goals and actions in corporate governance. The study includes an unrepresentative sample¹⁵ of corporate governance and proxy voting specialists within institutional investors, and a comprehensive sample of experts who advise institutional investors on corporate governance and proxy voting matters. The project also includes a study of the comment letters submitted to the SEC on a proposal made by corporate "issuers"¹⁶ to regulate the activities of proxy advisory firms which advise institutional investors, which further illuminates the differences in how corporations and institutional investors oppose each other.

This research is important because there are few studies which seek to document institutional investors' views and actions. There are many econometric studies of individual corporate governance issues and of individual institutional investors.¹⁷ More recently, there have been a number of studies seeking to correlate corporate governance activity with corporate financial performance.

This project takes an interdisciplinary approach to interpreting the influence of institutional investors on corporate governance. There is a great deal of study and writing from the individual perspectives of law, business, politics, economics, history and sociology; however, it is impossible to understand this question without considering all aspects of it. This project draws on literature from all of these fields, thus approaching the topic more like the old field of political economy.¹⁸ It is necessarily a complicated story because the strategy and tools of both types of institutions are inherently complicated and multi-disciplinary.¹⁹

This unusual methodology, scope and perspective have been useful in identifying an important difference at the root of the failure of institutional investors to make much difference in corporate governance. The individuals who act for management interests and those who act for investor interests appear to have characteristic differences in style, personality and motivation, which lead to significant differences in how the institutions engage each other. Managers are skilled at strategy, goal-setting, marketing and

¹⁵ Unrepresentative because of a significant response bias in the participation of the institutions sampled.

¹⁶ Issuers is a securities law term which refers to corporations which issue stock. All public corporations are issuers.

¹⁷ These are heavily biased toward the activities of unusually "activist" institutional investors, especially CalPERS.

¹⁸ Before it focused on positive political theory.

¹⁹ One interesting aspect of this is the unusual inclusion of practicing attorneys and sitting judges in the debates; both are well-represented in the academic literature, conferences and public discourse.

negotiation; investors tend to be analytical, technical and process-oriented. More importantly, managers live in a world of risk-taking and risk management, while investors are particularly risk-averse. Certainly, there are exceptions on both sides, but the tendencies are strong enough that the contest for corporate governance changes is systematically imbalanced.

Chapter 2 will provide a brief introduction to the historical evolution of corporations, corporate law and external rules of corporate governance, which create a relatively unconstrained environment.

Chapters 3, 4 and 5 will provide a review of the literature in the legal, political and economic aspects of corporate governance. Chapter 3 covers how this liberal legal environment permitted significant managerial entrenchment and led to many of the contentious issues of corporate governance. Chapter 4 covers how managers have used political influence to advance their interests and protect against reform. Chapter 5 covers a number of economic tendencies which strengthen management, undermine investor efforts for reform, and provide arguments against political responses. Business literature is incorporated in each of these areas.

Chapter 6 introduces institutional investors, the existing research about their corporate governance efforts, and the key role played by the proxy advisory firms.

Chapters 7, 8 and 9 cover the methodology, results and observations from the core research study and the study of SEC comment letters regarding the proposed regulation of proxy advisory firms.

Chapter 10 draws the overall conclusions, most notably that the mismatched individual incentives of those who manage corporations and institutional investors will probably continue to result in corporate managers' having a significant advantage in corporate governance. One of the key insights from this project is that proxy advisory firms provide *de facto* coordination of institutional investor views and positions on corporate governance, despite institutional investors' otherwise passive nature. This is a pivotal function, but management interests are well aware of its importance, which has led to their efforts to reduce proxy advisors' effectiveness through imposing SEC regulation on them.

Chapter 2.

Background and History of Corporations

The purpose of this chapter is to show how the evolution of U.S. corporations resulted in an enabling and permissive legal environment.

Many of the problems of corporate governance flow from the fact that there is no clear overall theory of corporations. Unlike democracy, there is no root like “of the people, by the people, for the people.” Instead, corporate law and corporate governance have constantly evolved and have been relentlessly contested. This has made it unusually susceptible to manipulation for the purposes of those whose interests are most concentrated: initially the great industrialists and, later, corporate managers. This is partly a result of historical path; the original corporate charters were remarkably “light” on the details of how a corporation should be structured and operated. And it is partly a result of federalism; corporations were generally left up to the states, which lacked the resources to regulate them and tended to have a greater interest in attracting and supporting corporate economic activity.

This indeterminacy left many of the most important questions about corporations open for argument. This chapter includes discussions of several of the most important questions about corporations:

1. Whether they naturally evolve to protect shareholders?
2. Who should benefit from corporations?
3. Who should manage corporations?

Even though the third question is the only one which directly relates to corporate governance, all three set the stage for the ongoing contests over individual corporate governance rules and demonstrate the remarkable degree of openness and flexibility in corporate law and governance.

A Brief History of the Corporation in the United States

Economic activity in the United States began with individually-owned farms and businesses. (Chandler 1977) While corporations had long existed in Europe by sovereign charters to hold property or the exclusive right to open trade in new regions, they were exceptionally rare in pre-revolutionary America. When enterprises grew so large that they needed more people or capital, people hired other people and borrowed from other people. Particularly large or sophisticated ventures formed associations or partnerships that lasted as long as their participants were directly involved.

Only nine colonial era business corporations have been identified, including six in the 1700's which were chartered by colonial councils and survived the Revolutionary War.²⁰ This paucity of colonial business corporations was attributed to the independent temper of American colonists, the lack of large-scale enterprises and the unavailability of capital and labor. (Davis 1917)

This situation changed dramatically with the end of the Revolutionary War. The state legislatures were no longer occupied with financing the war, business conditions settled down, people from different colonies and countries had traveled and met each other, some members of the community had accumulated capital during the war, and disbanding the army had created a supply of labor for hire. The American cultural value of equality²¹ led to relatively free grants of corporate charters and several states adopted general incorporation acts for ecclesiastical, educational and literary corporations. Between 1783 (The Treaty of Paris) and 1800, more than three hundred charters for business corporations were granted. (Davis 1917)

Industries began to develop rapidly as networks of individual proprietors. Cottage industries such as textile spinning began to work in parallel, pooling the purchasing of wool and concentrating the supply of yarn. Small producers came to realize that they shared a common fate, and that cooperation and joint investment could result in economies of scale. Specialization led to efficiencies for larger organizations, and larger organizations led to the broadening of markets. (Perrow 2002)

This opening of markets and trade created increasing demand for infrastructure. A tremendous number of new roads, highways, ferries, bridges, canals, aqueducts and water systems were built, at first through public benefit corporations, which very quickly gave way to profit-making investments through charging tolls. Many of the first business corporations were banks to facilitate more open trading, through the creation of currency, moving money and offering credit. The concentration of investments in structures soon led to the need for insurance, which led to companies pooling large numbers of risks in corporate entities. The largest source of investment for these corporations was the merchant class, often from outside the area. (Davis 1917)

While the form of these early charters varied widely, they almost all provided for unlimited life, limited liability, centralized management and free transferability of shares. The main differences from modern corporations were specific limitations on capital and business activities, and grants of powers of eminent domain for infrastructure corporations. Exclusive

²⁰ Two wharf proprietors (in New Haven and Boston), three small water companies in Rhode Island, and a mutual fire insurance society in Philadelphia.

²¹ At least for white men who owned property.

economic privileges were very, very rare and highly controversial. There was not much restriction on holding companies, but neither did many corporations hold the shares of other corporations. Some charters prohibited interlocking directors and called for equal voting rights, but most were silent on corporate voting and control issues. Few charters addressed the protection of corporate capital, and it was only assumed that corporate profits would be paid to shareholders. (Davis 1917)

Early U.S. corporate law was established by practice and precedent until the 1820's. It was almost exclusively home-grown, with little reference to historical foreign experience. It was clear that corporations were only created by government action, and usually involved some public purpose and specific franchise. Delegated management authority, unlimited corporate vitality, and standardization of entity structure were important motives for incorporation, but limited liability should not be exaggerated as a reason for early corporations. Incorporation became controversial in the 1830's due to egalitarian concerns, which often confused corporate status with grants of special economic rights.²² State legislatures steadily granted corporate franchises, raising fears that corporate power would subvert the market. Concerns for shareholder rights focused on insuring proportionality and concerns for creditor rights focused on assuring the integrity of a pool of assets. (Hurst 1970)

The opening of coal mines in Eastern Pennsylvania in 1830's created opportunities to apply industrial technology to a much wider range of products than textiles and armaments. The advent of railroads and the telegraph in the 1850's-1860's required unprecedented amounts of capital from large numbers of passive investors. They also expanded the reach of markets, supporting larger production facilities, creating the first modern business enterprises and revolutionizing the financial markets. Communication, coordination and control mechanisms, and large enterprise accounting and reporting developed alongside management hierarchy to permit growth; many of these ideas may have been derived from the military, but trial and error appears to have been the predominant teacher. Cooperation and interconnection of networks led to standardization, formal markets, competition and defensive consolidation in numerous industries. (Chandler 1977)

By the 1890's, general incorporation acts²³ created ready access to corporate status, with less regulation and fewer restrictions on scope of activity. Concerns about the legitimacy of corporations moved from limits on government to limits on corporate power. These gave way to limits on

²² i.e, "monopolies."

²³ General incorporation acts permitted automatic incorporation upon the satisfaction of standardized requirements, instead of the necessity for a discretionary act of the legislature.

government regulation, especially under the Fourteenth Amendment. (Hurst 1970)

But the Progressive Era also brought great public concern about the growing power and influence of large corporations, both on the economy and on politics. These fears were exacerbated by a period of significant consolidation in many industries and a major recession in the late 1800's. David Millon described it:

“Incorporation appeared to offer opportunities for the accumulation and entrenchment of wealth that would be otherwise un-obtainable. . . And, more ominously, economic power would generate political power that would be exercised in ways contrary to the public interest.”²⁴

The 1890 Sherman Antitrust Act was one of the first important federal incursions into regulating interstate commerce. It prohibited contracts, combinations and conspiracies “in restraint of trade,” as well as any act which acquires or supports the existence of a monopoly. The Act was largely a codification of common law concepts limiting “unreasonable” restraints of trade, but its creation of federal crimes provided the authority to control large national businesses. The Act’s author made clear that it was meant to regulate, not to abolish, large corporations. Early interpretations of the Act made clear that intent was a necessary element and that monopolies which arose as a result of superior quality, skill or efficiency were not prohibited. A battle over whether the Act applied to “reasonable” restraints of trade was finally resolved in the negative in 1911. The Sherman Antitrust Act was expanded by the Clayton Antitrust Act and supplemented by the Federal Trade Commission Act in 1914. (Sklar 1988)

Large industrial companies flourished in the early 1900's when they used capital-intensive, energy-consuming, continuous production technology for mass markets. Their growth tended to involve vertical integration because antitrust law discouraged horizontal cartels. These vertically-integrated companies quickly became multinational as well. They developed sophisticated marketing programs, utilized advertising, created brand awareness,²⁵ used franchised dealers to control sales strategy, and established facilities for after-sales service and repair. Product distribution became more complex and efficient, with inventory warehouses, finishing and packaging located near customers. These improvements, in turn, permitted more efficient production and purchasing functions. Long-term planning, cost accounting and technology development functions became possible, once businesses were stable systems. Management became professionalized, with specialized training, organizations and journals. These all strengthened the

²⁴ Millon (1990) at page 207.

²⁵ Even before branding was a recognized concept in business.

role of middle management, which permitted the separation of management and ownership. (Chandler 1977)

The excitement around new technologies led to significant over-building and over-capacity. Great fortunes were made by the visionaries who bought their failed competitors and consolidated the railroad, steel, oil and banking businesses. They became known as the “Robber Barons.” (Chernow 1990, Josephson 1962) Very large corporations’ need for multistate charters and holding companies led to the use of business trusts. When the State of New York refused to allow Standard Oil Company to own the shares of its state-by-state subsidiaries, Standard Oil lobbied the legislature of New Jersey to adopt its first general corporation law to permit the first corporate holding companies. (Chernow 1988, Tarbell 1904)

Management corporations first appeared around 1890, developing into large entities performing multiple tasks and led by salaried managers. They rapidly came to dominate the economy and to replace the individualistic industrialists. Economies of scale required large investments in long-term assets, which in turn, required the development of capital markets. Corporate relationships came to be viewed as contractual, but the corporation itself was viewed as an entity. Internal organization into divisions appeared after World War I, leading to the idea of “top management” above them. (Bratton 1989)

William Bratton noted:

“Berle and Means²⁶ recognized that shares of stock no longer carried the traditional incidents of property ownership. They offered a substitute concept of shareholder/corporate relations built around intermediate securities markets. This was a contractual concept: Shareholders supplied capital and took risks, but then looked to the securities markets for fulfillment of their essential expectations of liquidity and appraisal. Failures in the operations of the marketplace required legislative intervention. But, even assuming successful technical correction of these failures, the shareholder interest could not be said contractually to control management.”²⁷

The boom brought on by industrialization and the rise of the great corporations in the early 1900’s was never consistent, but setbacks seldom lasted long and the trend was clearly upward. That ended in 1929, when a four-fold increase²⁸ in stock market multiples unwound quickly and unmasked excessive leverage across the business world. The loss of savings

²⁶ Berle (1932).

²⁷ Bratton (1989) page 1493.

²⁸ From 1921 to 1929.

and investments led to a prolonged drop in consumer spending, which led to a drop in manufacturing and trade, which led to a drop in employment and all sorts of economic activity. Political conflicts and philosophical disagreements led to governmental inaction or worse,²⁹ extending the drop into a decade-long depression.³⁰ Repeated policy failures led to a dramatic increase in governmental involvement in business regulation. While the New York Stock Exchange dates its history to an agreement under a buttonwillow tree in 1792, the current incarnation of the public corporation was born out of the legislative response to the Crash of 1929 and Great Depression. (Romer 1990, Friedman 1963 and Galbraith 1961)

The Securities Act of 1933 and the Securities Exchange Act of 1934 together were the second major intrusion into the authority of the states over corporations. These Acts created federal regulation of many aspects of companies whose shares are sold to the public³¹ or traded on an exchange, including requirements for registration of stock offerings with the SEC, how offerings are conducted, annual and quarterly reporting, public notice of significant events, standards for financial reporting, and the solicitation of proxies necessary for the conduct of corporate annual meetings and elections. Perhaps most important is that the 1933 Act made securities fraud a federal crime, resulting in federal monitoring, investigation and prosecutions. Through the Acts, and regulations issued under them and the ability to influence stock exchange rules, the U.S. Securities and Exchange Commission has acquired extensive authority over the relationship between corporations and their shareholders. But the SEC has refrained from regulating most of the internal affairs of corporations, leaving most issues of corporate governance to state law. The vast majority of the SEC's regulation has taken the form of disclosure requirements instead of specific standards or limitations.

By the 1930's, utility became the primary basis of corporate legitimacy and, primarily through the impetus of promoters and lawyers, corporate law became state enabling-acts. States began to seek chartering revenues. Corporations came to be seen as productive rather than speculative. Concerns began to focus on rights of minority shareholders and the rights of shareholders generally to be protected from management insiders. Industry concentration of corporations raised questions about the ability of market competition to regulate corporations. (Hurst 1970)

²⁹ Including counterproductive government actions such as the Smoot-Hawley Act which imposed protective tariffs and is widely blamed for triggering a worldwide trade contraction and, more importantly, overly restrictive fiscal and monetary policies.

³⁰ Actually, a double-dip depression.

³¹ With limited exclusions for private offerings to certain qualified investors and intrastate offerings. The JOBS (Jumpstart Our Business Startups) Act of 2012 will greatly ease the standards for private offerings.

According to Alfred Chandler, the revolution was complete by World War II. Further advancement no longer came from outside companies, but through refinement of functions within them. Companies diversified and developed new technologies, preferably patentable. By mid-century, even the legal fiction of outside control was beginning to disappear. Roughly 85% of the 200 largest non-financial companies were management-controlled. The power of organized labor in influencing corporate behavior, which started in the 1930's, began to decline after the 1950's. Government never had a significant role. Chandler concludes:

“The appearance of managerial capitalism has been, therefore, an economic phenomenon. It has had little political support among the American electorate. At least until the 1940's, modern business enterprise grew in spite of public and government opposition. Many Americans—probably a majority—looked on large-scale enterprise with suspicion. The concentrated economic power such enterprises wielded violated basic democratic values. Their existence dampened entrepreneurial opportunity in many sectors of the economy. Their managers were not required to explain or be accountable for their uses of power.”³²

The federal and state constitutions generally omitted any mention of corporations, leaving the legislatures broad scope in developing policy. Executive branch action was limited until the development of regulatory apparatus with the Securities Acts of the 1930's. Judicial branch power was derived from statutes, and was largely concerned with the interpretation and enforcement of contracts and with interpreting the limits of corporate powers under state statutes. Congress largely left the subject to the states, although the Supreme Court took on a supervisory role. The diversity of state corporate law gave way to uniformity. (Hurst 1970)

Corporate Personality

The concept of corporate personality encompasses the questions of whether a corporation is a person, what sort of a person is a corporation, how that sort of person is treated under the Constitution and laws, and what attributes and rights of a person are held by a corporation? These concerns trace back at least to 1612: “Corporations cannot commit treason, nor be outlawed, or excommunicate, for they have no souls”³³ As with other areas of law (and philosophy), writers and theorists have sought to simplify these inquiries by identifying some unifying theory from which the consequences would flow naturally. David Millon says of these efforts:

³² Chandler (1977) at page 497.

³³ Lord Edward Coke in *Case of Sutton's Hospital* 5 Rep. 303; 10 Rep. 32b (1612)

“While apparently metaphysical questions about ‘the nature of the corporation’ might strike one as vaguely continental and surely alien to our hard-headed, pragmatic legal culture, theorizing about ‘what corporations are’ has in fact occupied a great deal of home-grown mental energy and has played an important role in arguments about concrete questions of corporate law.”³⁴

This theorizing has evolved over time in a manner which has shifted back and forth on the basic question of whether a corporation is even an entity, while at the same time increasing in its sophistication. Millon provides a good summary of the path:

“During much of the 19th century, the idea of the corporation as an artificial entity characterized corporate legal discourse. This view perceived the corporation as an entity, rather than an aggregation, and emphasized the state’s constitutive role³⁵ . . . By the last decades of the 19th century, commentators noted the decline in the state’s use of its chartering authority to impose substantive regulations on corporate activity and argued that corporations were nothing but aggregations of private individuals³⁶ . . . The aggregate characterization did not prove to be persuasive, but the notion of the corporation as a natural creation of private initiative and market forces replaced the idea that the corporation was artificial³⁷ . . . Just as the natural entity theory had achieved dominance, advocates of corporate social responsibility seized on that theory in the wake of the Depression and used it as a basis for arguments in favor of a corporate citizenship idea. . . In its most recent incarnation, the private aggregation idea has assumed the garb of neoclassical economics under the ‘corporation as a nexus of contracts’³⁸ rubric.”³⁹

This pattern of shifting back and forth necessarily raises the question of whether multiple views might be partially right. That is, the corporation might properly be viewed as some combination of an entity and some sort of aggregation of participants. It also raises the question of why the theory is shifting. It becomes important to try to distinguish between changes in theory which result from new discoveries or changes in the nature of the corporation or changes in viewpoint, from changes in theory which are put forward for instrumental purposes in order to justify particular consequences. Millon captures part of this challenge when he says:

³⁴ Millon (1990) at page 201.

³⁵ See also Greenwood (1996) and Friedman (1985) for further discussions of artificial entity theory.

³⁶ See also Horwitz (1985) for further discussion of aggregate theory of corporations.

³⁷ See also Millon (1990) and Horwitz (1985) for further discussions of natural entity theory.

³⁸ See also Posner (1998) and Bainbridge (2002) for further discussions of the nexus of contracts theory.

³⁹ Millon (1990) at pages 202-203.

“At any point in time, particular theories of the corporation are perceived to justify particular legal rules or, at a more general level, a particular approach to regulation of business activity. . . . However, at the same time that theory is influencing doctrine, theories of the corporation themselves are influenced strongly by legal doctrine defining the corporation’s attributes. . . . Each simultaneously influences the other.”⁴⁰

Lawrence Friedman describes the result:

“The general trend in the law was clear: corporations could do as they wished, arrange their affairs as they pleased, exercise any power desired, unless some positive rule outside of ‘corporation law’ made the action plainly illegal. In short, the trend was toward freedom of corporate management. . . . Perhaps the major event in corporation law, between 1850 and 1900, was the decline and fall of the special charter. This was, if nothing else, an advance in legal technology. It was cheap and easy to incorporate under general laws In the same period, the states, burnt by experience, began to forbid direct [government] investment in enterprise As public investment withdrew, corporations had to rely exclusively on private investors for money. The investment market was totally unregulated; no SEC kept it honest, and the level of promoter morality was painfully low. It was an age of vultures In the face of this threat, legislatures seemed supine, powerless. The Goulds, the Fisks, and their corporate creatures, seemed able to buy and sell local lawmakers; through them, they controlled the law. . . . The courts were corrupted, too.”⁴¹

“Constitutional law, too, developed in ways quite favorable to big business, even though some state constitutions seemed to *restrict* corporations. As “persons,” corporations were under the protection of the 14th amendment, the same as flesh-and-blood people, if not more so. The idea that the 14th amendment sheltered corporate enterprise was an idea first hinted at in the 1880’s. From 1890 on, it became an important constitutional doctrine. Laws which regulated business, then, faced the constitutional gamut. In the late 19th century, a striking series of cases turned the due-process clause into a kind of great wall against populist onslaughts.⁴² The wall had been built, or has seemed to be built, for the protection of blacks; by irony or design, it became a stronghold for business corporations.”⁴³

⁴⁰ Millon 1990 at page 204.

⁴¹ Friedman 1985 at pages 512-513.

⁴² This isn’t to say that the external behavior of corporations cannot be regulated by law; it clearly can be. But the “wall” has been very effective in shielding the internal management and decision-making of corporations from scrutiny and interference.

⁴³ Friedman 1985 at pages 520-521.

Beginning about 1980, legal academics associated with the growing field of law and economics developed the nexus of contracts theory of corporate personality based upon the economic nature of the corporation. This theory is based upon the work of Ronald Coase, who identified the critical role played by transaction costs in the evolution of economic systems. Coase noted that the costs of locating interested trading partners, investigating backgrounds and previous experience, negotiating transactions, monitoring performance, and collecting consideration were often so significant that they exceeded the benefits of doing business. (He also noted that transactions would always evolve in the most efficient way possible when transaction costs approach zero.) Thus, he viewed the role of the corporation as reducing transaction costs. (Millon 1990, Coase 1937)

Nexus of contracts theory views the corporation as a place in which all of the factors necessary for efficient production converge. The corporation contracts for management, employees, capital, resources, suppliers, and all of the other inputs in the most efficient manner possible. Behavior is limited only by the market, including the effects legal penalties, which are discounted by the likelihood of getting caught, the probability of punishment and the present value of the future payment. The nexus of contracts theory gives primacy to freedom of contract and private ordering, and argues implicitly against external interference in corporate governance. It denies any contribution from state law or any need to regulate the contractual relationships.

David Millon says:

“To the extent that there is any role for legal rules in this framework, the need is for rules that provide mandatory contract terms designed to lessen agency costs [the costs incurred by shareholders when management fails to act in their best interests] by discouraging mismanagement. Rules that fail to protect shareholders from agency costs serve no legitimate function because reduction of agency costs is the only justification for corporate law . . . Less than optimal rules of corporate law will not survive because shareholders will not tolerate them. Instead, according to the new economic theory, they will cause the corporation to reincorporate in another state that does not have those rules.”⁴⁴

State Corporate Law

State corporate law is a special case of government, where power is arbitrarily split between the federal and state governments more by historical

⁴⁴ Millon 1990 at page 230.

practice than by constitutional specification. There were very few corporations in the American colonies in 1787, when the drafters convened to create the U.S. Constitution, so the influence of corporations was unlikely to have been a major factor. The drafters twice debated whether corporations should be chartered by the federal government. This was reportedly opposed by a majority of delegates who had been instructed by their states to avoid the possibility of a federal grant of monopoly powers, such as those held by the East India Company.⁴⁵ In the end, the U.S. Constitution contains neither an enumerated power nor a prohibition on federal chartering or regulation of corporations. In this environment, the states became the primary source of corporate charters.⁴⁶

Renee Jones writes:

“The incoherence of federalism concepts in corporate governance is more than a mere theoretical problem. Efforts to define separate spheres of authority for corporate law and securities regulation often have the practical effect of thwarting the policy objectives of legislators and administrative agencies. . . Under the interstate commerce clause it is beyond serious question that Congress can preempt the field of corporate law if it so chooses. Therefore, federalism arguments advanced in the corporate arena are properly understood as normative, rather than constitutional, claims.”⁴⁷

Jones notes that many federalism arguments are merely deregulatory arguments in disguise.⁴⁸ (Jones 2006) Alfred Conard observes that “What is unusual about the race of laxity in corporation codes is that its effect will be felt almost entirely outside the state.”⁴⁹

How does the second smallest state, Delaware, whose population is less than San Jose, California’s, dominate the market for corporate charters and corporate law, including more than 50% of the S&P 500 companies? (Bebchuk 1992, Alva 1990) The answer appears to be a textbook example of historical path dependence. New York was long the financial center of the United States, but was not particularly accommodating to the needs of multi-state corporations. The 1896 New Jersey General Corporation Law, which allowed for business trusts and permitted one corporation to hold the shares of another,⁵⁰ provided a convenient alternative next door and quickly became

⁴⁵ Roy (1997) at page 50.

⁴⁶ The federal legislature has chartered a limited number of financial and nonprofit institutions on an individual basis.

⁴⁷ Jones (2006) at page 879.

⁴⁸ See Feeley (2011) for a discussion of federalism as a rational decision of regulatory efficiency and Carney (1997) on the problem of rent-seeking facilitated by the interstate market for corporate charters.

⁴⁹ Conard (1973) at page 633.

⁵⁰ i.e., holding companies.

the dominant home for large corporations. In 1913, then-Governor Woodrow Wilson pushed the New Jersey legislature to pass the “Seven Sisters”⁵¹ amendment prohibiting trusts and holding companies. The result was highly predictable; most major companies moved almost immediately to the next-closest state with a hospitable corporation law, Delaware. Delaware’s Corporation Law was enacted in 1899 and appears to have been modeled on New Jersey’s original law. (Kaouris 1995)

The Delaware Department of State’s⁵² website prominently features an article entitled “Why Corporations Choose Delaware” by Lewis S. Black, Jr., a Delaware corporate lawyer:

“The statute itself is an enabling statute intended to permit corporations and their shareholders the maximum flexibility in ordering their affairs. As such, it does not purport to be a code of conduct. Indeed, it is written with a bias against regulation. When compared to some corporation laws where the drafters have attempted to regulate every nuance of corporate behavior or deal with every conceivable eventuality, the Delaware statute has a spare, almost open quality. Every effort is made to simplify drafting and to avoid complexity.”⁵³

Thus, the leading state corporate law is primarily an enabling statute, permitting sponsors of corporations to structure their corporate governance in any manner they see fit. Corporate charters themselves are generally limited to specifying the fundamental rights of the classes of shares to be offered, any limitations on the activities to be conducted, and the types of transactions requiring the approval of shareholders. Virtually all other governance issues are determined by the bylaws of the corporation, including directors, officers, elections, meetings, rights, powers, management, reporting requirements, informational rights, and distributions. Bylaws are generally drafted by attorneys for the corporation at the direction of the initial managers and are not filed with the state authorities. State corporate law often governs fraud and fiduciary duties, but even these rules can be limited by provisions in the corporate charter in many states.

Delaware, and virtually every other state, offers the four common characteristics of corporations:

Unlimited life is a critical feature for any enterprise which intends to operate or own assets lasting longer than a human lifetime. A partnership or association can partially solve this problem by having enough members to

⁵¹ Referring to the amendment’s presumed target, the seven regional operating companies of the Standard Oil Company.

⁵² The state agency which charters Delaware corporations.

⁵³ Black (2012)

last for a longer time. But the relationship among members or partners is viewed as too personal to force them to accept new members or partners without their consent. Thus, each time there is a change of membership, the association or partnership is deemed to terminate for various legal purposes. The continuity of life of a corporation was a very attractive solution to these issues.⁵⁴

Centralization of management becomes very important in any organization with many participants. Perhaps this characteristic would be better called delegation of management, because the central problem is that partners in partnerships are each presumed to have the right to proportional power in making decisions. This is too unwieldy to operate when the number of participants rises because the cost of communicating and reaching agreement is too high.⁵⁵

Free transferability of shares is the only corporate characteristic that comes close to distinguishing corporations from other types of entities, and even it is eroding as ownership of partnerships, LLCs and other entities becomes transferable. Free transferability is key to publicly traded securities.

Limited liability usually means the characteristic that creditors cannot collect the debts of the corporation from the shareholders, as they would be able to do from partners in a business.⁵⁶ The ability to invest without risking one's other assets becomes very important as the management becomes more distant from the investors, as the investors know each other less well and as the scope of the enterprise grows. Limited liability is critical to raising large amounts of capital from large numbers of investors.⁵⁷

Marcel Kahan and Edward Rock note that Delaware has adopted a number of unique corporate law institutions and characteristics, including a high level of reliance on the courts to "fill-in" the law left unstated by their relatively liberal statute. Delaware has a specialized corporate trial court⁵⁸ which decides without juries. The state Supreme Court usually has several members from the Chancery Court. The Delaware judiciary is selected by a commission based on merit and not elected. The justices are unusual in the extent to which they publish and speak outside the court, making their views

⁵⁴ The force of this distinction has become much diminished by the development of new partnership and association contracts which avoid termination, and by the creation of a menu of new limited liability business entities which share this characteristic.

⁵⁵ Again, this characteristic has become less important because of improved contracting and the parallel development of new types of legally-recognized entities with the same characteristic.

⁵⁶ Hansmann (2006) observed that limited liability is actually reciprocal, and creditors cannot collect the debts of the shareholders from the assets of the corporation ("entity shielding").

⁵⁷ Economists have been quick to argue that limited liability could be achieved by contract with all the parties to the corporation, but this is neither practical nor strictly true; without government intervention, there would be no way to contract with unforeseen tort claimants, for instance.

⁵⁸ The Court of Chancery.

known in advance. Delaware has almost no public enforcement, but has developed extensive private rights of action. The courts are quickly available and decisions at all levels are rendered promptly. This all tends to make Delaware corporate law appear technocratic and apolitical, reducing visible conflict and increasing confidence and certainty. Delaware leaves most corporate lawmaking to its judges and has given them unusually broad discretion to create new rules. The Delaware Supreme Court has resisted legislative intrusions and the legislature has only acted to overturn the courts once. Legislative amendments are usually technical, are drafted by a Delaware Bar committee, and are generally adopted intact. (Kahan 2005)

Jill Fisch also focused on the “peculiar role of the Delaware judiciary in corporate lawmaking,” which she sees as a comparative institutional advantage because it is more flexible, responsive, transparent and insulated from political influence. Delaware’s corporate law relies more on courts than other states and its statute is silent on many important issues. Delaware’s Chancery Courts are courts of equity (Delaware is one of only three states which maintain this distinction), which means that they are not bound by precedent, jury trials are not possible and decisions are usually specific to the facts of each case, but they have maintained the practice of issuing written opinions in every case. As specialty courts, they have developed great expertise in business and corporate matters. According to Fisch, the use of appointed judges for the lawmaking function insulates it from the political influence of contributions, lobbying and public relations. (Fisch 2000)

But Curtis Alva described a legislative process in Delaware that appears to contradict the presumptions of transparency and objectivity that flowed from the focus on Delaware courts as a point of competitive advantage. In 1984-85 the Delaware legislature was part-time, included no attorneys,⁵⁹ and had five Du Pont employees among its 62 total members. There were twenty committees, none focused on corporate law and none with any staff support.⁶⁰ A member of the legislature is quoted as explaining that if a corporate law bill has the support of the Delaware Bar Association and the Secretary of State’s office, it is passed without amendment or debate. No proposal recommended by the Corporate Law Section of the Delaware Bar Association has ever failed to pass in the legislature. The author documents three case histories which demonstrate a process by which major corporate law figures⁶¹ submit comments by private letters to the chairman of the Corporate Law Section. The chairman is quoted as saying that Delaware is not part of any race for the bottom, but is the best corporate code for firms

⁵⁹ There had not been an attorney in the legislature with corporate law experience in twenty years.

⁶⁰ The website for the Delaware legislature <http://legis.delaware.gov/> indicates that not much has changed as of 3-5-2012, although there are a few more committees, none devoted to corporate law matters.

⁶¹ Generally the heads of Business or Corporate Law Practices of major New York City law firms.

and is serving the interests of the United States in continuing to provide the optimum corporate environment. (Alva 1990)

Alva concluded that the Delaware bar, legislature and judiciary offer the lowest costs to obtain the corporate law decisions wanted by management. Furthermore, Delaware law has great stability because it takes a 2/3 majority to amend the General Corporation Law and because Delaware is extremely dependent upon franchise taxes. Finally, there is an almost total absence of competing interest groups. Delaware is also incredibly timely and responsive on corporate filings and documents. (Alva 1990) This certainly appears to add a different kind of advantage than Delaware's responsive and professional court system. While the Delaware corporate law does not change often, this creates a clear path for corporate management to seek, through the major New York and Delaware law firms who serve them, changes to Delaware corporate law that are important to them, and the entire process can happen essentially in private.

Delaware has led the way in permitting a wide range of corporate governance practices which appear to favor management over shareholders' interests. The Delaware General Corporation Law has been amended to accommodate anti-takeover devices, exclusive board amendment of bylaws, limitation of director liability, waiver of shareholders' meetings, and indemnification of directors and officers. The Delaware courts pioneered the business judgment rule⁶² and have frequently established rule changes ahead of the Delaware legislature. (Black 2012, Cary 1974)

Is This a Race to the Bottom or a Race to the Top?

William Cary wrote an article in 1974 in which he said "Delaware is both the sponsor and the victim of a system contributing to the deterioration of corporation standards."⁶³ He included an extensive review of Delaware corporate court cases in fraud, disclosure, fiduciary duty, proxy contests, takeovers, greenmail,⁶⁴ misleading proxy material, meeting notices, appraisal rights, conflicts of interest, fairness to subsidiaries and minority shareholders, duties of care, etc. which show a bias in favor management over investors. He also cited examples of corporate law provisions adopted specifically because they would increase the business of Delaware law firms. Likewise, he cited Delaware court decisions which follow Delaware law in the face of obvious fairness problems, as well as a history of revolving justices from law firms and political positions in Delaware.

⁶² The business judgment rule is a judicially-established doctrine that the courts will not review the substance of a corporation's internal business decisions, subject to conditions discussed in Chapter 3.

⁶³ Cary (1974) at page 663.

⁶⁴ Greenmail is the practice of threatening a takeover and then accepting a large premium over the stock price for withdrawing the threat, thus permitting management to retain their jobs and pay, while costing existing shareholders the amount of the premium.

Cary cited the drafters of the original Model Business Corporation Act in 1943 in support of his thesis that states (and especially Delaware) compete for corporate charters: “the Delaware statute bids for the corporate business of promoters [sic]. It makes little or no effort to protect the rights of investors. Hence in the opinion of the committee it was not the type of statute which the committee should present as a model for states intending to revise their laws.”⁶⁵ Cary concludes that federal corporate law or a “Federal Corporate Uniformity Act” would be necessary to halt the “race to the bottom.” (Cary 1974)

Cary was answered in 1977 in an article by Ralph Winter that became known for advocating the view that state corporate law was a “race to the top,” not the bottom. Winter accepted the idea that “. . . the decision as to which state to incorporate in is in almost all cases a managerial decision . . .”⁶⁶ and said that “No one denies that Delaware’s open bidding for corporate charters has led to a steady lessening of the restrictiveness of state corporation law.”⁶⁷ But Winter argues that this permissiveness in corporate law is more efficient because it avoids all the costs of intrusion by shareholders and regulators, which is eventually borne by the shareholders themselves. He argues that this is “amply demonstrated by the notorious fact that the vast, vast majority of shareholders in large corporations do not want the power to interfere in corporate affairs, would not use it if they had it and do not regard themselves as corporate overseers. Instead, they quite sensibly view themselves solely as investors whose ‘control’ is in the stock market.”⁶⁸ Winter’s conclusion is that market forces lead to corporate rules which protect investors and that there is no reason for federal involvement.

Roberta Romano observes that Delaware has an even higher share of corporate re-incorporations than original incorporations, indicating that corporations will actually choose to increase their tax burden in order to get the benefit of Delaware laws. She concludes that institutional features which pre-commit a state to a responsive legal regime and first-mover advantages tend to make it difficult for competing states to get a foothold:

“Once Delaware established a dominant position, it became cheaper for it to maintain its commanding lead over a newcomer because there is value or security in numbers. The more corporations there are, the more the state relies on their business and will respond with desired legislation. The more corporations there are, the more likely courts will interpret

⁶⁵ Campbell (1956) at page 100.

⁶⁶ Winter (1977) at page 252.

⁶⁷ Winter (1977) at page 254.

⁶⁸ Winter (1977) at page 276.

major statutory provisions and decide important issues, providing a sound basis for corporate planning.”⁶⁹

In *The Genius of American Corporate Law*⁷⁰ Romano argues that the rich diversity of corporate law ideas from various states is refined through competition for corporate charters on the basis of which rules maximize the value of the corporation. Romano is clearly siding with Winter in arguing that competition for corporate charters serves the interests of investors. She says:

“The crux of their disagreement⁷¹ concerns whose demand schedule for corporate charters is driving the system. Cary and the proponents of a national corporation code consider the demand function to be derived from managers’ preferences. They view the state legislative process as a political market failure in which managers are better organized than the more numerous but dispersed shareholders, and they characterize managers’ preferences for codes as diametrically opposed to those of shareholders’.”⁷²

Lucian Bebchuk concludes that charter competition works well for some issues and not for others, resulting in the need for more federal corporate law. But he notes that the median CEO owns 0.25% of the shares, making their incentive for value enhancement through the adoption of shareholder-friendly legal provisions quite small. (Bebchuk 1992)⁷³

Marcel Kahan and Ehud Kamar question the conventional wisdom that states compete for incorporations at all. No state other than Delaware structures its taxes to benefit from incorporations. Half the states adopt the Model Business Corporations Act, eliminating them from competition. The adoption of other statutory innovations is generally random among the other states, eliminating any other systematic advantage.⁷⁴ Differences in anti-takeover statutes appear to be driven by protecting local companies rather than attracting incorporations. No other state has adopted the system of judge-made law found in Delaware. Nevada and Maryland are the only other states that openly endeavor to attract incorporations, but Nevada is focused on close corporations and Maryland is focused on regulated investment companies. Delaware earns about \$500 million per year from public companies, with minimal costs, so it has substantial incentives to fight any

⁶⁹ Romano (1985) at page 277.

⁷⁰ Romano (1993a)

⁷¹ Cary and Winter.

⁷² Romano (1993a) at page 15.

⁷³ Schleifer (1997) supports this conclusion, saying that expropriation is more profitable than maximizing company value. Rock (1997) also concludes that managers will tend to act in their self-interest. Macey (1987) suggests that Delaware seeks to maximize work for its lawyers.

⁷⁴ But Moodie (2004) finds that other states have moved quickly to adopt anti-takeover laws to protect their own incorporations.

competition. Delaware's position is protected by economic entry barriers which would be very difficult to replicate. Their specialized court system costs little, but has built a track record which no other state has the opportunity to establish. Other states have failed to act, rather than acted and failed, primarily because most states pursue political goals, not profits. (Kahan 2002)

Mark Roe, in a trio of articles, argues that the idea of competition among the states is misconceived. He says that Delaware has clearly won the inter-state competition and that the real issue is for Delaware to make sure that it pre-empts any action by the federal government to take over an issue if it becomes too important. He says that Delaware has a strong incentive to move first so that it sets the initial content of new corporate law, thus both retaining dominance and deflating the value of federal action.⁷⁵ (Roe 2011, Roe 2005, Roe 2003)

Who Should Benefit From Corporations?

Without a clear theory of who a corporation is, it is inevitable that there is uncertainty about who should benefit from their activities. The debate was framed by a pair of Harvard Law Review articles in 1931-1932 by Adolf Berle and Merrick Dodd. The debate has focused on whether the corporation is operated for the benefit of its common shareholders or a broader community of stakeholders.

Berle's article, titled "Corporate Powers as Powers in Trust," took the shareholder only position. Berle argued that all corporate actions must be tested for legal power and for their conformity to the equitable limitations of a trustee. In fact, this analysis appears to be the entire basis for his conclusion that shareholders are the ultimate beneficiaries of corporations. By examining existing law and case decisions, he concludes that they systematically measure corporate actions for whether they benefit shareholders. He concludes that corporation law is a subset of trust law and that all corporate actions must benefit shareholders, even if they also benefit others. (Berle 1931)

Dodd's prompt answer, an article asking "For Whom Are Corporate Managers Trustees?," (Dodd 1932) takes the community stakeholder position. Dodd agrees that it is desirable to prevent managers from diverting profits to themselves, but does not believe that the sole purpose of corporations is to make profits for the shareholders. He says that business is private property only in a qualified sense and society may demand that it safeguard the interests of others with whom it deals. Dodd views the corporation as a

⁷⁵ McDonnell (2004) and Thompson (2003) tend to support this idea.

separate legal entity and the directors as fiduciaries for the entity, not for shareholders.

The shareholder beneficiary position was strongly supported by Milton Friedman in a famous article titled “The Social Responsibility of Business is to Increase Its Profits,” (Friedman 1970) which argued that it was socially and economically optimal for management to focus only on maximizing the shareholders’ benefits.⁷⁶ It was supported more gently by Lawrence Friedman, who pointed out that it is dangerous to permit corporate managers and directors, who are not elected by the public at large, to make unchallengeable decisions to apply corporate assets toward “socially responsible” ends. (Friedman 1985) The Revised Model Business Corporation Act, American Law Institute, California Corporations Code, Delaware Corporation Law and New York Business Corporation Law⁷⁷ all provide that the principle objective of corporation activities must be for the benefit of the corporation and its shareholders.⁷⁸ This has been upheld by dozens of court decisions, beginning with *Dodge v. Ford Motor Company*⁷⁹ in 1919.⁸⁰

Robert C. Clark supports primary allegiance to shareholders:

“A single objective goal like profit maximization is more easily monitored than a multiple, vaguely define goal like the fair and reasonable accommodation of all affected interests.”⁸¹

Lynne Dallas argued that profit maximization was not in the best interest of society because of the external effects on society and that corporations should balance the interests of all parties. (Dallas 1988) Dallas’ view was strongly reinforced by Margaret Blair and Lynn Stout, whose “Team Production Theory of Corporate Law” proposes the idea that the purpose of director-centric corporate law is to facilitate the mediation by the directors of the competing interests of the shareholders, employees, suppliers, customers, creditors, community and environment. (Blair 1999)⁸²

The idea of stakeholder benefits has a close cousin in the realm of Corporate Social Responsibility (“CSR”), which David Vogel says is

⁷⁶ While meeting social and moral expectations and legal requirements.

⁷⁷ Among others.

⁷⁸ With appropriate exceptions for non-profit or public benefit corporations.

⁷⁹ 204 Mich. 459 (1919)

⁸⁰ Sommer (1991) suggests that it is in the long-term interests of shareholders to treat other stakeholders fairly, but Greenwood (1996) disagrees.

⁸¹ Clark (1986) at page 20.

⁸² Hansmann (2001) declared the argument in favor of shareholder primacy, but see Blair (2001), Strine (2002), Talley (2002), Stout (2003a), Winkler (2004), Licht (2004), Fisch (2006), Lee (2006), Stout (2008), Macey (2008b), and Greenfield (2008) for further variations of the debate.

sustainable only if virtue pays off; that is, it is only possible if the market values it. Consumers will only pay for CSR when they are persuaded that it is good for them in other ways. Vogel concludes that CSR only makes financial sense when it is a core strategy or when it is adopted defensively to prevent damage from negative publicity of reprehensible conduct (when it often can be turned to advantage because of the publicity). (Vogel 2005)

It is interesting to note that, despite the extensive arguments in favor of stakeholders being beneficiaries of corporations, the only dilution of the shareholder beneficiary view has been the adoption of reasonable charitable contribution statutes and the practical protection offered by the business judgment rule of directors' discretionary choices to benefit other stakeholders; stakeholders⁸³ still have no rights.

Who Should Govern Corporations?

Stephen Bainbridge made the sage observation that the question of who should benefit from corporations was being conflated with the question of who should govern them. He stresses the Coasean view that corporations make decisions by authority, rather than market mechanisms, as a means of reducing transaction costs.⁸⁴ He notes that virtually all corporation laws allocate the power to manage the corporation to the directors, and that the law supports the directors' formal power to hire and fire management. The corporation and its assets are not owned directly by the shareholders; he says the shareholders only have the right to certain distributions from the corporation.

In Bainbridge's view, the argument that the shareholders' interests make them the best party to make risky decisions doesn't work because they have neither the information nor the legal power to make these decisions. Shareholders are only permitted to elect directors, vote on fundamental changes and issues referred by the directors, and amend bylaws. Shareholder influence, even in these matters, is limited because of meager information and inadequate attention. The disclosure requirements for large holders, the voting and communication rules, as well as the insider trading and short-swing profit rules all discourage communication and coordination among investors.⁸⁵ Bainbridge says that there is relatively little evidence that institutional shareholder activism has mattered; they spend little and they monitor little.

Bainbridge concludes that director primacy is critical to "fiat" decisions and that directors must be charged with managing for the benefit of

⁸³ Other than shareholders.

⁸⁴ Coase (1937)

⁸⁵ State law protections for minority shareholders may also contribute to this.

shareholders, in order for them to have a clear goal to assess potential decisions. If there isn't a goal, they become free to pursue their own interests. Directors who are responsible to everyone are accountable to no one. Thus, the stakeholder model fails to create adequate accountability. (Bainbridge 2003)

Lucian Bebchuk called for a reconsideration of the allocation of power between boards and shareholders. Bebchuk's analysis and his empirical evidence indicate that shareholders' existing power to replace directors is insufficient to secure the adoption of value-increasing governance arrangements when management disfavors them. Providing shareholders with such power would operate over time to improve all corporate governance arrangements. This would address governance problems that have long troubled legal scholars and financial economists. These benefits would result largely from inducing management to act in shareholder interests without shareholders having to exercise their power to intervene. (Bebchuk 2005)

Bebchuk was answered with the following arguments: that shareholder power is not value-enhancing, centralization of decision-making is more efficient, and shareholders would be unlikely to utilize any new power (Bainbridge 2005a); that shareholders have differing interests and conflicts with the corporation (Anabtawi 2006); that increasing shareholder power will undermine managerial flexibility and will give too much clout to unaccountable institutional intermediaries (Strine 2006); that directors aren't self-interested and are constrained by extensive monitoring (Lipton 2007); that directors are qualified to run corporations, that the capital markets provide sufficient discipline to prevent self-interest, and that shareholders would make bad decisions (Mirvis 2007); and that there is little evidence that shareholders value companies that give them more rights and that the status quo is more efficient.⁸⁶ (Olson 2007)

Christopher Bruner says that the law is, and will remain, ambivalent about the three big questions of corporate law: who has ultimate corporate governance authority, for whose benefit the corporation operates, and the relationship between corporate law and social good. In each case there are competing claims which are not easily (or permanently) resolvable. He says:

“In a modern corporation, as a practical matter, retail shareholders—by which I mean living, breathing, individual shareholders—generally hand over their money and then check out. . . shareholders generally do not monitor corporate boards and management in any meaningful sense due

⁸⁶ See Veasey (2007), Stout (2007) and Fairfax (2008) for further variations on the debate. Mitchell (2010) questions the whole idea of shareholder power because they contribute little to production and because creditors are a far more important source of capital.

to rational apathy, limitations on their ability to initiate corporate actions, and restrictive voting procedures . . .”⁸⁷

“If investors are insulated from the consequences of corporate production in public corporations in which they own stock directly, then one might reasonably expect those same individuals to be even more insulated from what is going on in companies the stock of which they own only indirectly through [institutional investors].”⁸⁸

“Although institutional investors, with larger holdings and dedicated research staffs, would appear to offer a form of solution to the collective action problems that plague retail investors, historically institutions have remained relatively inactive themselves. Indeed, if anything, many institutions have strong incentives to cozy up to corporate management to maintain other lucrative business relationships . . .”⁸⁹

The Corporate Governance Committee of the American Bar Association Section of Business Law issued a task force report which strongly endorsed the legal status quo on these questions. It concluded:

“The corporation is an ‘artificial person’ with the same capacity to own assets and enter into contracts as a natural person, and the ability to issue freely transferable shares to a large number of investors. . .

Control of, and responsibility for, the business and affairs of the corporation is vested in the board of directors, rather than in the company’s shareholders. . .

The allocation of decision rights as between shareholders and the board provides a mechanism for efficient decision-making regarding entrepreneurial activities. It avoids the significant difficulties of educating and bringing together thousands of equity investors to make key decisions by shareholder referendum.”⁹⁰

Despite a vigorous debate, there is not much agreement in the academic literature on the question of who should govern corporations. The only thing that can be said is that the law does not appear to be changing significantly with respect to the underlying rules and structure of corporate governance, and that it grants corporate directors and managers very broad discretion to structure corporate governance as they prefer.

⁸⁷ Bruner (2008) at page 1409.

⁸⁸ Bruner (2008) at page 1433.

⁸⁹ Bruner (2008) at page 1439.

⁹⁰ ABA (2009) at page 4.

Chapter 3.

Legal Entrenchment in Corporate Governance

The purpose of this chapter is to identify the corporate governance mechanisms which developed within the permissive legal environment and which tend to favor management interests over shareholders.

Corporate governance generally consists of two elements. External corporate governance--in the form of state corporate laws and federal securities laws, together with a large number of court decisions, regulations and rulings--represents the governmentally-imposed constraints on public company governance. These are supplemented by a more modest number of private constraints found in the rules of the major stock exchanges, the standards imposed by rating agencies, debt covenants, and, to a lesser extent, criticism from the media and academia. As discussed in Chapter 2, these external standards are limited by the lack of constitutional authority, fragmented authority under federalism, and an environment of contestability created by the lack of any real theoretical basis for what a corporation is. This lack of discipline leads to great flexibility for corporations in the selection of their own internal corporate governance rules and customs.

Internal corporate governance, in the form of bylaws and accepted business customs, represents the greater portion of the structure of corporate governance. Both portions have evolved in the direction of rules which are favorable to corporate management, largely because there is little representation of the interests of investors. The interest of management in enhancing and protecting its compensation and authority provides the consistent pressure which causes this tendency. These favorable rules have been entrenched in the U.S. legal system to a degree which resists most of the strongest efforts for reform, even in the face of successive corporate scandals and major financial crises.

The bylaws of most corporations create a governance structure which recapitulates representative democracy in many respects. There is a board of directors, which appears much like a legislature. There are officers, whose titles and roles sound like the executive branch. There are frequent elections, which one would expect to be highly responsive to the interests of the "citizens" from whose authority the whole corporation arises. While many people are probably comforted by the resulting appearance of Constitutional division of power, "checks and balances," and ultimate control by the real parties in interest, this is mostly a fantasy about a corporate ideal. The reality is a set of bylaw provisions, operating customs and legal rules which undermine the effectiveness of corporate structure in countering the agency

problem described by Berle & Means.⁹¹ For instance, while corporate boards of directors usually have ultimate authority over management, including the power to fire management, management has a great deal of influence over the board and the ability to control what the board knows.

Most of the problems and issues of corporate governance mentioned in the literature or by the interviewees in this research fall within three major categories, mentioned briefly here and elaborated later in this chapter:

Alignment of board and management interests. This is the essence of the agency problem. Investors and policy-makers are generally clear that they do not want to have to manage corporations, but want the directors and managers to act in the best interests of the corporation and its shareholders. Issues of elections, board independence, excessive CEO influence and the like all relate to trying to create a structure which more reliably and consistently represents shareholder interests instead of management interests.

Compensation problems. This is really a subset of the overall alignment of interests. Boards of directors are generally in control of executive compensation and are in a position which could fairly represent shareholders' best interests in structuring pay. Issues of excessive pay, failure to align pay with corporate performance, and excessively short-term pay goals are all problems of alignment of interests, but take on a separate place in reformers' thinking because these problems are so important by themselves.

Removal of anti-takeover devices. Many commentators view the threat of corporate takeovers as one of the strongest mechanisms limiting agency costs, although there continues to be debate about it. The surge of anti-takeover devices adopted in the 1980s and 1990s had the unfortunate collateral effect of entrenching management and protecting agency costs of various sorts. Much of the corporate governance reform effort in the 1990s and 2000s was directed to the restoration of the rules which existed before, including the return to annual elections of directors, elimination of voting control devices, and cancellation of "golden parachute" arrangements. At the end of the day, these are also alignment of interest issues.

Based on the academic literature, the following legal provisions, practices and omissions appear to contribute the most to entrenchment of management and the prevention of private remedies:

1. Secrecy. The norm of corporate confidentiality is essentially unchallenged by the courts or legislatures, except in the few instances where disclosure is specifically required or when information would have a material

⁹¹ Berle (1932).

effect on the securities market. This permits management to control almost all information about the company and management's decisions.

2. Business judgment rule. In cases of shareholders or creditors suing corporate directors and managers under state corporate law, the courts have respected the claim of management that their business decisions should not be subject to review or challenge. The justifications for this are that internal business deliberations and decisions should remain secret in order to protect them from competitors, that the market reaction to the financial results provides sufficient discipline, and that outside parties are not competent to review them.

3. Erosion of fiduciary duties. The common law concept of agency originally imposed a broad range of fiduciary duties on corporate officers and directors, including full disclosure, accounting, and strict loyalty. The de-emphasis of agency law in state corporation law, and the steady dilution of common law fiduciary duties by both Delaware courts and its legislature, has led to an increase in the discretion of directors and managers to increase agency costs.

4. De-regulation. The de-regulatory trend⁹² begun in the 1980s has resulted in norms of non-interference in private ordering and reliance on market mechanisms to control business behavior. This has reduced the involvement of courts, regulators and legislators in corporate governance.

5. Narrowing of private remedies. Numerous laws and court decisions have limited private remedies and reduced the threat of lawsuits against management, often in the name of "tort reform" and "stopping class action abuse."

6. Securities law focus on disclosure. The Securities Acts tend to avoid direct regulation of undesirable conduct, relying on private lawsuits and disclosure instead, in the hope that the market will regulate it.

7. SEC proxy voting rules. The SEC has limited shareholders' rights to "veto" management actions by granting management the right to exclude many types of shareholder proposals from consideration at annual meetings.

8. Lack of personal responsibility. The courts have gradually imposed such high standards of proof on criminal and civil actions for securities fraud

⁹² Including repeal of regulatory statutes, dismantling of regulatory agencies, liberalization of regulatory enforcement, and reduced funding of many regulatory functions. For instance, the field of consumer protection law, which was supported by law school courses, textbooks, and practice groups in large law firms, was a significant subject in 1980 and has largely disappeared. The Corporate Finance Division of the SEC, which routinely required substantiation of claims about market potential in securities offering documents in 1980,

against individual directors and officers that prosecutors have largely given up.⁹³

This is not to say that there are no constraints on management or that there are no efforts to reform corporate governance. Each recent crisis has brought new legislation which seeks to change corporate governance in ways which might improve behavior. The Sarbannes-Oxley Act made significant changes to board independence, officer responsibility, and audit and internal control standards. Most recently, the Dodd-Frank Act, while primarily aimed at financial institution reforms, includes new duties on securities sales, limits regulatory capture at the SEC, creates an SEC whistleblower program and mandates “Say-on-Pay” votes.⁹⁴ The perspective of this thesis is that management interests will be more successful than investor interests in using political influence and litigation to limit the impact of pro-shareholder changes through delay, through negotiating the details of the regulations and regulatory actions to dilute their effect, and through long-term lobbying to bring about the gradual, incremental repeal of these provisions.⁹⁵

The relationship between the corporation and management has become the predominant subject of corporation law, as creditors’ rights have increasingly moved to lending laws, bankruptcy law, and securities law,⁹⁶ and the number of controlling shareholders has diminished. Robert Clark finds that the primary constraint on managerial discretion is through the common law fiduciary duty of loyalty, which prohibits intentional fraud and unfair self-dealing. This is a relatively limited standard, applying to taking of corporate property or opportunities, or blatantly mis-priced transactions between the corporation and managers or directors. (Clark 1986) Rainier Kraakman notes that, “Contrary to conventional wisdom, U.S. law – even Delaware law – is relatively *unfriendly* to the interests of the shareholder class by international standards.”⁹⁷

⁹³ The Transactional Records Access Clearinghouse at Syracuse University publishes data at www.trac.syu.edu on prosecutions for corporate fraud, financial fraud and securities fraud which show a steady decline over the past twenty years (ending with FYE 9-30-2012). A brief review of the 2012 securities fraud cases shows that they are overwhelmingly insider trading cases and a brief review of the 2012 financial fraud cases shows that they are overwhelmingly loan application fraud cases. There did not appear to be a single case against a corporate executive for other types of fraud against the government or investors.

⁹⁴ Say-on-Pay votes are non-binding shareholder votes to approve a company’s overall executive compensation program. See further discussion in this chapter, under “Shareholder Voting and Control of Managerial Discretion.”

⁹⁵ Discussed more extensively in Chapter 4.

⁹⁶ Creditors rights are protected in the vast majority of states’ corporate laws, but the primary protections related to the conservation of corporate capital have been eroded in practically all cases.

⁹⁷ Kraakman (2004) at page 67. For instance, U.K. law permits shareholders to initiate corporate governance changes through the right to call special shareholders meetings and Swiss law requires shareholder approval of all corporate governance provisions.

The particular balance of rights and powers found in U.S. corporate law and governance is clearly not terrible,⁹⁸ given the relative strength of our financial markets, the profitability of U.S. public corporations, the level of innovation in American business, and the remarkable increases in productivity which have been achieved, even in a period of financial crisis and serious recession. The problem is not that our business and financial institutions are fundamentally corrupt, that our economy is endangered or that our public companies fail to deliver solid returns and reasonable growth. But as suggested in the introduction to this chapter and as elaborated below, the legally entrenched powers of corporate management do result in some serious problems.

What is the Problem?

In a word, the problem starts with compensation. Berle and Means⁹⁹ pointed out the problem of agents (i.e., management) seeking to increase their compensation and other benefits, at the expense of shareholders. Even though compensation problems are theoretically a subset of the overall problem of aligning directors' and managers' interests with those of shareholders, the research interviews from this project and the focus of much of the literature suggests that the desire to increase and protect management compensation leads to the actions which create many of the other corporate governance issues. All of these, together, constitute "agency costs" which investors seek to reduce.

There are at least dozens, and probably hundreds, of academic studies showing the increases over time of executive compensation against various indices. One of the most significant was done recently by Carola Frydman and Raven Saks (Molloy), who created the first long-term comparable pay data for senior corporate executives of the 50 largest U.S. public companies over 1936-2005. They found that real (inflation adjusted) executive compensation was remarkably flat from the end of World War II to the mid-1970s, even though firms grew considerably during that time. This result contradicts the prevailing view that total compensation rose significantly from the 1940s to the 1960s. Stock options were a negligible portion of compensation until 1950, when the tax law introduced restricted stock options taxed at capital gains rates.¹⁰⁰ More than 40% of the firms studied adopted them within five years. Since 1990, more than 90% of the executives in the sample held stock options.

⁹⁸ In an economic sense.

⁹⁹ Berle (1932).

¹⁰⁰ Stock options give employees a share of the increased value of corporate shares by giving them the right to buy shares at a later date, chosen by the employee, at a price fixed at the date the option is granted, usually the market price as of that date (the "strike price").

Their data show that real pay growth averaged 0.8% per year from 1950 to 1975 and 20% per year from 1975 to 2005. The authors were unable to account for the dramatic increase in compensation in their models of corporate governance, pay-for-performance, company size, or managerial skills. Thus, there is an un-explained inflection point in executive compensation in the mid-1970s.¹⁰¹ (Frydman 2010)

More important than the large dollar amounts and the number of executives in the top 1% or top 0.1% is the rising percentage of total corporate earnings claimed by executive compensation. A study by Lucian Bebchuk and Yaniv Grinstein found that senior executive pay during the period 1993-2003 grew almost twice the amount that would be predicted by previous trends and relationships. Executive pay rose from less than 5% of corporate earnings to more than 10%, despite the fact that the period ends in a significant economic downturn. (Bebchuk 2005b) This rising percentage is important because the value of the shareholders' interests is determined by the residual earnings after paying management. An investor must value the investment based on the current level of management compensation. If the percentage of income devoted to management compensation rises, there is less income left over for shareholders than was expected. The effect is a major loss in the value of the investment made when purchasing the company's shares and, eventually, a probable loss of confidence in investing in corporate equities.

The portion of the value of the average company allocated to executive compensation roughly doubled in the twenty years from the mid-1970s to the mid-1990s, and roughly doubled again from the mid-1990s to the mid-2000s. There is some indication that this kind of increase may be slowing,¹⁰² but any increase in excess of the growth rate of corporate profits is a far more important problem than the absolute pay levels. Absolute pay levels of corporate executives may also be a societal problem, in the sense that they create pay equity problems and appear to cause the same problem of excessive compensation in other organizations by spreading to educational and non-profit organization leaders; movie stars, recording artists, and sports figures; attorneys; and Wall Street employees.¹⁰³

Compensation Decisions

The determination of top executive compensation, especially the CEO's pay, is the responsibility of the board of directors under most companies'

¹⁰¹ Core (2010) and ERI (2008) find similar rates of increase.

¹⁰² Kaplan (2012) argues that 2010 executive pay levels are at the same real level as 1998, although he appears to have used the low point of the financial crisis and recession.

¹⁰³ Employees in many of these fields negotiate their compensation by reference to the publicly disclosed compensation of senior corporate executives.

bylaws. The Sarbanes-Oxley Act of 2002, and new conforming rules of the NYSE and NASDAQ, require boards of directors to establish compensation committees composed entirely of independent directors. But one should pity the poor director whose responsibility it is to negotiate the CEO's pay. Regardless of their other skills, virtually all CEOs are master negotiators and the negotiation of their pay is exceptionally awkward, even if the party representing the board is a more powerful or experienced CEO of another company. Fortunately for the comfort of both parties, CEO pay is almost never actually negotiated.

In 1991, Graef Crystal published an exceptionally clear explanation of how top executive compensation is established in the preponderance of U.S. public companies. Mr. Crystal spent twenty years¹⁰⁴ as a legendary compensation consultant to corporations, most of it as the head of Towers Perrin's compensation consulting practice.¹⁰⁵ The practices described by Mr. Crystal probably existed for many years before he began practicing and evidently continue today. (Crystal 1991)

There is no effective market for CEOs and CEO pay. There is no pool of available CEOs competing for a pool of available jobs. CEOs are hired rarely and often have exceptional skills which are difficult to value. They rarely are hired away by other companies. It is often almost impossible to compare their specific responsibilities or contributions to their companies. Each member of the Compensation Committee may have had exposure to a few other companies' CEO hiring experiences, but no company has enough information to understand the market for executive hiring and compensation.

According to Crystal, the answer that has evolved as a business norm is to look to the pay levels and practices of other companies. While this might be a useful process if there was an actual market in operation, it only tells us what other CEOs at other companies were able to achieve. This process is made more ostensibly independent and scientific by the retention of outside compensation consultants to study the roles and comparable compensation of executives of other companies. The compensation consultant is usually retained by the company, not the board or compensation committee, and the consultant usually works directly with the company's management. Remarkably, the CEO often takes a lead role in this process and the human resources professionals working for the company rarely are included.

The process usually begins with the identification of "peer" companies, considering size, industry, quality, and other factors. Crystal makes clear that this is where the process loses objectivity. Companies and CEOs rarely

¹⁰⁴ 1966-1986.

¹⁰⁵ During that time, Towers Perrin was regarded in business circles as the pre-eminent compensation consulting firm.

accept the consultant's selection of appropriate peers and usually require that the consultant provide the comparable pay information at this stage. Since CEOs usually have superior knowledge of their competition, they are very persuasive about which "peers" are actually comparable. Qualitative considerations are usually the basis for excluding particular "peers," who happen to pay less than the companies chosen for inclusion.

The pay information for the peer companies is then sorted and analyzed statistically to provide the range of results, usually by percentiles. Since every company wants above-average performance, most companies set their pay expectations at the top 25% percentile or higher. The joke in the compensation world is that this results in the "Lake Wobegon" effect: every company tries to pay above average.¹⁰⁶ Crystal points out that, if most companies target pay above average, the average will inexorably move upwards. The higher the percentile target, the faster compensation will rise ahead of the previous base. (Crystal 1991)

Others have theorized about the agency cost problem posed in establishing executive compensation.¹⁰⁷ Lucian Bebchuk, Jesse Fried and David Walker point out that there are two basic views of the process: the optimal contracting approach, which theorizes that directors would seek compensation arrangements which minimize agency costs; and the managerial power approach, which theorizes that management will use its opportunities to influence the decision process in order to maximize its own compensation. (Bebchuk 2002c)

Executive compensation has become an extremely salient topic after the 2008 crash. Bonuses paid by Wall Street firms provoked widespread public outrage and President Barack Obama described them as "shameful." The Dodd-Frank Wall Street Reform bill required increased disclosure about compensation consultants. Compensation consultants frequently provide significant amounts of other services to companies, usually have long histories of repeat business, and appear to have little legal risk if they seek to please management. (Conyon 2011)

There is considerable evidence that the use of compensation consultants is associated with higher executive compensation. (Armstrong 2012b, Conyon 2011, Cadman 2010) There is also fairly strong evidence that CEO avarice is associated with decreased company financial performance. Lucian Bebchuk, Martijn Cremers and Urs Peyer found that the fraction of total compensation of the top five executives which is captured by the CEO is negatively associated with firm value (Tobin's Q), accounting profitability, stock returns, quality of acquisition decisions, and CEO turnover. It is also

¹⁰⁶ See Hayes (2009) for a current analysis.

¹⁰⁷ See discussion of Berle (1932) in Introduction.

positively associated with opportunistic stock option grants to the CEO. (Bebchuk 2011) Adair Morse, Vikram Nanda and Amit Seru found that powerful CEOs induce boards to shift the weight on performance measures toward better performing measures, increasing incentive pay and making it less sensitive to performance. A firm with rigged incentive pay is associated with subsequent decreases in firm value and operating returns. (Morse 2011)

Do investors “exit”¹⁰⁸ companies that “over-compensate” CEOs? There is little evidence that they do. One reason may be that, if all companies increase executive compensation at similar rates, even at rates far ahead of inflation or earnings growth or pay levels for other employees, all companies remain proportionally attractive to investors. Even if a particular company moves significantly ahead of its peers’ compensation levels, there is a gray area or “zone of indifference” where the cost of selling the stock and re-investing in a comparable company with more reasonable executive compensation exceeds the per share amount of the excessive compensation.

In addition, this element of “conscious parallelism”¹⁰⁹ inherent in using comparable pay studies has effectively eliminated any external market signals which might limit executive compensation. Neither state corporate law nor SEC rules¹¹⁰ provide any legal limitations on compensation structures or amounts, and the business judgment rule effectively forecloses any private rights to legal action based on claims of excessive compensation. Without any legal or market limitation on executive compensation, executives have a strong incentive to influence any other aspects of corporate governance which might threaten or limit their compensation.¹¹¹

Incentive Pay/Pay for Performance

One of the most obvious solutions to the agency problem identified by Berle and Means is to try to align compensation of executives with financial results of shareholders. Top management of U.S. public companies has received incentive compensation, in the form of bonuses, stock options, restricted shares, and many creative contractual arrangements denominated “phantom stock,” going back to the beginnings of managerial capitalism.¹¹² But a landmark article by Michael Jensen and William Meckling in 1976 introduced a theory of agent (i.e., manager) incentives which unleashed a

¹⁰⁸ The idea of “exit” is simply to sell one’s interest in the company.

¹⁰⁹ To borrow a dis-used term from antitrust law, denoting the once-prohibited practice of price fixing by moving prices in tandem with competitor price changes by constantly monitoring their prices.

¹¹⁰ The SEC’s rules on compensation focus on prescribed disclosures and proper (under state law) shareholder approval of any programs which call of issuance of corporate shares.

¹¹¹ Interestingly, there are few investor complaints about corporate executives’ base pay levels or retirement programs, presumably because they are dwarfed by incentive compensation programs. Golden parachutes do draw investor concern, and are discussed under “Job Security,” below.

¹¹² Berle (1932).

torrent of new stock options and other equity incentives for management. In essence, they theorized that the more incentive compensation received by management, the better the company would perform and the smaller the extractions by management.¹¹³ (Jensen 1976) This type of compensation became a key element of the total compensation recommendations of compensation consultants discussed above. Incentive compensation is probably at the root of some of the best and some of the worst management conduct, as discussed below.

The most common form of equity incentive compensation is stock options, partly because they receive the most favorable tax treatment and partly because they provide the most potential compensation for the least amount of reported compensation expense.¹¹⁴ A stock option allows the executive to choose to exercise the option after some specified vesting period and before a specified expiration date. If, on any date after vesting, the market value of the underlying stock exceeds the strike price specified in the option document,¹¹⁵ the executive can receive a cash payment of the excess without having to actually pay the strike price. This creates a strong incentive for managers to work to increase the price of the stock, thus maximizing shareholder value as well. Unfortunately, it also permits the executive to exercise a great deal of discretion over the timing of the transaction, which allows them to freely use their inside knowledge of company plans and performance.

Lucian Bebchuk and Jesse Fried published a widely-noted critique of incentive compensation in 2004, which pointed out that management was receiving substantial compensation despite poor company performance and that incentive compensation appeared to be inducing management to take significant short-term risks, while deferring long-term investments. They argued that flawed executive compensation arrangements result from inadequate corporate governance structures, which permit management to exert excessive influence over boards of directors. The board is weak because of CEO dominance, lack of sizeable shareholders with incentives to demand limits, institutional shareholders who have conflicting incentives, and anti-takeover mechanisms. They advocated a significant increase in shareholders' power to initiate decisions and to elect directors, in order to establish the threat of pressure against excessive compensation decisions by the board. (Bebchuk 2004)¹¹⁶

¹¹³ They also noted that the agent will have an incentive to extract benefits whenever 100% of the benefit is worth more than the reduction in the agent's share of profits.

¹¹⁴ Because the prevailing Black-Scholes valuation model imputes a value of the options based solely on the volatility of the underlying stock.

¹¹⁵ Nearly always the stock price on the date of grant of the option.

¹¹⁶ Kramer (2005) makes almost the same observations about the problems of incentive compensation. In contrast, Bratton (2005) noted that economists argue that high compensation is rational contracting for the risk of equity-based compensation, or the result of distortions caused by regulation, or the amounts are insignificant and will self-

Lucian Bebchuk and Jesse Fried followed up their own critique with an article suggesting important revisions to align pay with long-term performance. Their key prescriptions are that (1) executives be forced to hold their options for long periods, even beyond retirement, (2) sales should occur gradually with limitations on annual exercise, (3) the timing of stock option grants should not be discretionary, (4) the timing of exercise should be automatic or committed to in advance, and (5) hedging transactions which would reduce incentives (or penalties) be prohibited. (Bebchuk 2010a) These seemingly technical requirements would go a long way toward aligning incentive pay with performance, but still fail to align management interests perfectly with investors because managers would still not have any investment at risk and might tend to take risks which investors would not. This problem of inadequate exposure to the downside (i.e., compensation falling when profits and value fall) may be more to blame for excessive risk-taking than the incentive to share in the profits.¹¹⁷

Again, the key problem is that the legal framework for incentive compensation is discretion and permissiveness. Without the external force of a legal requirement, there is no incentive for any company to make the sort of changes suggested by Bebchuk and Fried. Any company that made these changes voluntarily would face a significant disadvantage in attracting and retaining management talent.

Job Security

Corporate law does not provide job security and boards can fire CEOs and managers, except as provided in employment contracts. In fact, corporate executives face a meaningful chance of losing their jobs for reasons beyond their control. The average turnover for S&P 500 CEOs was 10.3% for 2009-2010. Only 16% of those departures were retirements and virtually none of the CEOs were hired away by other companies. (Conference Board 2010) This implies that many CEOs are fired by their boards, although the specific reasons are usually unclear. The probability of CEO firing rises significantly after institutional investor sell-offs. (Parrino 2003) Broad economic downturns, changes in consumer preferences and taste, technological change, new regulatory constraints, fixed special-purpose investments, loss of key relationships and the like can happen to the best of

correct. Jensen (1990) found that CEOs receive \$3.25 in incentive compensation for each \$1,000 increase in shareholder value. Twenty years later, Gong (2011) found that CEOs received 2% (or \$20.00 per \$1,000 increase in shareholder value). Hall (2003) found that stock option grants to senior executives at S&P 500 companies grew from \$11 billion in 1992 to \$119 billion in 2000, possibly increasing risk-taking behavior.

¹¹⁷ The work of behavioral economics is increasingly showing that risk aversion, particularly the risk of losing resources already held, is more powerful than the motivation to gain more. See, for example, Becker (1976), Camerer (2003), Cooter (2004), Pindyck (2001), Salanie (2000), Schleifer (2000), Sunstein (2000), and Thaler (2005)

companies and executives. Moreover, executive power can be eroded by changing political environments. (Economist 2012e, Kahan 2010)

Consequently, one predictable result of management's relatively generous compensation is that they attempt to prevent the loss of their jobs through the many strategies within their control. Because one of the risks to their employment is takeovers by other firms, a great deal of modern corporate law is devoted to anti-takeover devices that managers have instituted to protect against that eventuality. These arose in the 1970s and 1980s during an era of corporate acquisitions financed by Wall Street. Acquirers looked for companies that were doing so poorly as a result of their current managers' failings that it was worthwhile for them to pursue "hostile" (i.e., involuntary) acquisitions. There was a race among corporate law firms to devise new ways of making it difficult for the acquirer to obtain voting control of the target company and to reduce the economic benefits of doing so. Corporations amended their bylaws to provide for (a) staggered boards¹¹⁸ which delayed the time to complete the takeover, (b) multiple classes of stock with different voting power which let minority shareholders retain control, (c) poison pills¹¹⁹ which gave current shareholders most of the profits if a takeover occurred, and golden parachutes¹²⁰ which gave current management severance packages that penalized the shareholders.¹²¹ All of these tended to entrench current management against the threat of being fired by acquirers by making a takeover too expensive to pursue. State corporate law did little to control these efforts and, in many cases, was amended to permit them.¹²²

CEOs have also tried to enhance their job security by reducing the pool of potential replacements. In the 1950s, 1960s and 1970s, many companies had formal management development programs which sought to prepare a number of executives for eventual promotion to senior management positions. These programs intentionally rotated executives through key functional and geographic divisions so that they became acquainted with all aspects of the company. Many companies sent their executives to MBA programs or contracted with top MBA programs to conduct executive training within their companies. Boards of directors sought opportunities to meet and observe a number of senior executives, and often informally tracked their progress. The success of CEOs in developing their potential replacements was a key

¹¹⁸ E.g., a board in which 1/3 of the members come up for election every three years, so that it would take two years to obtain voting control and three years to be rid of dissidents.

¹¹⁹ E.g., stock splits that arise upon closing of a takeover which give continuing shareholders ten times their previous number of shares, thus diluting the value of the shares obtained in the takeover.

¹²⁰ E.g., an agreement to pay very large bonuses to the senior executives for any change in their employment terms or their departure, or (more commonly today) upon any change of control of the company.

¹²¹ Because they reduce the value available to them.

¹²² ISS (2006a), Bebchuk (2002e), Bertrand (2003), Masulis (2008), and Subramanian (2010) all show that anti-takeover devices introduce agency costs and are disadvantageous to shareholders; While others argued in favor of them (Gordon 2002), the removal of staggered boards became one of the principal targets of institutional investors' corporate governance efforts. (Bebchuk 2012).

measure of their performance. This focus on succession planning is extremely important because nearly 75% of new CEOs come from within the company. (Conference Board 2011) It is also important because the presence of a number of suitable alternatives changes the dynamics of the implicit negotiation of CEO pay, even if it is never discussed.

It is telling, therefore, that these management development and succession planning efforts have largely disappeared from boards' agendas. In a 2007 survey of S&P 500 companies, only 51% of companies could immediately name a permanent successor to the CEO and 39% had no viable internal candidates. (Larcker 2011a)

Andrei Shleifer and Robert Vishny note another interesting managerial longevity strategy previously documented by numerous academic studies. Some managers make significant investments in assets or lines of business which current managers have unique abilities to manage.¹²³ These manager-specific investments might increase returns in the short run, but reduce the probability of being able to replace the manager, help extract higher wages, and create more manager discretion in determining strategy if the company cannot easily replace the manager and would be faced with a loss on the investment. (Shleifer 1989)

Shareholder Voting and Control of Managerial Discretion: A Hollow Hope?

Corporate governance differs in significant ways from political democracy. Corporate shareholder voting is more limited under most companies' bylaws, covering only the election of directors, certain proposals, and approval of major transactions. Corporate voting serves an essentially "error correction" function. Shareholders cannot vote on anything they choose; they are constrained by the slate of directors submitted by management or by dissidents, and by the major transactions arranged by management. What is important is that shareholders can remove directors if they are blocking a value-increasing transaction for entrenchment reasons. (Thompson 2009)

Shareholder voting persists despite evidence that shareholders are apathetic and that efforts to improve shareholder voting are inefficient and result in poorer performance. Most state corporate laws permit almost any voting arrangements, including none, but most corporations provide for one share, one vote elections. Most mandatory voting laws are oriented toward preventing corruption of whatever arrangements have been chosen. This evolved as the efficient solution to problems of incomplete contracting,¹²⁴

¹²³ "Manager-specific investments."

¹²⁴ Incomplete contracting is the problem that it is not possible to anticipate every problem which might arise in connection with the performance of the contract in the future (and that it is not economically possible to devote the resources to come close).

because someone must have the residual power to make decisions which have not been anticipated. Voting rights are vested with shareholders because they are usually the residual beneficiaries or victims of corporate decisions. (Easterbrook 1983)

Under most companies' bylaws, director candidates are nominated by the board, giving shareholders only a "yes or no" decision. Until very recently a director only had to receive one "yes" vote to be elected if they were the sole candidate. This practice was referred to as "plurality voting," and is rapidly being replaced by "majority voting" in which any candidate must receive more "yes" votes than "no" votes to be elected. This problem would have been worse under previous rules, but the SEC recently prohibited the inclusion of "broker non-votes" which allowed securities firms (which hold the vast majority of corporate shares in "street name"¹²⁵ accounts) to vote any shares for which the underlying shareholders had not given voting instructions. These votes were customarily made in accordance with management's recommendations. Both of these changes were sought by institutional investors.

Economic theory says that shareholders will vote for directors and proposals which maximize the economic value of their investment. Thus, underperforming directors and managers should be motivated by the threat of removal in corporate elections. But skill at enhancing firm value has less to do with whether directors win votes and stay at the helm of public companies than previous commentators have presumed. Like incumbent politicians, some stay in charge because they understand the political dynamics of corporate voting. Corporate elections share many characteristics with political elections. They are protected by law and respected by the courts. In a contested election, there is extensive campaigning and name recognition, reputation and media coverage are important. In a study of 190 contested elections from 2006-2009, winning challengers spent more on their campaigns (\$730,912) than losing challengers (\$468,969). It showed that prior performance of incumbents was not related to the outcomes. (Harris 2011)

Corporate elections are conducted by "proxy" solicitation made with the notice of the annual shareholders meeting. The company generally engages the transfer agent to act as the inspector of the elections, insuring that each share is properly accounted for in the election. In any election which might be close, management will usually engage a separate proxy solicitation firm to contact shareholders and seek their votes in favor of management's proposals. Proxy solicitation firms are often retained on an incentive basis, giving them bonuses for obtaining votes in favor of management, all at the

¹²⁵ "Street name" refers to the registered holding of shares in the name of a Wall Street securities brokerage firm, which allocates the beneficial ownership to their customers. The firms were never all on Wall Street.

shareholders' expense. Management controls the whole process and generally obtains real-time information about the vote count from the transfer agent. This gives management a key advantage in knowing when to apply extra resources to try to win elections. Management also gains important advantages by structuring its proposals to qualify as routine matters, on which "broker non-votes" can still be counted and on which shareholders generally pay less attention, providing a 14% average increase in affirmative votes. (Bethel 2000)

Yair Listokin noted that a remarkable proportion of contested corporate elections are won by management by small margins.¹²⁶ (Listokin 2007) Geoff Colvin (Colvin 2007) commented that it wasn't because management is illegally stealing elections:

"Management's remarkable ability to win squeakers arises from a raft of features built into the system. Nothing like them exists in electoral democracy, except in banana republics. . . Most important is management's ability to monitor results as voting takes place. Shareholder votes stretch over days and weeks, and since the vote counter is typically paid by the company, managers can check running totals as proxy cards come in. Shareholders cannot. So if a vote is going badly, managers can get on the phone (or on corporate jets) to influence large shareholders who may not have voted yet. Because managers know how it is going day by day, they can target their efforts quite efficiently."¹²⁷

Lucian Bebchuk noted that numerous commentators and court decisions refer to the right of shareholders to elect directors as the principal mechanism to change corporate decisions and to discipline management. Corporation law's reliance upon the directors to govern all aspects of the corporation, the assumption that director's incentives should be aligned with shareholders, the prohibition in most corporate bylaws of shareholder initiation of business decisions, and the courts' reluctance to review director decisions all make director elections extraordinarily important. But challenges to director nominations and elections are extremely rare (118 in ten years, of which only 24 involved companies of \$200M or greater market capitalization¹²⁸ and of these, only 8 succeeded).

Bebchuk says that this rarity probably does not represent widespread satisfaction; rather, there are significant impediments to electoral challenges, including the cost of mounting a contest against incumbents spending

¹²⁶ Very few corporate elections are contested at all.

¹²⁷ Dal Bo (2007) analyzes hypothetical voting strategy and concludes that secret elections are necessary.

¹²⁸ Most of these are still small companies. The minimum cutoff for S&P 500 companies is a market capitalization of \$4 billion.

corporate funds; the difficulty of convincing other shareholders under conditions of inattention, uncertainty and incomplete information; the difficulty of providing a sufficient plan for future operations, including a willing and viable CEO candidate; and the near impossibility of overcoming a staggered board. (Bebchuk 2007) These problems were not generally created by laws, but institutional investors have been trying to create remedies to them without much success.¹²⁹

Regulatory Attempts to Strengthen Shareholder Influence

In addition to the question of shareholder voting on director candidates nominated by the board, Jill Fisch reports that the SEC has considered rule-makings¹³⁰ which would have permitted certain shareholders to nominate director candidates who would be included in the company proxy statement. This might have helped to solve the problem of companies re-nominating directors who failed to get a majority vote and would have made the threat of replacement more meaningful.¹³¹ The Dodd-Frank Act of 2010 included a provision which specifically empowered the SEC to adopt a shareholder proxy access rule, which the SEC did soon thereafter.¹³² The rule permitted owners of at least 3% of the outstanding shares for at least three years to nominate one to 25% of the directors, whichever is greater. The SEC also created a limited exception to the proxy rules to permit the formation of a nominating group, so that shareholders could cooperate.¹³³ Fisch noted that the number of comment letters on proxy access was, by far, the SEC's most controversial rule-making initiative to date. She concluded that the proxy access rule adopted by the SEC was ambiguous and unlikely to increase shareholder input into board composition. She argued that the core of the problem is that federal regulation is poorly suited for regulating corporate governance. (Fisch 2012)

Unfortunately for corporate governance activists, the U.S. Circuit Court of Appeals vacated the SEC proxy access rule in 2011,¹³⁴ despite the specific congressional authorization. Petitioners argued that the SEC did not adequately consider the effect on efficiency, competition and capital formation, which renders it automatically arbitrary and capricious, and not in accordance with law. The court found that the SEC inconsistently and opportunistically framed the costs and benefits of the rule.

¹²⁹ Macey (2007) questions the practicality of solving these problems. Fenn (2009) argues that a subsequent increase in director challenges indicates that the current system is effective.

¹³⁰ On at least six occasions beginning in 1942.

¹³¹ Bebchuk (2003b), Katzovicz (2009) and Millstein (2010) support proxy access. Lipton (2003) and Kahan (2011) oppose this idea.

¹³² SEC Rule 14a-11.

¹³³ So long as a change in control is not the purpose.

¹³⁴ *Business Roundtable and Chamber of Commerce of the United States of America v. Securities Exchange Commission*, 647 F.3d 114 (2011). Eugene Scalia, the justice's son, argued the case for the petitioners.

The SEC responded by announcing that it would neither appeal the decision nor initiate a new rule-making proceeding that would attempt to satisfy the court. Instead, the SEC amended its existing rule¹³⁵ regarding the types of shareholder proposals which management can *exclude*. The new rule compels management to include, on the annual proxy, shareholder proposals to give shareholders the right to nominate directors. This represents an SEC invitation to the shareholders to establish proxy access by “private ordering,” as encouraged by many of the comments submitted by parties opposed to the proxy access rule.¹³⁶ James Morphy¹³⁷ noted that 2012 was the first proxy season in which proxy access proposals could be submitted and too few qualified to draw any conclusions, but it appears that management may succeed in excluding many of them from the ballot for technical reasons. (Morphy 2012)

Shareholders often submit proposals for inclusion on the annual proxy on a wide variety of subjects, ranging from other governance issues to social and environmental issues. These must meet the requirements of the company’s bylaws and pass SEC Rule 14a-8, which permits management to exclude a number of types of proposal. Many proposals are referred by management to the SEC to obtain a “no-action” letter that permits management to safely exclude them from the proxy. Furthermore, the bylaws of many corporations prevent shareholder proposals which would amend the bylaws, thus making most such proposals mere requests to the board.¹³⁸

A report by The Conference Board regarding the 2011 proxy season shows that there are still quite a number of shareholder proposals on other subjects. Shareholders filed 0.28 proposals per company, down from 0.34 in 2010, with volume varying considerably by industry (technology and finance are the leaders). The volume of corporate governance proposals has risen steadily since 2007. Individuals were the most frequent proponents (42%), followed by unions (18%) and public pension funds (11%). (Conference Board 2012b)¹³⁹ A persistent pattern of failure to act on shareholder proposals, particularly ones receiving significant support, is the most common reason for

¹³⁵ SEC Rule 14a-8.

¹³⁶ Young (2009) challenges the presumption that individual choices are possible, citing the fact that nearly 50% of companies have either prohibitions on shareholder amendments to bylaws, supermajority (generally of outstanding shares, not just voting shares) requirements, or voting rights arrangements (principally multiple classes of stock) that effectively prevent the adoption of optional proxy access provisions.

¹³⁷ Practicing attorney with Sullivan & Cromwell.

¹³⁸ So-called “precatory” proposals.

¹³⁹ Gordon (1993) notes that institutional investors are increasingly using shareholder proposals to amend corporate governance rules. Listokin (2007, 2010) notes that shareholder proposals were the principal mechanism to force the removal of anti-takeover devices. Ferri (2009), in a study of 150 proposals, finds that shareholder power is increasing and management is frequently responding. Likewise, Ertimur (2010), in a study of 620 shareholder proposals, finds that implementation of non-binding proposals is related to the voting outcome and influence of proponents. Armstrong (2012a) finds shareholder proposals less effective where compensation is involved.

shareholder opposition to board candidates or management proposals needing shareholder votes.

In an ostensible victory for corporate governance activists, the Dodd-Frank Act of 2010 included another major change in corporate governance that appears to have survived management opposition better than proxy access.¹⁴⁰ Most public companies are required by the Act to conduct advisory “Say-on-Pay” votes at a frequency determined by shareholders in the first vote, beginning in 2011 or 2012. Data from the initial results of Say-On-Pay indicate that most proposals receive strong shareholder support, while poorly performing companies with high pay levels can expect dissent. Most companies recommended an every-three-year frequency, while shareholders overwhelmingly voted for every-year votes. (Thomas 2012) Reporting part way through the 2012 proxy season, Jeremy Goldstein¹⁴¹ found that, of the 396 companies in the S&P 500 reporting Say-on-Pay vote results by June 22, 2012, 384 (97%) received majority support for their compensation programs, with vote totals averaging 89%. The overwhelming reason for “against” votes is “pay for performance” issues.¹⁴² (Goldstein 2012)

It is too soon to know just how management will respond to “against” votes and to significant opposition, but there is no reason to expect that it will comply because there is no legal requirement to do so. It seems clear that shareholder voting remains an area where the rules are systematically biased in favor of management and provide management with many opportunities to protect its compensation and power.

Board Governance

The structure and operation of the board of directors is determined almost entirely at the company’s discretion through its bylaws. There are essentially no legal constraints on the structure or operation of the board of directors, despite the fact that the law generally supports the delegation of plenary power to the board. The most significant limitations are the Sarbanes-Oxley Act’s requirements for a majority of independent directors, and independent compensation, audit and nominating committees, and the long-standing SEC rules regarding disclosure of director nominee’s backgrounds, current director compensation, and material conflicts of interest. Yet, as discussed below, much of the effort discussed above to limit shareholder power and influence elections aids management in obtaining great influence over boards.

¹⁴⁰ Possibly because it poses a less direct threat to management because it is non-binding in nature.

¹⁴¹ Practicing attorney with Wachtel, Lipton, Rosen & Katz.

¹⁴² Pay for performance, discussed above in this chapter, is the question of whether compensation is sufficiently responsive to company financial results. Sheehan (2012) reports that CalSTRS concurs that this is the most frequent cause of “against” votes.

Most external corporate governance standards have been developed without an understanding of how boards operate, largely because they are one of the most closed institutions in society. Virtually all corporate governance research has been forced to rely upon data reported under SEC disclosure requirements. Richard Leblancc and James Gillies conducted a study based upon direct access to board meetings of 29 for-profit companies, four government-owned enterprises, and six non-profit organizations, all of a variety of types and sizes, continuing over a period of five years. It is supplemented by interviews of 194 directors. (Leblancc 2005)

The failure of the board to monitor management is often the root of investment losses and corporate failure. Leblancc and Gillies believe that board effectiveness hinges on the competencies and behavioral characteristics of the directors and how they fit together. Berle and Means¹⁴³ confirmed the conventional wisdom that even though directors have all the power by law, they exerted practically none. Miles Mace¹⁴⁴ confirmed that boards generally do not do much. Boards first became important in the 1980s, when takeover transactions became more common. They also became more important as institutional investors' ownership rose and exit became more difficult. For a time, the standards of effective board performance rose as a result of increased legal liability imposed by private lawsuits.¹⁴⁵

Leblancc and Gillies found roughly 80% of directors have business experience, either CEOs, representatives of major shareholders or retired executives. Lawyers, former politicians and educators generally make up the rest. Because boards control the nomination process, directors tend to be very secure and many of the directors interviewed commented on the number of incompetent directors and the dysfunctional relationships within boards. They report that board activities are generally routinized, with a highly recurring agenda guiding the attention of directors to monitoring financial performance and reporting, compensation, and legal formalities. There is relatively little attention paid to strategy, despite the common assertion that the board should act as an advisor to the CEO. This pattern is broken only by urgent problems and business opportunities. Directors have essentially no independent information, are frequently inexperienced with the challenges they face, and are often dependent upon outside experts for advice. Few of them are prepared to invest the time necessary to become better educated.

“One of the interesting characteristics of corporate governance—a characteristic that makes it almost unique—is that by and large its

¹⁴³ Berle (1932).

¹⁴⁴ Mace (1971) discussed below.

¹⁴⁵ This ended under the Private Securities Litigation Reform Act of 1995, discussed in Chapter 4.

quality is judged not on the basis of results but rather on the basis of form.”¹⁴⁶

Each year, Spencer Stuart¹⁴⁷ publishes its “Board Index.” The 2010 version presented a number of key comparisons with the data twenty five years ago (1985), which gives us a very helpful perspective on board characteristics and how things are changing. (Spencer Stuart 2010) They report that twenty-five years ago:

- The average board was 3:1 outsiders, compared to 5:1 independent¹⁴⁸ now.
- Only 3% of boards had the CEO as sole insider, compared to 53% now.
- Boards met an average of 11 times per year, compared to 8.6 now.
- Average board retainer was \$20,000, compared to \$80,000 now (doubled in constant dollars). Average total board compensation now is \$215,000, 57% in equity (43% stock and 14% options).
- Separation of chair and CEO roles was not even discussed, and was very rare. Currently 40% of boards have separate chairs and CEOs. Of independent chairs, nearly half are retired chairs, vice-chairs, presidents or CEOs. 92% of boards have a lead independent director.¹⁴⁹

Some other important findings in the Spencer Stuart report are:

- 71% of companies require directors who fail to get majority vote to submit their resignation.¹⁵⁰ 72% of boards elect directors annually, up from 40% in 2000.¹⁵¹
- Only 26% of new directors are current CEOs, down from 53% in 2000.¹⁵² Overall, fewer active executives are joining boards (59%

¹⁴⁶ Leblanc (2005) at page 107.

¹⁴⁷ One of the largest executive search firms, with a large share of the board candidate search and vetting business.

¹⁴⁸ A more stringent definition required by the Sarbanes-Oxley Act and amended stock exchange rules.

¹⁴⁹ It is not clear why 92% of boards would have lead independent directors, if only 60% of boards have combined chair and CEO roles. The purpose of a lead independent director is to handle board activities which exclude the CEO, which would be handled by the chair.

¹⁵⁰ This may mask a certain “softness” on this issue, because few companies are required to accept the resignation and there are increasing reports of such resignations being declined.

¹⁵¹ This indicates substantial progress in eliminating “staggered” boards as an anti-takeover device, but many of the remaining ones are thought to be protected by dual classes of voting shares, supermajority provisions, and other voting devices.

compared to 66% in 2006). This implies improved diversity of backgrounds and dilution of the “CEO perspective” of many boards.

- 54% of director nominations are from executive search firms, 22% from independent directors, 12% from the CEO and 10% from other insiders.¹⁵³
- Compensation continues to be the most frequent issue considered by the board (80%), followed by its role in strategy (67%), its role in risk management (63%, up from 50% in 2009), CEO succession (57%, up from 45%), director recruitment (44%, down from 49%) and shareholder concerns (29%, down from 40%).
- Virtually 100% of boards have independent nominating, audit and compensation committees. There is a large increase in the percentage of audit committee chairs with financial expertise, and far fewer current CEOs.
- More than 80% report that shareholders initiated contact. Of these, 32% were regarding CEO compensation and Say-on-Pay, 23% on environmental issues, 20% on majority voting and 15% on board chair independence. 80% report that management reached out to investors proactively. (Spencer Stuart 2010)

A large study begun in 1945 demonstrates that management tends to control boards of directors.¹⁵⁴ (Gordon 1961) One of the key elements of this is a “re-framing” of the purpose of the board, from the entity responsible for the operation of the corporation and the power to which the CEO reports, into a role that is primarily advisory to the CEO. This seemingly sensible role, for which many directors are eminently qualified by their other experience, could change everything. Logically, it could empower the CEO to lead and manage the board. It could permit the CEO to decline the board’s advice. It would allow the CEO to dominate the operation of the board in such important areas as director selection and compensation. Few CEOs actually seek out such advice from the other directors.¹⁵⁵ These all seem to conflict with the purposes of the Sarbanes-Oxley Act of 2002 in requiring a majority of independent directors and completely independent nominating and audit committees. Unfortunately, “Sarbanes-Oxley does nothing to prevent the CEO from controlling the nomination process for directors.”¹⁵⁶

¹⁵² This masks the fact that many current directors are CEOs of other companies and will take many years before this change in “input” dilutes the high concentration of CEO directors.

¹⁵³ This does not address how director candidates are selected; it only represents how the pool is selected.

¹⁵⁴ Control is not defined, but the author appears to have intended “strongly influences.”

¹⁵⁵ Dallas (2003) and Fisch (1997) show that monitoring is diminished when strategy is emphasized.

¹⁵⁶ Brown (2004) at page 376.

Another large interview study by Myles Mace found that when a CEO's performance is inadequate, directors either 1) hire a consultant, 2) resign from the board (the most common response), or 3) request the resignation of the CEO. "It was found that boards of directors of most companies do not do an effective job in evaluating, appraising, and measuring the company president until the financial and other results are so dismal that some remedial action is forced upon the board."¹⁵⁷ "The basic objectives, corporate strategies, and broad policies of companies are not established by the board in most large and medium-sized companies."¹⁵⁸ "Research interviews indicate that in most companies directors at board meetings do not in fact ask discerning questions."¹⁵⁹ Except when the previous president was fired, the board rarely actually selects the successor. Almost all director functions are actually performed by management. Directors tend to be top people at their organizations and top people are too busy to devote substantial time to directorship. The president is almost always the person who selects board candidates and drops board members from the annual proxy, and candidates are almost always people with ties to the president. (Mace 1971)

There is little indication that board monitoring and control over management has improved. Jay Lorsch and Elizabeth MacIver found that CEOs exercise significant influence over the selection of board candidates. Sixty-three percent of outside directors of the 1,000 largest American companies are themselves CEOs of other corporations. (Lorsch 1989) John Smale, et. al., said "Deep down [CEOs] really wish they didn't have boards. That's why, at the end of the day, most independent directors get neutralized in one fashion or another."¹⁶⁰ Jonathan Macey said "The problem with boards is their unique susceptibility to capture by the managers they are supposed to monitor. The problem of capture is so pervasive and acute that almost no board, not even those that appear highly qualified, independent, and professional, can be relied upon entirely."¹⁶¹ Judge Posner stated that "Directors are often CEOs of other companies and naturally think that CEOs should be well paid. And often they are picked by the CEO."¹⁶² Claire Hill and Brent McDonnell explained the impact of Judge Posner's observation:

"First, directors of a corporation may be beholden to the corporation's officers for their jobs. Second, they may abide by a "pernicious golden rule" under which they defer to the officers as they would have directors defer to them in their capacities as officers of other corporations. Third, directors may simply see the world from the same vantage point as the

¹⁵⁷ Mace (1971) at page 41.

¹⁵⁸ Mace (1971) at page 43.

¹⁵⁹ Mace (1971) at page 52.

¹⁶⁰ Smale (1995) at page 8.

¹⁶¹ Macey (2008a).

¹⁶² *Jones v. Harris Assocs., L.P.*, 537 F.3d 728 at 730 (7th Cir. 2008).

officers do, a vantage point from which the executive compensation packages we have seen are reasonable and appropriate.”¹⁶³

Henry Butler and Fred McChesney address the question of whether directors have the incentive to do their job. Corporate law provides standard-form fiduciary duties of care and loyalty, but it is widely recognized that directors easily satisfy and rarely violate the standard of care. The authors theorize that market forces provide directors with an incentive to monitor performance of senior managers. They argue, without evidence, that competitive markets for outside directors’ services reward directors if the firms they monitor perform well. Also, directors know that they could lose their positions if the firm is taken over in a control transaction due to poor performance. The article argues that this market mechanism is frequently stronger than the legal constraints. (Butler 1999) Lynn Stout argues that values and character play an important role in board behavior. The penalty for breaches of the duty of loyalty is only to give back what was taken (not much incentive against theft). “It is only a slight exaggeration to suggest that a corporate director is statistically more likely to be attacked by killer bees than she is to have to ever pay damages for breach of the duty of care.” (Stout 2003)¹⁶⁴

Both of these ideas, that directors have economic incentives to monitor (Butler) and that they have personal motivations to do their job well (Stout), have some role in the behavior of boards. But the research on board monitoring cited earlier has a much stronger grounding in board observation and evidence, and appears to provide stronger support for the idea that boards don’t monitor attentively, tend to value collegiality above intervention, are influenced by pro-CEO attitudes, and avoid making hard decisions, especially the removal of a CEO. But the evidence on CEO turnover also supports the conclusion that boards will remove the CEO when they must¹⁶⁵ and may even resort to removal too often because they have few other mechanisms to regulate CEO behavior.¹⁶⁶

A survey of 150 directors of more than 300 companies and 44 fund managers with a total of \$3 trillion of assets under management shows that there is wide support for separating the roles of chair and CEO. (McKinsey & Co. 2004) Paul Hodgson¹⁶⁷ found that, when the same person serves as Chair and CEO, all authority is vested in one individual, eliminating checks

¹⁶³ Hill (2009) at page 335. Similar observations are reported by Useem (2006) and Sharpe (2012). Hermalin (2003) finds that CEO turnover is diminished by who chooses board candidates.

¹⁶⁴ Gordon (2007), Smale (1995), Weisbach (1988) argue for improved independence, but Larcker (2011a) and Langevoort (2001) find independence impedes performance and Ravina (2010), Hinsey (2007) and Leblancc (2005) question the effectiveness of independence. Olson (2008) questions the efficacy of any reforms.

¹⁶⁵ Even if it is sometimes too late to protect the corporation from damage.

¹⁶⁶ As might occur if the board had a stronger supervisory role or greater input on executive compensation.

¹⁶⁷ Executive compensation expert with GovernanceMetrics International.

and balances, and the balance of power. The CEO becomes charged with monitoring his or her self, presenting an obvious conflict of interest. In addition, individuals holding both titles are typically paid more than the combined total of separate CEOs and Chairs. More importantly, companies with combined Chair/CEOs present greater risks and lower stock prices than other companies. (Hodgson 2012)

A number of commentators have noticed a high concentration of CEOs on other companies' boards of directors. (Fich 2005) Fahlenbrach, Low and Stulz noted that CEOs on boards are thought to be more capable directors and may be useful to add prestige and assurance, but are suspected of entrenching management rather than advancing the interests of shareholders. They found no evidence of significant impact during their tenure on operating results, decision-making, compensation or monitoring. (Fahlenbrach 2010)¹⁶⁸

Accountability/ Discretion

Corporate management sometimes behaves as if whatever is not prohibited is permitted. Legal institutions which minimize liability and accountability support maximum discretion, and maximum discretion can lead to self-interested behavior. Of course, it also leads to quick, creative business ideas, strategy and action, which often lead to better corporate performance. As a result, rules limiting discretion or increasing accountability must be crafted with care to minimize their impact on beneficial behavior.

Outside directors almost never face actual out-of-pocket liability for good faith conduct, even when it is disastrous. Liability is almost entirely eliminated by indemnification and insurance. The primary risk is under securities law for insolvent companies and rich directors. From 1980 to 2005, only twelve cases involved financial losses to directors, including defense costs, and these cases included Enron, WorldCom and Tyco. The risk is almost entirely reputational. (Black 2006) This would tend to reduce the incentives for directors to monitor or restrict management, especially if they thought the behavior was unlikely to become public or to cause the business to fail.

One of the most important sources of discretion is the corporate norm of secrecy. Most corporations are vigilant in requiring directors, officers, employees and contractors to sign broad confidentiality agreements. Even when they do not, it is universally understood that all discussions, handouts, and decisions of the directors are confidential, and directors who breach this

¹⁶⁸ Faleye (2011) found that CEO directors increase CEO compensation, reduce sensitivity to firm performance, and systematically favor CEOs in performing monitoring duties. Elstein (2010), Kaufman (2006) and Hallock (1997) noted troubling consequences of CEO representation on boards.

expectation are usually purged, often before their term has expired.¹⁶⁹ These rules are supported by the courts as necessary protections for corporate trade secrets, confidential strategies, private financial arrangements, customer and employment relationships, and other competitive advantages dependent upon secrecy. Unfortunately, the courts rarely permit any inquiry regarding whether these purposes are being served by secrecy, which becomes a cloak for less beneficial purposes. (Nadel 1975)

Just as in government, sunlight might be the best corporate disinfectant, but companies tend to disclose only what they are required to disclose and what they decide will be beneficial to them to disclose. This becomes further protected by SEC rules which prohibit selective disclosure.¹⁷⁰ While federal securities laws also prohibit fraudulent, false, misleading and incomplete statements, no law or rule compels corporations to answer shareholders, reporters, analysts or anyone else who seeks information that the corporation does not want to share.

Jesse Fried points out that there is mounting evidence that markets are “noisy” and that share prices can deviate substantially and persistently from their long-term values. When markets are noisy and inefficient, they tend not to price the effects of insider extractions fully, especially where they impact future values more than current earnings. This includes seeking rules and making choices which tend to entrench management and to reduce shareholder power. Managers can benefit from noise fluctuations created by their own disclosures, by timing their option and share sale transactions. (Fried 2006)

The Decline of Fiduciary Duties in Corporate Law

Perhaps the greatest “disconnect” in corporate governance is the common expectation of investors that corporate directors and officers owe fiduciary duties to shareholders and the corporation. Robert Brown said:

“. . . state law [does] not impose meaningful obligations on the board of directors in supervising the activities of the company. . . States retained the authority to determine the duties and obligations of directors in management of the company through the establishment of fiduciary obligations. The obligations imposed on directors a duty to act with care, loyalty, and good faith.

¹⁶⁹ Most bylaws permit this by some specified vote of the board.

¹⁷⁰ Selective disclosure is the problem of companies providing material information to some, but not all, of the shareholders. The rules make it difficult to provide information except through press releases, analyst meetings, and similar forms of broad publication.

Over time, state courts interpreted the duties in a manner that left little substance. The business judgment rule¹⁷¹ and universal adoption of waiver of liability provisions¹⁷² all but eliminated causes of action for breach of the duty of care. The duty of loyalty, particularly self-dealing by officers and directors, could be validated through procedural mechanisms. With proper procedures, the fairness of the transaction was not subject to judicial review. The approach allowed self-dealing by officers and directors almost without limits.”¹⁷³

Mel Eisenberg notes that the obligational norm for directors’ level of care has become more stringent since 1990. Delaware court decisions required reasonable inquiry in order to invoke the business judgment rule and imposed duties to monitor and review, but these were effectively reversed by the enactment of director shield statutes.¹⁷⁴ The norm for board function has shifted from responsibility for managing the company to responsibility to monitor the management by others.¹⁷⁵ (Eisenberg 1999)

Julian Velasco noted that historically there were two fiduciary duties in corporate law, care and loyalty, with violations of loyalty the only one likely to lead to liability. In the 1980s and 1990s the Delaware Supreme Court revived the duty of care with a number of new standards and elevated the duty of good faith. In *Stone v. Ritter*, the court declared that good faith was a component of loyalty, effectively reversing the creation of a new third duty. (Velasco 2010)¹⁷⁶

Beyond the limitations on the application of fiduciary duties of care and loyalty to corporate directors and officers, directors are protected from liability under the business judgment rule for their decisions if they are (1) in good faith, (2) without self-dealing, (3) reasonably informed, and (4) a reasonable belief that it is in the corporation’s best interest. According to Kenneth Davis, all business decisions involve risk and imperfect information, and making directors liable for their mistakes would concentrate too much liability on them. Judges and juries are ill-equipped to review business decisions. Furthermore, business decisions cannot be reviewed fairly many years later. Because of the variety of businesses, circumstances and strategies, it is very difficult to establish standards that directors or courts could apply. (Davis 2000) The business judgment rule acts as an umbrella or backstop for the

¹⁷¹ Discussed below.

¹⁷² Waiver of liability provisions generally permit waiver of any potential liability of directors or officers for breach of the fiduciary duty of due care in exercising their duties. These provisions are permitted under Delaware corporate law and the laws of many other states, usually by inclusion in the corporate charter or a vote of shareholders.

¹⁷³ Brown (2004) at pages 318-319. Marsh (1966) points out that clear conflicts of interest can be protected from fiduciary liability by approval by independent directors. Fairfax (2005) argues that legal liability remains important.

¹⁷⁴ Another term for statutes permitting waivers of liability.

¹⁷⁵ By this, Eisenberg presumably means that the directors are no longer responsible for corporate decisions and can satisfy their responsibilities by showing that they asked reasonable questions and received satisfactory answers.

¹⁷⁶ This resolved a point argued back and forth by Veasey (2003), Sale (2004), Eisenberg (2006), and Strine (2010).

other mechanisms shielding boards and management from potential liability for breaches of fiduciary duties, and protects them from actions based on other theories as well.

Finally, directors and officers are routinely protected from liability by outside insurance and indemnification agreements with the company. Even though insurers have a strong reason to monitor and attempt to regulate corporate governance, but they do neither. It is management who buys this insurance and determines the terms, which have adapted to accommodate managements' interest in being unconstrained. (Baker 2007) But some potential penalties may remain. The Sarbanes-Oxley Act of 2002 mandated the "clawback"¹⁷⁷ of performance-based executive compensation when the performance is re-stated because of accounting and reporting errors. The *faithless servant doctrine* may permit clawback of other benefits, losses and penalties for officers' failures. (Warren 2010)

This system of governance has granted corporate management remarkable levels of compensation, job security, discretion, freedom from board interference and absence of liability for mistakes. It developed under a state legal framework which emphasized permissive and enabling rules, and a federal legal framework which exhibits a preference for disclosure rules and reliance on private ordering. It appears very well entrenched.

¹⁷⁷ Clawback is the recoupment of compensation that would not have been earned if the correct facts had been known.

Chapter 4.

Politics of Corporate Governance

The purpose of this chapter is to show how management interests have developed political tools and resources which are used to defend and enhance corporate governance mechanisms favorable to management.

Political influence has been a perennial tool of the wealthy and of business interests, including corporations, since before the founding of the United States. (Beard 1913) The rise of corporate political power paralleled the industrial revolution, growth of the railroads and the rise of the “Robber Barons” in America. Edwin Epstein opened his study of corporate political activity and regulation with this quotation:

“A United States Senator . . . represented something more than a state, more than even a region. He represented principalities and powers in business. One senator, for instance, represented the Union Pacific Railway System, another the New York Central, still another the insurance interests of New York and New Jersey . . . Coal and iron owned a coterie from the Middle and Eastern seaport states. Cotton had a half a dozen senators. And so it went.”¹⁷⁸

David Vogel points out that there have been numerous periods of resistance to, and increased regulation of, corporate political activity in general, including the Progressive era around 1900, the aftermath of the Great Depression in the 1930’s, and the consumer and environmental protection boom of the 1960’s and 1970’s. But he points out that business political power tends to grow when the public’s perception is that jobs and the economy are at risk. He also observes that business tends to be more powerful than reform interests more of the time. (Vogel 1989) Robert Collins notes a post-war pattern of repeated periods of loose controls on business to foster growth. (Collins 2000)

Business and management interests clearly do not win every battle, but Charles Lindblom concludes that government officials recognize the key role played by business in achieving material well-being, and grant access, cooperation and deference to them. He says that business has three advantages over other interest groups in actively influencing government decisions: use of company funds, existing organizations, and special access compared to other constituencies. (Lindblom 1977)¹⁷⁹

¹⁷⁸ Epstein (1968) at page 1, quoting White, William Allen, *Masks in a Pageant*, Macmillan (1928) at 79.

¹⁷⁹ Smith (1999) extended this into a structural power thesis, concluding that the demands of capital will trump popular control. Staats (2004) argues that the media and academia no longer act as a check on business.

The period beginning the late 1970's through today appears to be another of those times when business has held a favored position in American politics. The explosive growth of the regulatory state in the 1960's and 1970's,¹⁸⁰ possibly coupled with the demonstration of the power of political action by the left, stimulated American business and management interests to react. As will be developed further in this chapter, corporate leaders (a) organized, (b) built a much larger lobbying and political presence in Washington, (c) became more critical and more vocal against government regulation, and (d) developed a much closer relationship with an increasingly conservative Republican party in opposing government regulation and regulatory stringency. (Hacker 2010)

John Cioffi focuses on the corporate resistance to corporate governance reform. While noting corporate governance reform has been part of a resurgent regulatory state, he shows that pro-shareholder corporate governance reform proposals have met with fierce resistance from Wall Street and their Republican party allies. In consequence, he suggests, federal regulators have not placed adequate checks on management recklessness, incompetence, dishonesty or opportunism. He attributes this in part to the widespread belief among legislators and financial regulators, since the 1980's, in the potential of financial markets and shareholder-oriented corporate governance to deliver prosperity. Cioffi also stresses U.S. Senators' sensitivity to state interests in maintaining control over corporate law, and increasing resistance (beginning in the 1980's) in the courts to both SEC regulation and private litigation-driven enforcement. Consequently, regulation of corporate governance has depended upon disclosure rules (rather than prescriptive rules) and enforcement of securities law via *ex post* private litigation. The state courts, in cases based on corporate law, have avoided the imposition of fiduciary duties on boards (and managers) by stressing the business judgment rule. (Cioffi 2010)

Corporate Political Activity

In 1964 the Harvard Business Review published the results of a survey of business executive subscribers regarding their political activity, giving us a benchmark of sorts. It found 78% of subscribers were Republicans and 22% were Democrats.¹⁸¹ It also found that, although 78% thought increased political activity would improve the political climate toward business, almost 80% agree that business was *afraid* to get involved in political activities. Only

¹⁸⁰ It must have been intimidating to face the Clean Air Act, Clean Water Act, Environmental Protection Agency, Occupational Safety and Health Act, National Traffic Safety Commission, Consumer Product Safety Commission, and many others in quick succession and all in the midst of the Civil Rights movement and Anti-War (Vietnam) movement.

¹⁸¹ Not much room for independents, declines to state, or any other non-conformists.

a small majority (57%) reported contributing to political campaigns. The only step taken by a majority of companies was to urge employees to register and vote. “Most businessmen¹⁸² still limit their own political involvement to discussions of campaign issues and casting their ballots.”¹⁸³ The essence was that business political activity was insignificant.

A widely cited memorandum written by Lewis Powell in 1971, two months before he was nominated to the U.S. Supreme Court, is considered to be the dawn of the modern age of corporate political activity. “No thoughtful person can question that the American economic system is under broad attack. . . The most disquieting voices joining the chorus of criticism come from perfectly respectable elements of society: from the college campus, the pulpit, the media, the intellectual and literary journals, the arts and sciences, and from politicians.”¹⁸⁴ Powell pointed out that business people are highly focused on their businesses and have little skill or experience in dealing with public debate. They have responded with appeasement, ineptitude and ignoring the problem.

Powell asserted that the first requirement for effective action is for “businessmen to confront this problem as a primary responsibility of corporate management.” Powell argued that coordination is critical and that action must be organized with long-term planning, with joint financing, with a pooling of political power through united action and national organizations. He laid out an agenda for the U.S. Chamber of Commerce which called for countering the “leftist bias” of academia through sponsoring scholars, creating speakers bureaus, screening courses and textbooks, demanding equal time and coverage of pro-business perspectives, and “balanced” faculties. He also suggested constant media surveillance, a constant flow of scholarly articles, and a paid advertising campaign. In the political arena, he prescribed constant cultivation of power and influence, use of the courts through funding of lawsuits and briefs to support a systematic agenda, and the creation of an in-house pro-business law firm. (Powell 1971) In many ways, the business community followed the moves called for in Powell’s playbook.

David Vogel notes that, after the political environment became more responsive to pro-regulation advocacy movements and groups, business adopted the strategies of liberal groups to regain its position: research studies, opinion research, media campaigns, grassroots mobilization and coalition-building. Campaign finance reform created coordination through Political Action Committees (“PACs”). Corporate political activity had become a survival issue in the minds of CEOs. Personal lobbying, public affairs staffing and

¹⁸² Probably correct that business executives were overwhelmingly men in 1964, but it wouldn’t have been acceptable to say this a few years later.

¹⁸³ Harvard (1964) at page 23.

¹⁸⁴ Powell (1971) at page 1.

stature, Washington offices, retained lobbyists and D.C. lawyers increased dramatically. The U.S. Chamber, National Association of Manufacturers, and the Conference Board expanded, but a key change was the formation of the Business Roundtable, which proved extraordinarily effective because of the prestige of an “all-CEO” organization. Similarly, after the 1970’s, small business became subject to federal regulation and organized for the first time, becoming particularly effective at grass-roots organizing. The biggest difference was in cooperation and coalition-building.¹⁸⁵ (Vogel 1989)

Courses in political skills and strategy began to show up in business school curricula in the 1970’s, often built around a common text written at Harvard Business School called *Winning the Influence Game*. The most important aspect of these programs is that they are focused on long-term results. They call for taking advantage of issues that are already salient and re-framing them to accomplish corporate purposes. (Watkins 2001)

Jacob Hacker and Paul Pierson described the results of the shift in business political activity:

“The organizational counterattack of business in the 1970s was swift and sweeping—a domestic version of Shock and Awe. The number of corporations with public affairs offices in Washington grew from 100 in 1968 to over 500 in 1978. In 1971, only 175 firms had registered lobbyists in Washington, but by 1982, nearly 2,500 did. . .

What the numbers alone cannot show is something of potentially even greater significance: Employers learned how to work together to achieve shared political goals. As members of coalitions, firms could mobilize more proactively and on a much broader front. Corporate leaders became advocates not just for the narrow interests of their firms but also for the shared interests of business as a whole.

Ironically, this new capacity was in part an unexpected gift of Great Society liberalism. One of the distinctive features of the big expansion of government authority in the ‘60s and early ‘70s was that it created new forms of regulation that simultaneously affected many industries.”¹⁸⁶

Hacker and Pierson credit Lewis Powell’s memo with triggering a broad effort to expand the power of the U.S. Chamber of Commerce. It doubled in membership between 1974 and 1980, and its budget tripled. In 1972, three organizations merged to form the Business Roundtable. Within five years, its members included 113 of the *Fortune 200* CEOs, accounting for nearly half of

¹⁸⁵ Martin (1994) argues that business mobilization actually began in the 1960’s when President Kennedy found it useful to serve his agenda.

¹⁸⁶ Hacker (2010) at page 118.

the economy. Using rapidly emerging tools of marketing and communications, the Chamber and Roundtable learned to generate mass campaigns. The Roundtable, in particular, coordinated personal relationship-building with key legislators and regulators. Business interests also massively increased their political giving—at precisely the time when the cost of campaigns began to skyrocket.¹⁸⁷ Wealthy families like Coors, Olin, Scaife and Simon created institutions devoted to conservative issues, including AEI, Heritage Foundation and George Mason University. (Hacker 2010)

It is very difficult to obtain comparable data for most corporate political activity, but reporting is mandatory for congressional election campaigns and congressional lobbying. Thus, we know that the following amounts were contributed for the 2000 and 2012 U.S. Congressional Campaigns:¹⁸⁸

	<u>2000</u>	<u>2012</u>
Business interests ¹⁸⁹	\$1,230,237,000	1,558,009,000
Labor unions	90,088,000	84,940,000
Ideological groups	76,341,000	171,025,000
Other	144,839,000	340,058,000
TOTAL	\$1,541,505,000	2,154,032,000

The following amounts were spent on lobbying the U.S. Congress in 2000 and 2010:¹⁹⁰

	<u>2000</u>	<u>2010</u>
Business interests	\$1,440,021,000	3,035,231,000
Labor unions	27,214,000	46,339,000
Ideological groups	85,017,000	157,606,000
TOTAL	\$1,552,252,000	3,239,176,000

Thus, American business interests were spending roughly \$2 billion per year¹⁹¹ in 2000 and \$3.8 billion per year in 2012 on the U. S. Congress alone (a

¹⁸⁷ The causation is not clear. The cost of campaigns may have risen because more money was available from corporations.

¹⁸⁸ Data reported by Center for Responsive Politics, derived from Federal Elections Commission reports for the two-year election cycles ending December 31, 2000 and October 1, 2012; as reported on OpenSecrets.org on May 1, 2004 and October 20, 2012.

¹⁸⁹ These amounts are primarily contributions to campaigns and PACs by individuals associated with businesses (i.e., mostly management).

¹⁹⁰ Data reported by Center for Responsive Politics, derived from reports filed with the Secretary of the U.S. Senate and the Clerk of the U.S. House of Representatives for the one-year periods ending December 31, 2000 and December 31, 2010; as reported on OpenSecrets.org on May 1, 2004 and October 20, 2012.

¹⁹¹ Computed by taking one-half of the two-year campaign contribution figure and adding it to the one-year lobbying figure.

90% increase). And the amounts they spent increased significantly over the intervening 10-12 years. These amounts do not include the growing amounts of independent expenditures through 527 organizations, 501(c)(3) charities, 501(c)(4) groups, trade associations and directly, as authorized by the U.S. Supreme Court's *Citizens United* ruling. They also exclude any amounts spent on contributions to state propositions, political and judicial campaigns, and on lobbying federal regulatory agencies or state government. There is essentially no disclosure required for any of these other amounts, except in a few states.

Corporate Political Speech

Corporations' political speech rights are derived from *Santa Clara County v. Southern Pacific Railroad Company*,¹⁹² which held that corporations are persons under the Fourteenth Amendment. There is little debate that corporations need to have certain rights, especially to own property, make contracts, sue and be sued, and probably even due process and equal protection as conceived by the Fourteenth Amendment. It is far less clear that corporations needed to be treated as persons to accomplish this, given that personhood has grown to encompass most of the rights of a natural, human person. This decision is interesting because it appears that business interests were represented in the drafting of the Fourteenth Amendment, the use of the term "persons" to facilitate the inclusion of corporations, and in meetings with the Supreme Court justice who initially heard the case;¹⁹³ the inclusion of the decision in a headnote added after the opinion had been announced; the complete absence of reasoning to support the decision; the complete irrelevance of the decision to the issues in the case; and the fact that the headnote recites facts which contradict the record of the case.¹⁹⁴

The importance of *Santa Clara* goes well beyond demonstrating the political power of business at an early date and giving corporations political speech rights. By treating corporations as normal persons, the ruling shifted the burden of justifying regulations to the state. Morton Horwitz put it this way: "Since corporations could no longer be treated as special creatures of the state, they were entitled to the same privileges as all other individuals and groups."¹⁹⁵

The development of political rights for corporations, themselves,¹⁹⁶ has been a key element of managers' ability to magnify their political views through the use of corporate resources. This, in turn, has created the

¹⁹² 118 U.S. 394 (1886).

¹⁹³ Kens (1997), Graham (1938a, 1938b, 2010), Swisher (1930)

¹⁹⁴ Records and Briefs of the Supreme Court of the United States on microfilm produced by Scholarly Resources, Inc. (Wilmington, DE), Part Four (1881-1890), Volume 565, Roll No. 259 show that the issue was briefed and argued, despite the statements in the headnote.

¹⁹⁵ Horwitz (1985) at page 183.

¹⁹⁶ As opposed to their wealthy shareholders or managers as individuals.

opportunity for management to oppose corporate governance reforms and strengthen their discretion over corporate decisions and compensation.¹⁹⁷

Corporate Political Contributions

One of the few areas where corporations were not quickly granted Constitutional rights was in free speech under the First Amendment. By the late 1800's there were indications that in the era of the Robber Barons, business influence on legislatures had become a concern to ordinary citizens. Several states had prohibited corporate campaign contributions.¹⁹⁸ The campaign of 1904 resulted in accusations that President Theodore Roosevelt (later the "trust-buster") had taken contributions from corporations interested in receiving favors and the public was becoming "suspicious of the political role of corporations."¹⁹⁹ In 1907 Congress passed the Tillman Act, which initially banned only corporate cash contributions to a political committee. In the Tillman Act's current incarnation, it is a criminal offense for any nationally chartered entity, corporation or labor union to make contributions or expenditures supporting any candidate for federal office in any election.²⁰⁰ But the Tillman Act does not apply to campaign contributions by managers.²⁰¹

Subsequent Supreme Court decisions have granted corporations the right to do just about anything else to support political campaigns, candidates, committees, and ballot measures. These decisions are generally based on findings that there is no evidence that corporate contributions corrupt democracy, that there is no imbalance of resources, or that corporations might be coerced to contribute by candidates. The decisions generally follow the rationale that the public's right to hear ideas trumps other considerations.

Corporations are also free to sponsor Political Action Committees and to pay their administrative costs. Corporate directors, officers, employees and shareholders are free to contribute to the PAC and to act as PAC officers, and the PAC is free to use its resources to support the corporation's preferred candidates.²⁰²

There is essentially no evidence that PAC contributions buy votes and most apparent bribes may be explained as contributions to legislators who

¹⁹⁷ Brudney (1981), Dan-Cohen (1986), Greenwood (1998) and Joo (2004) argue that corporate political speech is coercive to shareholders, whose resources are being diverted by managers to pay for it. Sitkoff (2002) views this as a mere agency problem. Gerencser (2005) points out that corporate political speech rights fail to consider the unequal resources held by corporations.

¹⁹⁸ Pollock (1926) at pages 8-9.

¹⁹⁹ Epstein (1968) at pages 10-11.

²⁰⁰ 2 U.S.C. Sec. 441b.

²⁰¹ The large amounts of business contributions to U.S. congressional candidates thus came mostly from managers because the corporation itself cannot contribute.

²⁰² See Baran (2002).

were already supporters. There is no feasible way to compile objective evidence of lesser favors obtained by making contributions. There is also a practical problem in long-term contribution relationships: is the vote because of a contribution or is the contribution because of a vote? Most contributions are solicited by politicians and most contributions are not tied to the legislators' districts. More important than contributions, however, is whether an interest group can mobilize significant numbers of electoral votes for or against the legislator. (Wright 1996)²⁰³

But a 1998 interview study by Dan Clawson, et. al., looked at the motivations of the corporate managers who made the decisions regarding corporate political activities. They describe an extremely complex and indirect process of corporate political contributions and expenditures which creates a "field" or "system" or "loose overlapping network" of activity that is pursued honorably and innocently by individual corporations, who believe that their individual actions are inadequate to buy votes. These "gifts," not "bribes," create a network of past and future obligations on the part of legislators who grow dependent upon the funds for electoral campaigns. Many of the corporate managers describe acting defensively against the risk of unrealistic government policies, although increasingly they find that they are "inundated with requests for money" from legislators. Most of the contributions are made to assure access to legislators merely to present their views and to warn of consequences of pending legislation. President Clinton is quoted as saying: "They should get a respectful hearing."²⁰⁴ The result is a system where legislators often can only afford the time to see those who contribute (and, according to David Austin-Smith, sometimes only those who contribute and have views similar to the legislator²⁰⁵). The contributors don't necessarily get what they want on big, visible issues, but tend to get subtle favors on many invisible issues that result in a "million singles."²⁰⁶ (Clawson 1998)

Clawson, et. al., also describe a trend, beginning around 1980, toward more ideological spending and greater alignment by corporations. The memo written by Lewis Powell for the U.S. Chamber of Commerce, which outlined a strategy of corporate activism to counter the "attack" on the American economic system, was discussed above.²⁰⁷ Powell's views were taken up by Ronald Reagan and William Simon (later President Reagan and Treasury Secretary Simon), who asked, "Why does half of the business PAC money go to candidates who may not be friends of business? The best thing you can hope for by following an anti-business incumbent contribution policy is that the

²⁰³ Fisch (2005) supports this conclusion and cites extensive empirical research.

²⁰⁴ New York Times, January 29, 1997, at B6.

²⁰⁵ Austen-Smith (1995).

²⁰⁶ This phenomenon was also found in a quantitative study of foreign corporation political activity in the United States, Hansen (Dec., 2000).

²⁰⁷ Powell (1971)

alligator will eat you last”²⁰⁸ and such contributions are “appeasement on a breathtaking scale.”²⁰⁹ These efforts led to a series of letters from the Business Roundtable urging corporations to reduce their contributions to liberal and moderate incumbents and to shift support to candidacies of conservative challengers. The results came to fruition in 1980 and tend to refute the assumption that business interests are diverse.²¹⁰ The Clawson, et. al., study found that after 1980:

“In about 3 out of 4 races, business can be classified as unified, giving about 9 times as much to one candidate as to the other; in 1 out of 5 races it provides predominant support to one candidate, giving him or her 2 to 9 times as much as the opponent; and in only 1 race out of 15 is business divided . . . A complicated computer simulation led us to conclude that PAC officers may disagree with their counterparts at other corporations, but the unstated rules forbid public disputes, and only reluctantly will one business directly oppose another.”²¹¹

The threshold problem with all political contributions, and corporate political contributions in particular,²¹² is that they appear to be bribes. Political contributions tend to come from persons who have an interest in some action by a politician, whether that action preceded or followed the contribution. The common understanding of the motivation of the donor is a payoff of some sort. But American law has generally taken a very narrow approach to political bribery, making it almost impossible to prove. There is no norm of avoiding the appearance of impropriety. The recipient must explicitly agree to take something of value in exchange for a discretionary political act in order for it to be a crime. Only the most inept donors or larcenous politicians manage to leave a sufficient evidentiary trail to risk meeting this standard. Merely voting in favor of one’s donors is not sufficient. The “disconnect” between the public’s understanding that most contributions are made for a reason²¹³ and their awareness that their representatives tend to favor their contributors²¹⁴ creates tremendous distrust and disrespect of democratic institutions. But it is all perfectly legal under the laws passed by our representatives. (Lowenstein 1985, Lindgren 1988)

In an impressive series of studies, Thomas Stratmann built an increasingly strong case for a relationship between political contributions and

²⁰⁸ Ronald Reagan quoted in Clawson (1998) at page 140.

²⁰⁹ William E. Simon quoted in Clawson (1998) at page 140.

²¹⁰ Clawson (1998) at page 151.

²¹¹ Clawson (1998) at page 169.

²¹² Because corporations are presumed to have more instrumental motivations for economic results, while individuals are more likely to have cultural, philosophical or ideological motivations. The profit motive behind corporate contributions is supported by Mitchell (1997b).

²¹³ As documented in Clawson (1998).

²¹⁴ West (2000), among many others.

legislative outcomes. By focusing on congressional votes on farm subsidies (where the benefits are highly concentrated and the burden is diffuse), Stratmann finds in eight out of ten votes that contributions are an important determinant of legislators voting behavior. Relatively small amounts of contributions can have an important effect on the outcome. He went on to show that contributors spend their funds in a very sophisticated manner, making smaller contributions to legislators whose districts' voters already compel support for the contributor's goals. He also showed that contributions are made to influence legislative voting and not merely to support preferred candidates. They time their contributions to be near the time of crucial votes. The article suggests that proximity in time is a mechanism to insure performance of the "implicit contract" between legislators and contributors. (Stratmann 1991, 1992, 1998)

The Conference Board²¹⁵ noted that corporate involvement in politics is often overlooked in corporate governance. In the 2006 election cycle, 73% of "hard money" contributions were from individuals and PACs identified with corporations. Significant charges, fines and penalties to corporations have resulted from their sponsorship of PACs and their failure to enforce all of the contribution and reporting rules. In large measure, these problems have resulted from lack of disclosure of political spending. As of March 2008, only 43 large public companies have adopted policies of disclosure and board oversight. (Conference Board 2008)

Lobbying

The data quoted above on corporate political expenditures show that corporations spend more on lobbying than contributions, and that the gap is growing.

Kay Schlozman and John Tierney wrote that the nature of lobbying has become highly sophisticated, although there are still favors, travel and entertainment given on a smaller scale. The focus of activity, in order of importance, is Congress, Executive Agencies, the White House and then the Courts. Interest groups' influence is likely to be less on highly visible issues and more likely to affect outcomes on less emotional or partisan matters. They are also more effective on defensive issues, where they are resisting new legislation, because of the multiple vetoes in the Constitutional system. Direct lobbying consumes the most time and resources. Contacts and information, both to the government and among interest groups, are probably the most important resources. So is the "revolving door," the expectation of future private employment for officials.

Schlozman and Tierney conclude that:

²¹⁵ A corporation-oriented and corporation-supported organization.

“ . . . organized interests rarely determine policy outcomes on important issues; the best that they can hope to do is to influence the details of policies. . . the ability to have an impact on the details is not in the least a trivial form of influence. . . How such particulars are defined determines whether a measure will be a mere symbolic gesture or a potentially effective policy.”²¹⁶

John Wright offers an informational theory of business political activity: “The central argument is that interest groups achieve influence through the acquisition and strategic transmission of information that legislators need to make good public policy and to get reelected. Indeed, most of what interest groups and lobbyists do involves acquiring expert information about policy and politics and reporting this information to legislators.”²¹⁷ All lobbying begins with access. Legislators usually have a pretty good idea of the economic impact, social equity and political viability of proposals before the lobbyist reaches them, but may be uncertain and willing to revise their beliefs if presented with persuasive information about any of these aspects. Legislators are concerned about re-election, good policy and influence within the legislature. Information and steps which secure these are particularly valuable. Lobbyists have become skilled at obtaining or creating this sort of information. Information and steps which are costly to perform and acquire are clearly the most valuable because they signal the greatest intensity, commitment and likelihood of reward to the legislator. Lobbyists are also adept at creating and countering disputes about the validity of information, a frequent element of political confrontation. While outright misrepresentation is rare, framing, spin, misimpression and other strategic manipulation have become common. (Wright 1996)

Sar Levitan and Martha Cooper highlighted the effectiveness of three great advantages of business lobbying: teamwork, depth and persistence. The authors demonstrate the necessity of controlling the agenda by proposing alternative policies, packaged with the public-oriented arguments that support them. Constant vigilance and political intelligence are crucial to ensuring that issues don't get away from business lobbies. (Levitan 1984)

Frank Baumgartner and Beth Leech report recent research which indicates that interest groups seek niches where there is less competition. While the great legislative battles involving armies of lobbyists draw the most attention, the preponderance of the issues appears to progress without much attention and with few interests represented. Many interest groups report being able to focus on only one issue at a time, leaving the others unopposed.

²¹⁶ Schlozman (1986) at pages 310-311.

²¹⁷ Wright (1996) at page 2.

And the clear advantage in terms of resources available to focus on these niche issues lies with business.²¹⁸ (Baumgartner 2001)

Business Organizations

The 1971 Lewis Powell memorandum stressed the need for business to organize to protect its interests. It was not that there was a lack of organizations before the memorandum. Each industry had its trade organization and many of them were politically active. But there were not many that looked after the overall, common interests of business, and those that did were not particularly powerful. Two groups rose to the call. They are exceptionally important in corporate political activity today because they are both public charities, which means that contributions to them are not reported, and because they have become the strongest voices on a wide array of legislative and regulatory issues, especially corporate governance.

Kim McQuaid described the Business Roundtable in the 1970's. During the 1970's, managers quit thinking of themselves as powerless in government and began to participate. The Business Roundtable was formed as an outgrowth of the Business Council by the CEOs, chairmen or presidents of the largest companies representing about half of the then current GNP. Its purpose is to promote broad big-business issues with the legislatures and regulatory agencies, especially through the direct participation of top business leaders as lobbyists.²¹⁹ It operates with a minimum of publicity or public disclosure. The Business Roundtable has become very effective at negotiating results at the congressional committee level, using its expert staff, carefully built connections, and taking strong positions in positive ways, followed by pragmatic, strategic compromise. (McQuaid 1981)

The second major business organization, the U.S. Chamber of Commerce, was described by the Economist in 2012. It was founded in 1912, but did not become an independent force until 1997, when Thomas Donahue moved from the American Trucking Association into the Chamber's chief executive position. "His goal, he wrote at the time, 'is simple—to build the biggest gorilla in this town—the most aggressive and vigorous business advocate our nation has ever seen.'" In 2010 it took in \$189 million, roughly five times its revenue before Donohue. It spent over \$130 million on lobbying and political activities in 2010, including outside lobbyists, issue advocacy advertising, and election spending. (Economist 2012)

²¹⁸ From my review of the list of issues, there is no indication that the less salient ones are unimportant.

²¹⁹ The Business Roundtable's staff routinely organizes congressional "tours," for which it prepares the CEOs in attendance with the statistics on how many jobs their companies represent in the particular legislator's district.

Litigation

In 1974 Marc Galanter made the profoundly simple observation that “repeat players” in litigation have systematic advantages over “one-shotters,” because of the value of experience, evolution of contracts, access to specialists, reduced start-up costs, informal relationships with institutions and courts, incentives and commitment to win, ability to play the odds, ability to pay for rules (lobbying, etc.), ability to play for rules (i.e., to invest in litigation to establish precedent), ability to discern which rules are worth investment, and ability to invest resources needed to win. While his observation applies more generally, it is only business and government which have the resources to take advantage of this, and only business which has the continuity of incentives to do it. (Galanter 1974)

In 2001 Robert Kagan added the insight that American law is uniquely adversarial, for a number of political and institutional reasons. He noted, in particular, that this results from the fragmented economic structure and fragmented regulatory environment of the United States, which depends on litigation for resolution of conflicts. This emphasis on litigation creates another systematic advantage for business because business can better afford the cost, uncertainty, inequality, and delay. (Kagan 2001)

Jeffrey Rosen describes the success of the long-term efforts of the U.S. Chamber of Commerce, beginning with the 1971 Lewis Powell memorandum, to advance the interests of business in the courts through lobbying, judicial appointments, shifts in review standards, limitations on damages, litigation support (such as rehearsals, argument reviews, briefing assistance, etc.), development of a specialized and experienced pro-business appellate bar, and coordinated litigation campaigns. Rosen also credits the success of the Law and Economics movement in leading courts to focus on economic efficiency and to favor free markets and competition, over protections for investors, consumers and employees.²²⁰ (Rosen 2008)

One area of particular success for business has been the long-running campaign for “tort reform.” Framed as an effort to rein-in runaway trial lawyers and frivolous lawsuits, this was a lobbying and public relations campaign for legislative changes to the rules of litigation and an effort to limit private remedies at the same time that public remedies were being abandoned through de-regulation. One of the most successful examples is the Private Securities Litigation Reform Act of 1995 (“PSLRA”), enacted as a part of Newt Gingrich’s “Contract with America” following the Republican Revolution of 1994. John Avery describes how its proponents conducted a professional

²²⁰ It seems likely, although I did not find any research on the question, that the willingness of both the U.S. Chamber of Commerce and the Business Roundtable to litigate vigorously would have the effect of reinforcing their lobbying efforts with regulatory agencies.

public relations campaign which created the impression of a class-action litigation explosion.²²¹ The resulting legislation limited causes of action to cases where the plaintiff already had and could plead specific evidence of the fraud; instituted proportional liability; limited the fraud-on-the-market theory; forced institutional investors to act as lead plaintiffs; created safe harbors for forward-looking statements; cut attorneys' fees; and reversed many other advantages of securities class actions. (Avery 1996) The effect was to reduce securities class actions and the risk of liability of corporate directors for the actions of corporate management. When trial lawyers shifted class action filings to state courts, the Institute for Legal Reform--an entity of the U.S. Chamber of Commerce--lobbied for the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), which extended PSLRA to the states.

Adam Pritchard studied the effects of PSLRA and noted that, although more cases are being dismissed now, the ones that survive lead to larger settlements. More important, he observed that one of the dirty secrets of securities litigation is that, although the principal beneficiaries of securities fraud are usually corporate executives, they themselves almost never contribute to the cost of settlements. The shareholders who were harmed by the fraud end up paying the cost of the settlement (or the premiums on the insurance that pays it). The gatekeepers, who should have prevented the fraud, including underwriters, lawyers, accountants and other professionals, are also protected by PSLRA.²²² (Pritchard 2003)

Regulatory Agencies

James Wilson wrote: ". . . a liberal democracy can only formulate public purpose and protect constitutional procedures if the government itself is not the instrument of some private faction that seeks to use public powers for narrow or self-seeking ends."²²³ The decline in popular confidence in government is partly the result of a belief that government benefits a few large interests. Regulatory agencies are not infrequently "captured" by business interests and used to maximize profits through controlling prices and limiting competition. (Wilson 1980)

A Common Cause study found that 48 percent of departing commissioners of various regulatory agencies were later employed in the industries they regulated during 1971-75; the next highest category was retirement. The important question is whether agency officials view their behavior favorable to industry as enhancing their employment prospects. Paul Quirk questions whether these opportunities are "delayed bribes" because industry motivation in hiring former officials is also likely to be

²²¹ While it is clear that class action litigation was increasing, it is not clear that it was unjustified.

²²² He doesn't mention directors.

²²³ Wilson (1980) at Introduction page vii.

related to their familiarity, connections and expertise. Accordingly, there was little direct indication of incentives leading to agency capture. (Quirk 1981) Martha Derthick and Paul Quirk looked at the significant deregulation of the economy which occurred between 1975 and 1981, and reached the overall conclusion that the idea of deregulation became a “policy fashion” and took on a life of its own that exceeded the original pro-competitive intention. (Derthick 1985)

Thus, evidence of regulatory capture and influence as a universal phenomenon is lacking. But surely it does occur, and seems to be most likely with respect to agencies that focus on a specific industry, such as securities regulation. While systematic evidence of direct capture of the SEC is not abundant, Cioffi (2010) and Hacker (2010) detail the intense efforts and successes of the Wall Street firms in pushing deregulation of banking by the repeal of the Glass Steagall Act and in blocking the regulation of derivatives, the subprime mortgage market and other practices that led to the financial crisis and great recession of 2008.

And former SEC Chairman Arthur Levitt offered this summation of business lobbying at regulatory agencies:

“During my seven and a half years in Washington . . . nothing astounded me more that witnessing powerful interest groups in full swing when they thought a proposed rule or piece of legislation might hurt them, giving nary a thought to how the proposal might help the investing public. With laserlike precision, groups representing Wall Street firms, mutual fund companies, accounting firms, or corporate managers would quickly set about to defeat even minor threats. Individual investors, with no organized labor or trade association to represent their views in Washington, never knew what hit them.”²²⁴

The bottom line is that management interests are pervasively active in the political process. Not only are small investors unrepresented, but institutional investors face well-funded, sophisticated, and intense opposition to any reform they seek. This doesn’t guaranty failure, but it makes mobilization difficult because it raises the level of resources and coordination needed for success, and it signals the threat of a damaging counter-attack.

²²⁴ Levitt (2002) at page 250.

Chapter 5.

Economics of Corporate Governance

The purpose of this chapter is to introduce several broad economic ideas which have bearing on the ability of institutional investors to accomplish corporate governance reform, as well as a number of economic analyses of the value of corporate governance reforms and provisions. It also covers some of the economic thinking behind the idea of a market for corporate governance that is integral to the “race to the bottom” issue.²²⁵

While there has been a stream of economic theories which relate to business and corporations going back to Adam Smith and Karl Marx, modern ideas of corporate economic theory really began in the 1930s with Berle & Means and Coase.²²⁶ But even these focused on particular ideas or problems, and more comprehensive treatments of corporations and corporate governance²²⁷ did not appear until the beginnings of the Law and Economics movement.

The field of Law and Economics has created a quiet revolution in the law over the last thirty years, persuading many legal academics, judges, and legislators to emphasize economic efficiency over considerations of distributional fairness. These changes have upended many of the fundamental conceptions of rights and equity drawn from the English Common Law, and are now reflected in American corporate law in areas such as fiduciary duties and shareholders’ rights. These ideas have tended to favor managerial discretion and have tended to be at odds with lay expectations of law, rights and fairness.

The field of Information Economics has questioned the traditional economic assumption that information was perfect and free. Joseph Stiglitz said:

“Modern information economics turned these presumptions on their head: even small information costs can have large consequences, and many of the standard results . . . do not hold even when there are small imperfections of information.”²²⁸ “The fundamental breakthrough in the economics of information was the recognition that information was fundamentally different from other ‘commodities.’ It possesses many of the properties of a public good—its consumption is nonrivalrous, and

²²⁵ Introduced in Chapter 2.

²²⁶ Discussed below.

²²⁷ See, for example, Bainbridge (2002), Easterbrook (1991), Posner (1980), and Viscusi (2000).

²²⁸ Stiglitz (2000) at pages 1443-1444.

so, even if it is possible to exclude others from enjoying its benefits of some piece of knowledge, it is socially inefficient to do so.”²²⁹

The relatively new field of Behavioral Economics²³⁰ is just beginning to give us an understanding of why there is often a tension between economically efficient rules and instinctively fair rules.²³¹ Psychologists and behavioral economists are devising experiments which show that human beings of many cultures have deeply-embedded conceptions of fairness in rules related to property, contracts, and economic transactions. More important, experiments are showing that humans frequently value fairness and equity more highly than material income and wealth. In welfare economics terms, people may well get more utility from fair treatment than from a greater share.

Behavioral economics also adds to the understanding of various other apparent exceptions to the rational actor assumption of traditional economics. It shows that we do not do a very good job of estimating the impact of rare or unlikely events. We often overcompensate for events with frightening consequences and underestimate the effects of those events more easily forgotten. Behavioral economics points up our inability to consider many factors simultaneously and our tendency to focus on those factors which were important in our recent experience. It also contributes to our understanding of humans’ excessive focus on the most immediate or near-term conditions, even when there is a more important event likely looming. These observations all seem to offer hope of a better understanding of the economics of corporate governance as they develop.

Theories of the Firm, Capitalism and Contracting

Hernando de Soto argues that contracts, property rights and recorded title are prerequisites to the use of capital, but they must operate efficiently. The creation of this legal infrastructure was key to capitalism in the West. (De Soto 2000) But Stewart Macaulay pointed out that business often fails to plan transactions and relationships completely and rarely uses legal sanctions to repair relationships or to settle disputes. Solutions are usually reached informally based on the value of the relationship. (Macaulay 1963)

In 1937 Ronald Coase noted that the most important characteristic of a firm is that the external market is replaced by entrepreneurial decisions. Transaction costs are avoided at the cost of a likely loss of efficiency.²³² (Coase 1937) But Coase’s key contribution is the idea that, absent

²²⁹ Stiglitz (2000) at page 1448.

²³⁰ See, for example, Shleifer (2000), Sunstein (2000) and Thaler (2005)

²³¹ See Frank (1995).

²³² Because the pricing determined by managers may not be the price determined by the market.

transaction costs, parties would naturally tend to negotiate transactions on the most efficient terms, regardless of the legal rights and rules that apply. (Coase 1960)

Frank Easterbrook and Daniel Fischel view a corporation as a “nexus of contracts.” Management is given vast discretion over most business decisions, but competitive conditions constrain the choices, the market is free to determine the value of the enterprise, and this ultimately controls the behavior of management. “It is inevitable that a substantial amount of undesirable slack or self-dealing will occur. The question is whether these costs can be cut by mechanisms that are not themselves more costly.”²³³ This is the essential challenge of corporate governance.²³⁴

Agency Costs

Adolf Berle and Gardiner Means’ 1932 book *The Modern Corporation & Private Property* was not the beginning of corporate governance as a field. The subject had been discussed for several decades, beginning essentially with the adoption of the states’ general corporation laws in the late 1800’s. The topic of shareholder protection was debated vigorously during the 1920’s, when many people saw that wild growth was obscuring corporate abuses. (Wells 2010)

What Berle and Means contributed was the first clear statement of the reason for widespread fraud and corruption within corporations that led to the 1929 Crash. The cause was the separation of ownership from control of the modern corporation, which arose from dispersed ownership²³⁵ and the reliance on hired managers. The interests of directors and managers frequently diverge from the interests of shareholders.²³⁶ This led to the emergence of the “quasi-public corporation” which often has tremendous size and usually relies upon the public capital markets, leading to increased economic concentration. Berle and Means predicted that this would lead to “undaunted managerial power” which would act without regard for shareholder interests and that those who control the corporation could serve their own pockets better by profiting at the expense of the company than by making profits for it. They were extremely concerned that hired management tends to lack the self-interest necessary to insure that economic resources are allocated to their most productive use. Ultimately, they thought that

²³³ Easterbrook (1991) at page 7. Hart (1995) also reached a similar conclusion about agency costs, which were first raised by Berle and Means. See Introduction and below.

²³⁴ Klausner (1995) and Hansmann (1988) question whether free contracting is efficient.

²³⁵ See Roe (1991 and 1994), discussed in Chapter 6.

²³⁶ Blanchard (1994) showed that this actually results in management diversion of corporate resources.

corporations would grow larger and more powerful than the state, particularly in the economic arena.²³⁷ (Berle 1932)

Michael Jensen and William Meckling added to the understanding of agency costs, noting that they consist of the cost of monitoring and enforcement by the principal, the bonding cost²³⁸ of the agent and the unavoidable losses due to the behavior of agents. If the equity market anticipates these agency costs correctly,²³⁹ the owner will bear the entire effect upon sale of outside equity.²⁴⁰ *The agent will have an incentive to extract benefits whenever 100% of the benefit is worth more than the reduction in the agent's share of profits.* No amount of monitoring and bonding can restore the organization to the same performance it would have attained if the agent had received 100% of the profits.²⁴¹ (Jensen 1976) This article is often credited as the origin for the idea of using incentive compensation to try to align managements' interests with the shareholders' interests.

Agency costs are rarely outright theft. They often take the form of misuse of managers' superior information, as in the negotiation of excess compensation or trading on inside information or failure to inform the board of important trends or events. They can include shirking of duties or avoiding performance pressure or making decisions that are more beneficial to management than to the shareholders. They can come close to theft, as when management spends money on excessive perquisites and extravagant working conditions. More questionable are managers who engage in transactions with the corporation or take business opportunities that should have belonged to the corporation. The management entrenchment moves discussed in Chapter 3 are also forms of agency cost.

It is arguable that corporate managers are not even agents anymore, as the liberalization of fiduciary duties has evolved to the point where managers have no duties to the shareholders directly and mostly avoidable duties to the corporation.

Collective Action Problem

Mancur Olson identified a problem that is one of the greatest impediments for institutional investors in the corporate governance reform efforts:

²³⁷ Fama (1980 and 1983b) argue that separation of ownership and control is more efficient because it permits specialization.

²³⁸ Bonding cost is the cost of actions to persuade other parties that the agent will act in their best interest.

²³⁹ Which is extremely difficult.

²⁴⁰ Fama (1983a) points out that this residual claim creates the incentive to monitor.

²⁴¹ i.e., unless the agent owns the enterprise, there is never enough incentive to perform as well as a principal who also manages and receives 100% of the results.

“ . . . it is *not* in fact true that the idea that groups will act in their self-interest follows logically from the premise of rational and self-interested behavior. It does *not* follow, because all of the individuals in a group would gain if they achieved their group objective, that they would act to achieve that objective, even if they were all rational and self-interested. Indeed, unless the number of individuals in a group is quite small, or unless there is coercion or some other special device to make individuals act in their common interest, *rational, self-interested individuals will not act to achieve their common or group interests . . .* These points hold true even when there is unanimous agreement in a group about the common good and the methods of achieving it.”²⁴²

Organizations exist to serve the common interests of their members. In addition, each member has individual interests and the individuals benefit if others bear the costs of collective action. It is not rational to expend resources to support the common purpose, if others will. Olson identifies three factors operating to cause this problem in large organizations: (1) The larger the organization, the smaller the fraction of the group benefit any member receives and the smaller the motivation for group-oriented investment of resources; (2) the larger the organization, the smaller the absolute benefit to any member and the less likelihood that the benefits will outweigh the costs to produce even a small amount; and (3) the larger the organization, the greater the initial startup costs. (Olson 1965)

The problem of collective action is critical to corporate governance at almost every turn. It is hardly worthwhile for a minority shareholder to vote in corporate elections. It is not uncommon for the annual meeting proxy statement to run to hundreds of pages. It requires a very high level of professional knowledge to understand what the financial statements and other disclosures really mean. It is very challenging to obtain comparable information about competitors or similar companies, in order to apply any perspective. There is essentially no way for a shareholder to obtain information about the backgrounds, skills, beliefs or intentions of corporate board candidates. There is rarely any objective news coverage of corporate elections, except when there is a major scandal. It is far easier to let the other shareholders go through these efforts and assume that they will have the same interests.²⁴³

Exit or Voice

The traditional corporate or Wall Street answer to any investor who is dissatisfied with the actions or performance of corporate management is that they can take a “Wall Street Walk.” That means, simply, that they can sell

²⁴² Olson (1965) at page 2.

²⁴³ This is also known as the “free rider problem.” Becht (2002) identifies five mitigating circumstances.

their shares. But this is usually after the investor has discovered the problem and the market has already adjusted the price of the shares to account for the damage, so the investor bears the loss.

Albert Hirschman developed a rigorous analysis of this problem. Society has mechanisms to remedy deterioration in performance: other participants may exit the relationship or exercise their voice to complain. But the presence of profit margins and consumer surplus make it possible for prolonged periods of mediocre performance (slack) when competition is not as robust as economists presume. Economics tends to favor exit and ignore voice; politics views exit as desertion and favors voice. The result is that there is little understanding of the relationship between exit and voice.

Hirschman says that exit provides a signal to leadership that it has failed to match the advantages offered by competing organizations. The cost of exit to the investor is usually less than the cost (and risk) of voice.²⁴⁴ Resort to voice also provides a signal, but in circumstances where the customer or member finds it more efficient to induce change through communication. This is a greater opportunity for leadership to recover without significant loss.

Voice doesn't work well when the participants most likely to use it are also the first to exit, leaving only the less vocal participants. Hirschman says:

“The relation between corporate management and the stockholders is a case in point. When the management of a corporation deteriorates, the first reaction of the best-informed stockholders is to look around for the stock of better-managed companies. In thus orienting themselves toward exit, rather than toward voice, investors are said to follow the Wall Street rule that ‘if you do not like management you should sell your stock.’ According to a well-known manual this rule ‘results in perpetuating bad management and bad policies.’²⁴⁵ Naturally, it is not so much the Wall Street rule that is at fault as the ready availability of alternative investment opportunities in the stock market which makes any resort to voice rather than exit unthinkable for any but the most committed stockholder.”²⁴⁶

Loyalty may hold exit at bay and activate voice. But the threat of exit is crucial to bringing about change. (Hirschman 1970)

One possible constraint on exit is the unavailability of alternatives or a high cost of accessing alternatives. The problem of inadequate alternatives

²⁴⁴ Admati (2010) argues that exit, or the threat of exit, is also an effective form of voice.

²⁴⁵ Graham (1961) at page 616.

²⁴⁶ Hirschman (1970) at page 46.

could arise if the conduct in question is comparable and consistent among most corporations, as when executive compensation is established by careful comparison to the alternative companies.²⁴⁷ The lack of alternatives has the effect of sheltering excessive compensation because it is just as high at the other companies that would be re-investment alternatives. In effect, there is a zone where companies can raise compensation without fear of triggering exit so long as they do it a little bit at a time and don't get so far ahead of the alternatives that the allocable share of excess compensation exceeds the cost of sale and reinvestment. And the cost of sale and reinvestment is often much higher than it appears. In addition to brokerage fees,²⁴⁸ the investor must scan for alternative investments, analyze those alternatives, investigate multiple finalists, pay brokerage fees for the replacement, and initiate monitoring of the replacement. These increase the incentive for investors to "stay put" and tolerate compensation increases.

The problem could also arise when an investor has no choice, but to hold the particular stock, as when it is a component of an index which the investor has promised to follow. There is also an issue when an investor becomes so large that they cannot sell the stock without driving the price down or they need to invest in so many companies that alternatives are hard to find. This creates a situation where they "can't sell so they must care." Such investors are forced to use other tools to improve management performance, including meetings, negotiation, shareholder proposals, and voting challenges. But the investor's power is limited when threats of exit become empty because management knows that the investor must hold the particular stock. And management also knows that publicity and coordination are as big a threat to the investor as they are to management, because they drive the share price down and cause greater losses to the investor than to the managers.

Value of Corporate Governance

La Porta, et. al., point out that the breadth and depth of capital markets, the pace of new issuance of stock and the efficiency of investment allocation all appear to be explained by how well the legal system protects outside investors. They said:

"Absent effectively enforced rights, the insiders would not have much of a reason to repay the creditors or to distribute profits to shareholders, and external financing mechanisms would tend to break down."²⁴⁹

²⁴⁷ In old antitrust law, this was the concept of "conscious parallelism."

²⁴⁸ Probably the least of the costs, often under 10 basis points (.001).

²⁴⁹ La Porta (2000) at page 7.

“Legal rules in the common law system are usually made by judges, based on precedents and inspired by general principles such as fiduciary duty or fairness. Judges are expected to rule on new situations by applying these general principles even when specific conduct has not yet been described or prohibited in the statutes. . . . The vague fiduciary principles of the common law are more protective of investors than the bright line rules of the civil law, which can often be circumvented by sufficiently imaginative insiders.”²⁵⁰

They conclude that legal rules do matter for corporate governance, that good legal rules are those that a government can enforce, and that regulation may be useful when courts cannot be relied on.²⁵¹ (La Porta 2000)

But there is a countervailing tension from corporate management to maximize discretion and avoid oversight,²⁵² and there is resistance to regulation.²⁵³ The courts have increasingly held regulation to high standards of proof and cost-benefit analysis.

In their book on corporate governance, David Larcker and Brian Tayan make two fundamental points in the case against corporate governance: First, “For a governance system to be economically efficient, it should decrease agency costs more than the costs of implementation,” and second, “There are no universally agreed-upon standards that determine good governance.” Taken together, these statements are both true and yet make corporate governance virtually impossible. It is exceptionally difficult to prove that corporate governance rules work efficiently²⁵⁴ and it is exceptionally difficult to regulate without applying rules²⁵⁵ to all corporations.²⁵⁶ Larcker and Tayan go on to argue that corporate governance rules should be based on rigorous theory and empirical research. (Larcker 2011) Many economists have risen to the challenge to try to measure the effectiveness and value of corporate governance.

Paul Gompers, Joy Ishii and Andrew Metrick constructed an index of 24 corporate governance factors and correlated it with share price performance over a ten-year period for approximately 500 companies. The result was a strongly positive correlation between good governance and good performance (an 8.9% per year difference in financial returns between the best and worst companies). (Gompers 2003) This study became the template

²⁵⁰ La Porta (2000) at page 9.

²⁵¹ Black (2000) made essentially the same point, while creating a catalog of corporate governance rules necessary to protect investors.

²⁵² Discussed in Chapter 3.

²⁵³ Discussed in Chapter 4.

²⁵⁴ And corporate management has little incentive to make this possible by providing unbiased information.

²⁵⁵ And, therefore, costs.

²⁵⁶ This issue appears later in a broad corporate campaign against “One-size-fits-all” rules.

for most of the research that followed,²⁵⁷ applying much of the rigorous analysis advocated by Jonathan Macey. (Macey 1998)

Value of Particular Governance Practices

There is a large body of research into the efficacy of particular corporate governance rules and provisions. Among the provisions found to improve performance are:

- Securities regulation and mandatory disclosures²⁵⁸
- Director independence²⁵⁹
- Annual election of boards²⁶⁰
- Fiduciary duties²⁶¹
- Absence of voting control mechanisms²⁶²
- Shareholder nomination of directors²⁶³

It is difficult to summarize the large volume of information, but a few trends are clear in the research cited. Insider CEOs and CEO/Chairs decrease value. Weak governance increases CEO compensation and decreases value. Incentive compensation increases value. Managers control information to take personal advantage of it. Boards are an efficient solution to resolving conflicting goals. Boards should represent shareholders and independent directors do a better job of doing so, especially in mergers and acquisitions, CEO removal and decreased CEO compensation. Proxy access clearly increases value.

Market for Corporate Law

Frank Easterbrook and Daniel Fischel wrote:

“There is a growing literature on the conditions under which competition among jurisdictions will tend to produce beneficial rules. This competition is never more powerful than in the market for

²⁵⁷ Billet (2011), Chung (2010), Cremers (2010), Cunat (2010), Bebchuk (2009), Brown (2009), Bruno (2007), Chhaochharia (2007a), Committee on Capital Markets Regulation (2006), and Eisenhofer (2005), among others, find evidence that overall measures of good corporate governance correlate with improvements in a wide variety of measures of corporate performance. But the research is not all positive. Larcker (2011b), Johnson (2009), and Larcker (2004) find that the evidence of positive correlation is weak or dependent upon unusual samples.

²⁵⁸ McLean (2012), Jackson (2009), Coffee (2007), Doidge (2007), Hail (2006), LaPorta (2006), Diamond (1991), Easterbrook (1984)

²⁵⁹ Bhagat (2011), Brewer (2010), Adams (2009), Chhaochharia (2009), Bhagat (1998 for some board functions), Borokhovich (1996), Morck (1988), Baysinger (1985), but see Adams (2007) for a contrary view.

²⁶⁰ Bebchuk (2005c)

²⁶¹ Edlin (1995 re: insider use of differential information)

²⁶² Such as dual classes of stock, voting preferences and voting trusts. Gompers (2010)

²⁶³ Cohn (2011), Becker (2010)

corporate charters . . . the jurisdictions that select rules most beneficial to investors will attract and hold the most capital.”²⁶⁴

Likewise, Roberta Romano pointed out that corporate law can only be mandatory if there are uniform laws or the place of incorporation is fixed. The most important rules, like the duty of loyalty, need not be mandatory because she says the market would clearly insist upon them. (Romano 1989) In a later article, she contends that the current approach to securities regulation is mistaken and goes on to advocate a market-oriented approach of competitive federalism, permitting the states to compete in the creation of securities laws. (Romano 1998) Merritt Fox responded to this idea by arguing that there is a socially optimal level of disclosure, balancing information and discipline benefits with the cost of production. Issuer choice²⁶⁵ would lead to a level significantly below this social optimum because managers, not investors, will make the choice.²⁶⁶ (Fox 1999)

Inevitably, this idea of evolution of corporate law would be applied to try to explain the dominance of Delaware corporate law. Elliott Weiss and Lawrence White attempted to determine the optimal approach by studying the reactions of investors to seven unanticipated changes in Delaware Corporate Law. However, they found no statistically significant market reaction to any of the seven decisions. All of the possible explanations of this result are inconsistent with the existence of a “market for corporate law.” (Weiss 1987)

Robert Daines applied Tobin’s Q analysis to show that Delaware firms are worth significantly more than similar firms incorporated elsewhere, regardless of size, diversification, profitability, industry, and managerial ownership. They are also significantly more likely to receive takeover bids and to be acquired. This is likely the result of reduced transaction costs, possibly indicating that Delaware corporate law is less entrenching than elsewhere.²⁶⁷ (Daines 2001) Lucian Bebchuk, Alma Cohen and Allen Ferrell argue that the positive correlation between incorporation in Delaware and investor returns reported by proponents of state competition for corporate charters is not robust, does not establish causation, and does not establish that Delaware law is desirable. The same benefits likely would exist in a “race-to-the-bottom.” States that provide anti-takeover protection are more successful in the competition for incorporations, and states that provide more anti-takeover protections do even better. (Bebchuk 2002a)

Lucian Bebchuk and Assaf Hamdani question whether states actually compete for corporate charters. The vast majority of non-Delaware

²⁶⁴ Easterbrook (1984) at pages 690-691.

²⁶⁵ Issuer choice is the idea of permitting each issuer to determine its own disclosure practices.

²⁶⁶ Bar-Gil (2006) supports this idea, but Hadfield (2006) questions it.

²⁶⁷ Subramanian (2004) finds that this effect disappears and concludes that the race to the bottom is still possible.

corporations are incorporated in the state where they are headquartered, rather than in some other state which might attempt to compete with Delaware. Delaware dominates the original incorporation market as well as the re-incorporation market, and its dominance is growing. No other state is making visible efforts to compete. Because of Delaware's monopoly position, it can retain its position as long as it satisfies management because only management can initiate an effort to change jurisdiction. This undermines the idea that the rules determined under state competition are necessarily efficient or value-enhancing, and returns us back to the question of whether a federal incorporation option might be beneficial. (Bebchuk 2002b)

Lucian Bebchuk and Alma Cohen studied the choice of states of incorporation and find that strong anti-takeover provisions more than double the share received by the state. Despite the evidence that anti-takeover statutes are detrimental to shareholders, there appears to be no penalty in the incorporation market for states which adopt them. (Bebchuk 2003a)

This idea of state competition for corporate charters, based on states adopting rules which are advantageous to investors, has been used to deflect concern about the "race to the bottom" and the possible need for additional federal involvement in corporate law. While it appears clear that Delaware actively defends its dominant position in corporate charters, it appears that it does so by responding to the needs of management.

Chapter 6.

Institutional Investors and their Role in Corporate Governance

The purpose of this chapter is to introduce Institutional Investors and their Proxy Advisors, and to summarize some of the existing research about them and their corporate governance reform efforts.

Introduction

As shown earlier, shareholder activism as a check on managerial control and self-protection tends to falter due to the collective action problem, rooted in widespread share ownership among many small investors; the challenges of opposing the substantial political resources of management; and the high costs and uncertain returns of corporate governance reform efforts. The consequence of limited shareholder activism, as shown in Chapter 3, is substantial evidence of managerial power over boards of directors, use of that power to increase their own pay and job security, and compensation packages that encourage pursuit of short term gains rather long term growth and stability. The growth of large institutional shareholders, such as pension funds and mutual funds, has periodically given rise to hope that such large investors will use their leverage to exercise voice and influence to improve corporate governance rules.

In 1965, Daniel Baum and Ned Stiles observed that corporate power was being concentrated in fewer hands, even as beneficial ownership was extending to more employees covered by pension plans, savers and investors. At the time of writing, institutions owned roughly 20% of U.S. corporate equities, which theoretically would provide a controlling interest in many companies. However, the authors noted that institutional ownership was highly fragmented and that no institution held more than 5% of a particular company's shares. The result was that institutional investors had insufficient interests to monitor management behavior and that they routinely voted their proxies according to management's recommendations. Baum and Stiles concluded that institutional investors were merely passive supporters of management of the largest corporations. (Baum 1965)

J. Willard Hurst expressed a similarly skeptical view:

“By the 1960's the great institutional investors were the largest buyers of corporate bonds and, in response to a steady march of inflation, became substantial buyers of stock. As the number of institutional investors increased, some prophets said that these investors, moved by their stakes and informed by their expertise, would begin to play in

earnest the supervisory roles of the legendary stockholder. But through the 1960's the record showed little to bear out the prophecies. . . On rare occasions institutional investors cast their weight for a change in top management; rarer was evidence of their influence brought to bear on particular issues of corporation policy. . . As their holdings became larger relative to supply, the possibility loomed that they might find themselves unable to resolve their dissatisfactions with corporate performance by selling out, lest they so dislocate the shares market as to cause unacceptable capital losses. Thus, weakness bred from the strength of their investment positions might force them to be active rather than passive shareholders. But as of the 1960's such a development was speculative. Meanwhile the relative passivity of these big investors underlined the general failure of shareholding to supply the steady surveillance by which stockholders were supposed to legitimate the power wielded in business corporations."²⁶⁸

But Peter Drucker, the revered management theorist, noted the rapid growth of corporate pension funds and their investment portfolios, and predicted that they would become a significant factor in the securities markets and corporate ownership. He predicted that the economic interests of beneficiaries would be expressed through the concentration of pension fund ownership. (Drucker 1976)

Beginning in the 1980's, it appeared that State Treasurer Jesse Unruh and CEO Dale Hansen were succeeding in making the California Public Employees' Retirement System ("CalPERS") into a major force for corporate governance reform, with serious monitoring of public companies, a highly-publicized "Focus List" of target companies, a campaign of shareholder proposals on various governance issues, and leadership of coordinated "Vote No" campaigns on excessive corporate equity compensation.²⁶⁹ The resulting media coverage led many to believe that institutional shareholders were finally gaining control over corporate management.

Hurst wrote in 1970. What have we learned in succeeding years about his pessimistic view as compared to the optimistic reformers' views? That is the subject of this chapter.

About Institutional Investors

In general, institutional investors are organizations which invest money aggregated from or for individual beneficiaries. In some cases, this represents

²⁶⁸ Hurst (1970) at page 76.

²⁶⁹ This appears to have come to an abrupt end when Governor Arnold Schwarzenegger and the U.S. Chamber of Commerce arranged the ouster of CalPERS' pro-corporate governance activism President, Sean Harrigan. (Walsh 2004, Yu 2004)

money owed by someone who has made a promise to the beneficiaries, such as an employer's pension obligations or an insurance company's obligations to its policyholders. Most institutional investors are, by definition, representative investors. They are not managing their own money and no more represent the financial interests of the ultimate owners of the corporations they invest in than corporate managers do. They are in the business of investing and trying to maximize the financial returns they deliver to their beneficiaries. The vast majority of institutional investors are not intentionally in the corporate governance business.²⁷⁰ (Davis 2001)

Corporate pension plan trustees or their investment managers are required to vote the annual meeting proxies for all of their investments in the best interests of the beneficiaries under a U.S. Department of Labor²⁷¹ private letter ruling issued to Avon Products on February 23, 1994.²⁷² This decision made it politically risky for public pension funds and union pension funds to fail to exercise their voting rights as well. Mutual funds were required to report their proxy votes on SEC Form NP-X beginning in 2004. Once these two major types of institutional investors were forced to vote their proxies, most other institutional investors' participation increased as well. (ISS 2006b) In order to exercise their proxy votes, investors had to decide how to vote and those decisions, in turn, depended upon the development of corporate governance goals and policies.

In the early 1990s, Mark Roe and Bernard Black focused on two important reasons for institutional investors' passivity. Mark Roe suggested that American law and politics deliberately impede concentrated institutional ownership of corporations, which could have provided oversight of managers.²⁷³ Banks,²⁷⁴ mutual funds,²⁷⁵ insurance companies²⁷⁶ and pension

²⁷⁰ A small number of institutional investors have incorporated corporate governance improvement as part of their investment strategy, including the Lens Fund (closed in 2000), the Hermes Fund (U.K.), and several hedge funds.

²⁷¹ The U.S. Department of Labor has enforcement responsibility for the Employee Retirement Income Security Act of 1974 ("ERISA"). The letter concluded that voting rights were "plan assets" which must be voted for the retirement plan beneficiaries' sole benefit. This became the "prudent man" standard for other investment fiduciaries as well.

²⁷² Widely known as the "Avon letter." Avon's CEO was investigated by the Department of Labor because he was known to maintain a list of investment managers who voted against management or for shareholder proposals, which had been publicly criticized as an attempt to intimidate them. (Rosenberg 1999)

²⁷³ The historical governance environment in Germany and Japan, for instance, has encouraged large bank holdings of industrial companies and interlocking ownership and board membership, which facilitates very direct exercise of shareholder power over management.

²⁷⁴ The National Bank Act of 1863 prohibits banks from owning non-banking corporations and federal bank regulations prohibit bank trust departments from holding more than 10% of the shares of other corporations on behalf of their clients. The Bank Holding Company Act of 1956 limits ownership of non-banking corporations to 5% of the investee, unless the excess shares are non-voting.

²⁷⁵ The Investment Company Act of 1940 defines any mutual fund holding more than 10% of any investee company as "non-diversified," and the Internal Revenue Code prevents non-diversified mutual funds from passing their earnings through to investors without a corporate-level tax.

funds²⁷⁷ all face ownership restrictions and diversification pressures that arise out of popular fear of institutional power and Wall Street control over business. The problem is that atomization of ownership creates a collective action and free rider problem²⁷⁸ with inadequate incentives for anyone to monitor management. Thus, Roe believes that a great deal of the Berle & Means problem is the result of political influences, rather than the economic and technological evolution of the corporate structure. (Roe 1994, 1991)

Bernard Black observed that markets are inherently imperfect, and the market for corporate control²⁷⁹ does not adequately monitor management, leaving institutions as the only monitors available. But institutions are themselves managed by agents who need to be watched and whose incentives are not necessarily aligned with their ultimate beneficiaries. Black called this the problem of “Agents Watching Agents.”²⁸⁰ He suggests that these agents do not have an incentive to exercise the same level of monitoring and control as an owner would. (Black 1992b)

For many years The Conference Board, a corporate management organization, published an extensive annual study of the institutional investment universe.²⁸¹ The Conference Board data is the most widely cited for the overall measure of institutional investment in U.S. financial markets. Their definition of institutional investors includes pension funds, mutual funds, insurance companies, savings institutions and foundations, but excludes banks, trust companies, and endowments.²⁸² Intermediate investment managers, including hedge funds, are eliminated to avoid double-counting.

At the end of 2009, The Conference Board reported that institutional investors held \$25.35 trillion in total investments of all types, similar to the level of 2005-2006, representing a substantial recovery from the financial crisis. Institutional investors represented \$10.239 trillion of the \$20.228 trillion U.S. public equity market (50.6%) at the end of 2009, down from a peak of 53.3% in 2005. Institutional investors represented 73.0% of the ownership of the top 1000 U.S. public corporations at the end of 2009, down from a peak of 76.4% at the end of 2007. They owned 63.7% of the top 50

²⁷⁶ Insurance companies are generally regulated by the states in which they issue policies, so a national insurance company is generally limited to the lowest percentage holding of investee companies permitted by the major states, which is often as low as 2%.

²⁷⁷ ERISA requires “prudence” of plan fiduciaries, which has been interpreted as requiring diversification and strong justifications for any concentrated positions.

²⁷⁸ Discussed in Chapter 5.

²⁷⁹ I.e., takeovers.

²⁸⁰ See also Coffee (1994) and Hawley (2000).

²⁸¹ It appears that the 2010 edition may be the last.

²⁸² It is unclear why The Conference Board excludes endowments, but the Federal Reserve Bank ceased publication of the data on bank and trust company investments in 2008.

companies at the end of 2009. Institutional investors owned 28.8% of the total bond market at the end of 2009.

Among institutional investors, pension funds represent 39.9% of the total investments (or \$10.1 trillion), followed by mutual funds at 28.4% (or \$7.2 trillion) and insurance companies at 24.4% (or \$6.2 trillion). The insurance company share has been relatively constant, but pension funds have declined from a peak of 44.4% of total investments in 2000 and mutual funds have grown from 2.9% in 1980 and 24.8% in 2000.²⁸³ Institutional investors' overall investment allocation was 40.4% corporate equities, 36.5% bonds and 20.1% other²⁸⁴ at the end of 2009.²⁸⁵ (The Conference Board 2010b)

For this project, institutional investors consist of:

Pension funds (public, private and union)

Pension funds tend to be long-term investors, attempting to grow their portfolios over the time employees will continue to work before retirement and to fund the retirement payments over increasingly long retirement periods. This has led most pension plans to be heavily weighted toward equity investments in order to earn returns that track and (hopefully) beat inflation. But the risk of ERISA liability²⁸⁶ makes them unusually focused on benchmark performance indexes and often leads to delegations of investment responsibility to outside managers. Pension plans are usually "trusteed" by one person or a few people, in order to minimize the number of people exposed to liability. A small minority of public and union pension plans have tended to be the most involved participants in corporate governance activism.

Mutual funds

Mutual funds include Regulated Investment Companies,²⁸⁷ closed-end funds, exchange traded funds and several other types of commingled investment funds. There is fairly extensive SEC oversight of mutual funds, they are required to use outside bank custodians of all their investments, and they tend to be audited by large accounting firms. There is a mutual fund for every risk profile and time horizon, so generalization is difficult. However, there is huge marketing pressure to beat the indexes (as well as their competitors) every month, sometimes through active trading and sometimes

²⁸³ This reflects a shift from defined benefit retirement investments toward individually-managed investments.

²⁸⁴ The "other" category consists of real estate, private equity, hedge funds and cash equivalents.

²⁸⁵ Compared to 46.7-32.0-21.3 at the end of 2000 and 18.0-35.9-46.1 at the end of 1980. There have been increases in the total dollar investments in every category, despite the shift in emphasis.

²⁸⁶ The Department of Labor, the Pension Benefit Guaranty Corporation and plan beneficiaries can sue for (among other things) lack of prudence if the fiduciary fails to deliver investment returns comparable to similar investors.

²⁸⁷ What most of us think of as a regular mutual fund.

through minor modifications of the index allocations. They are viewed as having little commitment to individual companies. Many mutual fund companies are large public companies themselves, with their managers having as much interest in protecting their compensation and minimizing interference as the managers of any of the companies in which they invest.

Insurance companies

Insurance companies have tended to be the most conservative of institutional investors because of the fixed and predictable nature of their obligations. They hold large portfolios of debt investments and mortgages. This is driven by the importance of credit ratings in the sale of whole life insurance and annuities. Their small allocations to corporate equity investments make them less significant participants in corporate governance reform.

Banks and trust companies

Banks and trust companies are included to the extent that they are acting as trustees or custodians for individuals. These tend to be wealthy families with complex estates. The investment strategies are extremely varied, often reflecting the investment constraints imposed by the trustors. Banks and trust companies are highly regulated and tend to be audited by large accounting firms. Almost all of these trust assets are small elements of the larger financial operations of the bank.²⁸⁸

Foundations

Even the largest foundations are essentially private entities, usually beginning with a sole contributor, and their investment strategies vary widely. The IRS requirement of a 5% annual cash payout for their charitable purpose tends to make them moderately aggressive investors.²⁸⁹

Endowments

Endowments, especially the large ones, are surprisingly willing to take risks and tend to be heavily invested in equities. This is likely the result of their perpetual nature and their flexibility to maximize total return, without the necessity of meeting a fixed payout each year. College and university

²⁸⁸ Savings institutions replaced Bank Trusts and Estates in The Conference Board's data when the Federal Reserve Bank discontinued reporting in 2008, but the sample for this study was drawn in 2006 and includes traditional bank and trust companies.

²⁸⁹ Their exposure to investment losses and the relatively high payout ratio combine to cause many foundations to suffer attrition and face limited lifetimes.

endowments became heavily involved in private investment vehicles as they realized that they did not have any fixed obligations.²⁹⁰

Hedge funds

Like mutual funds, the hedge funds are very difficult to generalize about, except that many of them take breathtaking risks. As private investors, they publish almost no information about their strategies. Because of their popularity at the time of this study, many aggressive investment strategies were offered as hedge funds in order to raise investment capital. A few hedge funds have undertaken corporate governance investment strategies that attempt to augment returns through activism.²⁹¹ (Brav 2006, Kahan 2007)

It should be noted that there are several types of institutional investors which are intentionally excluded from this project. Private equity and buyout firms are excluded because they are, by definition, focused on investing in non-public companies or taking public companies private. Likewise, venture capital investments are generally private during the period when they are controlled by venture capital firms. Also excluded are sovereign wealth funds and foreign investors, because of the difficulty getting information about them due to their concerns about secrecy.

Finally, and perhaps most important, a huge “parallel universe” of investment management firms is excluded. These are the securities firms, trust companies and registered investment advisers who act as the outside investment managers for most institutional investors. Research on these entities is fraught with methodological problems such as duplication, multiple roles (investment consultants, investment managers, custodians, etc.), and overlapping responsibilities. Fortunately, in the case of virtually every dollar of funds managed by these firms, there is an ultimate institutional investor whose investments are included in the study.

Corporate Governance Goals

We actually know quite a lot about what institutional investors want in corporate governance because of the many surveys that are conducted. Carolyn Brancato, the author of most of The Conference Board’s institutional investment reports, summed up their overall goals as accountability to investors (including financial reporting integrity and ability to elect new

²⁹⁰ It is not clear why The Conference Board data omits endowments as institutional investors.

²⁹¹ Hedge funds were intentionally omitted from The Conference Board data as intermediaries. They have been included in this study because they are not necessarily intermediaries of other institutional investors; most of them have substantial amounts of individual investment.

directors); professional and independent management; and transparency to the broad capital market. (Brancato 2000)²⁹²

Institutional Shareholder Services (“ISS”), which is the largest proxy advisory firm,²⁹³ reportedly had revenues of \$145 million from its proxy advisory business in 2009, based on voting recommendations for 37,000 companies in 108 countries on 7.6 million ballots representing over 1.3 trillion shares. ISS had over 3,500 investor clients in 53 countries, including 70 of the 100 largest investment managers, 43 of the 50 largest mutual fund companies and 42 of the 50 largest hedge funds. ISS conducts a large annual survey of its clients and other financial market participants on emerging corporate governance issues. The feedback they receive is used to develop proxy voting and corporate governance policies that represent best practices and the collective voice of ISS’ institutional investor clients. A total of 200 institutional investor clients responded, approximately 15% of ISS’ proxy voting clients. The respondents were just over 60% asset management firms (including mutual funds) and the remainder asset owners, such as pension funds, foundations and insurance companies. About 65% was U.S. based and the remainder was European. (ISS 2009, ISS 2011b)

Georgeson is the largest proxy solicitation firm,²⁹⁴ itself the product of a 1999 merger of the two largest proxy solicitation firms, and was acquired by Computershare, the largest transfer agent,²⁹⁵ in 2003. It, too, conducts an annual survey of corporate governance activity, largely oriented toward informing its corporate clients of the issues they face. 2010 was the first proxy season under the new NYSE rule against broker discretionary voting in director elections²⁹⁶ and the last one before mandatory Say-on-Pay votes.²⁹⁷ In 2010, 748 directors at 314 companies received 15% or greater “against” votes, 317 received 30% or greater against, and 41 had a majority against. These represent substantial declines in opposition from 2009, the first year

²⁹² Other surveys were much more specific and detailed. Stuart Gillan and Laura Sparks studied 2042 shareholder proposals. (Gillan 2000) McKinsey & Company surveyed more than 200 institutional investors in 31 countries. (McKinsey 2002) K. A. D. Camara, a skeptic about the ability of institutional investors to represent their interests, classifies institutional investors according to his view of their motivations and concludes that shareholders undermine their own wealth maximization. (Camara 2004) Kevin Hallock conducted a survey of 20 of the 25 largest institutional investors. (Hallock 2008)

²⁹³ Proxy advisory firms are generally retained by institutional investors to advise them on proxy voting issues and corporate governance policies, and to assist them in the actual mechanics of submitting proxy votes to companies.

²⁹⁴ Proxy solicitation firms are generally retained by corporate management to contact shareholders (including institutional shareholders) to persuade them to vote for management’s positions in contested corporate annual meeting elections.

²⁹⁵ Transfer agents maintain the ownership records for corporate shares, make dividend distributions and handle the mailing of proxy solicitation packages. Many companies also retain transfer agents to act as inspectors of corporate annual meeting elections and to provide current vote counts during the election process.

²⁹⁶ When an investor whose shares are held on account with a broker fails to vote, the previous SEC rules permitted the broker to vote the shares.

²⁹⁷ Discussed in Chapter 3.

after the crash. The number of contested director elections grew from 23 in 2005 to 57 in 2009, but fell 40% to 35 in 2010. (Georgeson 2010)

It is clear from the overall results of the surveys that institutional investors want to be able to invest with the assurance that boards will honestly represent their interests and that management will be paid commensurately with the financial results that they deliver in all market conditions. They do not want to have to manage the company themselves.²⁹⁸

The specific goals of significant numbers of institutional investors were as follows:

They want boards to represent their interests, and not management's interests. (ISS 2009) In order to accomplish this, they understand that the directors need to have something to lose. With the practical elimination of liability because of the limitations on fiduciary duties²⁹⁹ and PSLRA,³⁰⁰ they see the ability to vote against directors as the only way to have a threat of enforcement that induces directors to work in their interests. More recently, they have come to realize, however, that the threat of losing elections is not sufficiently meaningful because directors can be re-nominated by the board or replaced with identical candidates. As a result, the right to have proxy access for the nomination of replacement candidates has become important to shareholders. (ISS 2009, Georgeson 2010)

In order to make director elections more responsive to shareholders' interests, institutional investors also want to (a) eliminate staggered boards and force annual elections (Georgeson 2010), (b) require majority votes to elect directors (Gillan 2000, Georgeson 2010), and (c) eliminate all types of super-majority provisions (Georgeson 2010). Investors also want confidential elections to avoid management manipulation. (Gillan 2000) Finally, they want to be able to call elections so that they can intervene more rapidly to protect their rights.³⁰¹ (Georgeson 2010)

The stress on board independence and competence continues. This appears to be an effort to counter the influence of management, and the CEO in particular, over the board. Investors want directors with substantial qualifications who have the authority and ability to question the CEO. (ISS 2009) They want directors to be genuinely independent (Gillan 2000, ISS

²⁹⁸ Many of their comments indicate that they understand that they do not have the skill to manage companies and that they are concerned about being taken advantage of by their fellow institutional investors if they have too much control.

²⁹⁹ Chapter 3 discusses the judicial and legislative reductions in the scope of fiduciary duties to shareholders.

³⁰⁰ PSLRA is the Public Securities Litigation Reform Act, which substantially limited the use of securities class actions, discussed in Chapter 4.

³⁰¹ As shareholders in the U.K. and many other European countries are empowered to do.

2009, Georgeson 2010) and they want to separate the roles of Chair and CEO (McCahery 2010, ISS 2011).

Likewise, investors want managers' incentives to be aligned with theirs and, in some surveys, to stop the growth of overall management pay. (Georgeson 2010) Investors appear to have accepted the idea of significant equity incentive compensation and an increase in total compensation resulting from it, but they want the incentive pay to only increase when the company does genuinely well and they want it to decrease when the company does poorly. (Hallock 2008, ISS 2009, McCahery 2010) They want performance and incentives to be measured over a longer period, generally at least five years. (ISS 2009) They want performance to be measured against a stable group of actual peer companies. (ISS 2011)

Other compensation reforms wanted by investors include more disclosure about compensation consultants, their independence and their conclusions (Georgeson 2010), requirements to hold equity incentives for a fixed term that does not end with retirement of the executive or change of control of the company (ISS 2009, Georgeson 2010), and rules against option resetting and backdating (ISS 2009). Investors have been strongly in favor of Say-on-Pay votes.³⁰² (ISS 2009)

Investors continue to be very concerned about eliminating the remaining anti-takeover devices and disproportionate control mechanisms. (Gillan 2000, Georgeson 2010) They want to require shareholder approval of anti-takeover devices. (ISS 2009) They want to protect their authority to control mergers, acquisitions and sales. (ISS 2009, ISS 2011) Investors want specific board or shareholder approval of any self-dealing. (Gillan 2000)

Finally, one significant investor goal which arose in two surveys is to require specific board approval of political activities. (CPA 2005, ISS 2011)

Extent of Corporate Governance Activism

Despite the depth of information available about institutional corporate governance goals, there is less information about what institutional investors do to advance these goals. Most authors addressing the subject begin with the collective action issue discussed in Chapter 5. (Shleifer 1986, Conard 1988)

Some authors are optimistic about investors overcoming the collective action impediment. Matheson and Brent Olson predicted a "longterm shareholder phase" of activism, based on coordination through CII and ISS, but offered no evidence for their assertion. (Matheson 1992) Michael Useem

³⁰² Which have already been implemented, although there are many unanswered questions regarding how companies should respond to them.

said “At the leading edge of the owners’ mobilization are a relatively small number of activist institutions. They articulate the grievances, formulate the strategies, and launch the assaults. . . The activists play a role akin to that of political leadership in social movements. . . At the core of the investor movement leadership is a small set of public funds.”³⁰³ The Conference Board continued to emphasize the potential power of institutional investors: “A number of umbrella groups also help mobilize U.S. institutional investor economic and political clout beyond what could be achieved by even a single large institution.”³⁰⁴ An institutional investor survey by ISS found substantial support for the ideas that corporate governance activism increases value and is a competitive advantage, although it added little information about their activities. (ISS 2006)

Many other authors found little activism and a range of reasons to explain why. Edward Rock said “Institutional shareholder activism has been uneven, episodic, and trendy.”³⁰⁵ Institutional investors are intermediaries who often have conflicts of interest.³⁰⁶ In an indexed environment, the principal way to improve performance is to cut costs, but governance activism is costly. Rock notes that there is essentially no legal incentive for intermediaries to discipline management.³⁰⁷ He also notes the same legal impediments to coordination reported twenty-six years earlier in Baum (1965). (Rock 1991)

A number of authors noted that the need for activism arises because of the decline in takeover activity, which once acted as a check on agency costs. (Grundfest 1993, Karpoff 1996) This has led to increased efforts to remove anti-takeover provisions in corporate bylaws and governance. (Thomas 2007) But there is evidence that institutions are still buying IPO’s with extensive anti-takeover features, indicating that their commitment to corporate governance is subordinate to investment returns. (Klausner 2004) And a study by the Council of Institutional Investors finds that about half of public companies³⁰⁸ still have bylaws and voting blocks which preclude investor activism. (Council of Institutional Investors 2009)

³⁰³ Useem (1996) at page 54.

³⁰⁴ The Conference Board (1997) at page 81. Emphasis added. They appear to mean CII and the proxy advisory firms.

³⁰⁵ Rock (1991) at page 451.

³⁰⁶ Often because they are also corporate entities which would be constrained by the reforms. Conard (1988) and O’Barr (1992) agree. Rothenberg (2006), AFSCME (2007) and Cremers (2011) find that mutual funds’ corporate governance activity is diminished by conflicts. Romano (1993b, 2001), Schwab (1998), Copland (2011) and Agrawal (2012) all note that public and union pension funds’ activism is affected by their other goals. And Bainbridge (2005b, 2009a, 2009b) argues that passive investors are harmed by activism and that the status quo should be maintained.

³⁰⁷ Coffee (1991a) and Pozen (1994) agree.

³⁰⁸ These are far more prevalent in smaller public companies.

William O’Barr and John Conley performed an interview study of nine U.S. pension funds. “In every interview we conducted, fund executives talked at length about assuming, assigning, or avoiding responsibility. As we listened to them, it often seemed as if the funds had been designed for the purpose of shifting responsibility for decision making away from identifiable individuals.”³⁰⁹ They note that pension funds tend to see governance as a burden rather than an opportunity. “Their objective seems to be to meet the requirements of the law while maintaining the lowest possible profile.”³¹⁰ Pension managers cited the law more than any other factor in requiring or precluding decisions. Fiduciary standards, ERISA, delegation to named fiduciaries, actuarial assumptions, and beneficiaries’ interests drew constant attention. (O’Barr 1992) This over-riding concern about the law, and fear of violating it, is also identified by many other authors as an impediment to activism.³¹¹ Bernard Black thinks these fears may be excessive: “Some money managers also believe that legal obstacles are stronger than they really are.”³¹²

Alfred Conard noted that the costs of activism include the retaliation of management, which often comes in the form of cutting off information that is critical to trading, as well as personal attacks on the activist. (Conard 1988)

Some authors think that the external impediments are intentional. Bernard Black said that “To some extent, the promanager, antishareholder tilt of the rules affecting shareholder voting is deliberate: Congress, the SEC and the states fully intended the rules to insulate corporate managers from too much shareholder oversight, by financial institutions or anyone else.”³¹³ John Coffee observed that the SEC appears torn by the tension between those who think institutional investors are the solution to corporate governance and those who think that they are poised to monopolize all of American business. But he views the SEC as reluctant to take the risk of deregulation to facilitate coordinated action by institutional investors because of the SEC’s fear of empowering them as the new “robber barons.” (Coffee 1994)

Effects of Corporate Governance Activism

Stuart Gillan and Laura Starks wrote a sweeping review of shareholder activism. The formation of the Council of Institutional Investors in 1985 marked the beginning of institutional investor activism, primarily against antitakeover devices and for cumulative voting and director independence. They found that almost all shareholder activism is directed to solving agency problems, usually when the board fails to act. Institutional investors

³⁰⁹ O’Barr (1992) at page 85.

³¹⁰ O’Barr (1992) at page 194.

³¹¹ See, e.g., Gilson (1990), Sharara (1994), Pozen (2003), and McCahery (2010).

³¹² Black (1990) at page 563

³¹³ Black (1990) at page 564.

emphasize negotiation over proxy proposals. Most target poor financial performance rather than specific governance practices. They find that it is difficult to assess the impact of activism on financial performance; their extensive survey of studies of effects of activism shows strikingly different assessments. (Gillan 2007)

Sunil Wahal studied all firms targeted for corporate governance activism by nine pension funds from 1987 to 1993. None of the targets experienced longer-term increases in stock price or accounting earnings, leading the author to question the value of activism. (Wahal 1996) But many other studies find positive relationships between institutional investor activism and higher value, lower executive compensation, better financial reporting, good governance, etc. (Shleifer 1986, Hartzell 2003, Cornett 2007, Chung 2011, Ramalingegowda 2011)

A large number of studies have focused on the effects of CalPERS' governance activism. These found significant increases in returns and value by a wide variety of measures and over a wide variety of time horizons. (Nesbitt 1994, Smith 1996, Huson 1997, Crutchley 1998, Gray 2007, Barber 2007, CalPERS 2012) But in 2010 CalPERS announced that it had canceled its annual public Focus List. (Lifsher 2010) Other studies of activism by the Council of Institutional Investors,³¹⁴ TIAA-CREF,³¹⁵ and the Hermes UK Focus Fund³¹⁶ found similar results from relatively non-confrontational strategies.

Diane Del Guercio, Laura Seery and Tracie Woidtke found that relatively small withhold campaigns³¹⁷ in director elections have resulted in significant post-campaign performance improvements, including forced CEO turnover in 25% of the target firms in the next year.³¹⁸ (Del Guercio 2008)

Forms of Corporate Governance Activism

Robert Pozen noted that “Most institutional investors do not set out to become activist shareholders, nor do they want to get involved with a company’s operational issues.”³¹⁹ Most money managers are not entitled to reimbursement for the costs of activism, creating a strong incentive for passivity. Institutional investors almost never engage in fights for control because the cost is too high. Proxy proposal campaigns are far less expensive and more frequently used. Private communications³²⁰ are the least expensive and most common action. (Pozen 1994) Bernard Black wrote: “A small

³¹⁴ Oppler (1995)

³¹⁵ Carleton (1998)

³¹⁶ Brecht (2009)

³¹⁷ i.e., just voting no.

³¹⁸ Compared with 7.5% in similar firms and 2% in the general population of firms.

³¹⁹ Pozen (1994) at page 140.

³²⁰ Private communications or contacts are frequently referred to as investor “engagement.”

number of American institutional investors, mostly public pension plans, spend a trivial amount of money on overt activism efforts. They don't conduct proxy fights, and don't try to elect their own candidates to the board of directors."³²¹

Private "engagement" and negotiation appear to be the predominant form of corporate governance activism, although it is unclear to what extent threats of other actions are also involved. Michael Useem conducted a survey of the 40 largest pension funds, 40 largest money managers and 20 largest foundations which shows a wide range of activism methods and variation by investor type. Activist institutions prefer direct negotiation to proxy proposals because of the difficulty of reaching agreement with other institutions. (Useem 1993) The Economist noted that activist investors had been strangely quiet for the two years after the 2008 financial crisis and that many of them had closed. But they saw new activity because of companies' increased receptiveness to quiet negotiation. (Economist 2010) David Porter reflected that the majority of institutional investor activity in corporate governance takes the form of private contacts, although most of these are largely ignored. Only when there is a genuine threat does corporate management seriously consider changes. (Porter 2010) David Larcker and Brian Tayan pointed out that institutional investors have only indirect influence on company affairs, but that they can communicate their opinions directly to management and the board. If the response they receive is not satisfactory, they can seek to remove directors, vote against proxy proposals sponsored by management, or put forth their own proxy measures. (Larcker 2011a)

ISS recently complete an extensive study of institutional investor engagement. Approximately 87% of issuers, 70% of asset managers and 62% of asset owners reported at least one "engagement" with institutional investors in the past year. Roughly 30% of issuers, 34% of asset managers, and 28% of asset owners reported more than ten engagements in the past year. A majority reported that engagement was increasing, much of it attributed to Say-on-Pay. About 80% of issuers, 72% of assets owners and 62% of asset managers reported that the engagement was never made public. Issuers were materially more likely than investors to think that establishment of a dialogue was a success. Three-fourths of institutions report that time is the greatest impediment to engagement and a slight majority of investors report conducting engagement in concert with others. A majority of the issues were corporate governance or compensation-related, but issuers downplayed both. Neither issuers nor investors reported significant results. (ISS 2011c)

Stephen Choi and Jill Fisch surveyed public pension fund attorneys regarding corporate governance activism. Activity levels vary dramatically; a

³²¹ Black (1998) from the Abstract.

significant number do little or nothing. Virtually no funds participate in director nominations and very few make shareholder proposals. Nearly 77% have never targeted any investments for corporate governance purposes (and only 2.6% frequently do so) and roughly 75% have never lobbied. Activism is generally limited to low-visibility activities such as organization membership and withholding votes from a particular management nominee. They found that few resources were devoted to corporate governance and that many funds don't have even one full-time staff person. Only 17.5% had a separate budget for corporate governance. This low investment in corporate governance may explain the apparent strategy of low-risk, low-visibility and low-confrontation activities. (Choi 2008)

Bernard Black noted that institutional investors are most effective when they act in concert on the same issues at multiple companies. (Black 1998) Robert Pozen notes that SEC amendments to its rules in 2003 now permit shareholder coordination without filing proxy materials, so long as there is no intention of changing or influencing the control of the company.³²² (Pozen 2003) But Joseph McCahery, Zacharias Sautner and Laura Starks find that 59% of investors would *consider* coordinating their actions, but 41% would not, primarily because of legal concerns. (McCahery 2010)

The Conference Board prepared an extensive report on shareholder activism for corporate managers. Only a few years ago, the term shareholder activism was used to describe the effort of a small cadre of large institutional investors (mostly public pension funds or labor unions) to advance the dissemination of better standards of corporate governance in the business community. In retrospect, the term "shareholder advocates" would have been more suitable to their modus operandi, which has been distinctly mild. The targets of their efforts have changed to underperformance and opportunities for operational improvements, rather than corporate governance deficiencies. It is very important to note that none of CalPERS, TIAA-CREF or any others of the old corporate governance activists are even listed in the extensive catalog of activist investors. (The Conference Board 2010a)

Litigation

Stephen Choi and Jill Fisch found that public pension funds are more likely to participate in shareholder litigation than other activists. Roughly 55% report acting as lead plaintiff and 60% report opting-out of class actions to pursue their own litigation. (Choi 2008) Agnes Cheng, et. al., studied 1811 securities class action lawsuits between 1996 and 2005, and show that institutional lead plaintiffs are more effective than individuals at disciplining management and producing corporate governance reform. These cases are less often dismissed and they obtained larger settlements. Public pension

³²² SEC Rule 14a-2(b)(1)(vi) (2003)

funds are the most effective type of institutional investors, presumably because of their longer investment horizon. (Cheng 2010) Elliott Weiss and John Beckerman found that institutional investors frequently sue to recover damages from securities fraud, but do not mention any efforts to change corporate governance law. (Weiss 1995) It appears that institutional investor involvement in litigation yields corporate governance improvements only as an incidental by-product to efforts to recover financial losses.

Progress

There have been notable improvements in corporate governance, particularly in internal corporate rules. Vidhi Chhaochharia and Yaniv Grinstein found significant “improvements” in independence, committee independence, size, interlocks, director occupations, and multiple directorships, especially after 2000. However, they found little improvement in director shareholdings and separation of chair/CEO roles. (Chhaochharia 2007b)

Shearman & Sterling reported on a major survey of corporate governance reform up to 2010:

Of the largest 100 companies, 82 have adopted majority voting requirements for directors, 75 have addressed what happens if a majority is not achieved, and 72 require director resignation in this event.³²³ But 70 companies still have combined chairman and CEO positions, all based on asserted “efficiencies,” and 87 specify additional duties of the lead independent director, especially agenda-setting. Fifty-four have higher independent director quotas than the required majority, 59 have no non-independent directors other than the CEO, and 88 have 75% or more independent directors. Fifty-eight have limits on the number of public company boards on which directors may serve, but the numbers are quite liberal; and 84 have mandatory retirement, most commonly at 72. Sixty-two have explicit policies against term limits.

Fifty-four companies reported corporate governance shareholder proposals in their most recent proxy, including proposals for shareholder-called special meetings (24), independent board chair (18), cumulative voting (13), shareholder action by written consent (8), removal of supermajority voting requirements (3), establishment of succession policy (3), majority voting (2) and one share-one vote (1). Of these, there was majority support for only three: removal of supermajority voting requirements (72%), majority voting (70%), and shareholder action by written consent (57%). Shareholder-called special meetings drew 40% support and none of the others exceeded 30%, on average.

³²³ Few companies bind themselves to accept the resignation.

Eighty companies have unclassified boards³²⁴ and 68 of the companies permit shareholders to call a special meeting,³²⁵ but 70 of them require unanimous shareholder consent if a meeting is not called. Sixty-nine companies disclosed a total of 275 related-party transactions, for which 95 companies required approval of the nominating/governance committee or the audit committee. (Shearman & Sterling 2010)

The first year of Say-on-Pay voting resulted in relatively few outright losses. Data compiled for the Council of Institutional Investors by Fariant Advisers showed that about 98% of companies holding Say-on-Pay votes through July 1, 2011 received majority votes in support; only 37 companies received majorities against their compensation programs. Most of the issues in the “against” votes appear to be inadequate alignment between pay and performance. (Burr 2011)

ISS reported on the 4,290 U.S. Annual Meetings covered by ISS during the January-June 2011 proxy season. Shareholders supported companies’ pay programs 92% overall, voting a majority against Say-on-Pay in only 38 companies (out of 340 “against” recommendations from ISS, mostly over pay for performance concerns). Investors overwhelmingly selected the option for annual Say-on-Pay votes. The number of directors who failed to get majority support fell by half (from 91 to 45), as Say-on-Pay provided an alternative to voting against compensation committees. Poor attendance, failure to put a poison pill to a shareholder vote, and failure to implement majority-supported shareholder proposals accounted for the remaining votes against directors.

The report also noted that there were far fewer shareholder proposals related to compensation and a 26% decline in corporate governance proposals. Board declassification proposals drew 73% support, up more than 12% from 2010, and won at 22 out of 23 large-cap firms. Majority voting proposals averaged 60% support. Independent chair proposals won at four companies, but received overall support of only 33%. Support for political contribution proposals continues to rise, but the variety of approaches is confusing. Environmental and Social proposals continued to lose in all but five cases, with 21% average support. Anecdotal information and the number of public settlements indicate that the level of activism continues behind the scenes. (ISS 2011)

Proxy Advisory Firms

The Department of Labor’s 1988 *Avon* letter³²⁶ presented institutional investors with a serious logistical problem. There are roughly 5,000 publicly

³²⁴ i.e., annual elections of directors, as opposed to staggered boards.

³²⁵ Albeit with high participation thresholds.

³²⁶ Discussed in the Introduction to this Chapter.

traded companies in the U.S. and roughly another 5,000 foreign ones. Each company has an annual meeting at which there is an average of nearly 14 individual items requiring a vote. There are similar numbers of institutional investors who must vote in a large portion of these. This implies enormous numbers of redundant voting decisions. Just the mechanics of marking and mailing that many proxy cards would be daunting. Few institutional investors have the skills and resources to manage this process.

The proxy advisory business began in 1985 with Institutional Shareholder Services, founded by Robert Monks. ISS invested in computerized systems to handle the voting mechanics. ISS seeks input from institutional investors about corporate governance issues and their policy preferences on each of them. They use this input to create model proxy voting recommendations for a range of policy perspectives for each voting decision. The clients may choose which of several perspectives to apply, which policies to apply to particular common issues, or to override the recommendations and make their own individual policies or votes. By centralizing, streamlining, and sharing the process of reviewing all of the annual proxy statements, the proxy advisory firms make the process manageable and affordable for their institutional investor clients. Needless to say, this was a very popular service and by 2004 there were five U.S. firms operating in the industry.

By 2007, the proxy advisory industry was handling a significant share of corporate voting and was drawing complaints. Jennifer Bethel and Stuart Gillan argued that recommendations against management proposals from ISS resulted in 13.6 to 20.6% fewer affirmative votes, depending upon the type of proposal. (Bethel 2000) Paul Rose asserted that the industry creates inflexible standards which corporations must adopt even if they are not optimal. He argued that there is little evidence for the standards applied and that the firms are poorly equipped to advise institutional investors. (Rose 2007)

In 2006 the Washington Post carried an article reporting on an unfortunate business practice of ISS. In addition to serving investors, ISS also had corporate consulting clients and some investor clients were leaving for firms without conflicts.³²⁷ Corporations responded by complaining about a “politically correct” governance model that had little to do with profitability. ISS’ recommendations were credited with making the difference in several blockbuster corporate battles, including Hewlett-Packard and Disney. But ISS responded that they do not control any votes; their clients ultimately make all voting decisions. (Starkman 2006)

³²⁷ Fortunately there was at least one alternative firm which made exclusive representation of investors part of its business strategy.

In June 2007 the U.S. General Accountability Office issued a report on the proxy advisory industry addressed to Representative Spencer Bachus, based on the concerns raised about the industry, especially that ISS advises both institutional investors and issuers on corporate governance matters. ISS publicly discloses this potential conflict, and has separate staff operating in separate locations using segregated equipment and systems. “While all institutional investors we spoke with that use ISS’s services said they are satisfied with the steps ISS has taken to mitigate this potential conflict, some industry analysts we contacted said there remains reason to question the steps’ effectiveness.”³²⁸

The GAO report said: “Like large institutional investors, however, representatives of small institutions said that they are ultimately responsible for proxy voting decisions and retain the right to override recommendations made by advisory firms. The fact that large institutional investors cast the great majority of proxy votes made by institutional investors and reportedly place less emphasis than small institutions on such research and recommendations could serve to limit the overall influence advisory firms have on proxy voting results.”³²⁹ Institutional investors had varying views of whether there were enough or too many firms in the industry. Several indicated that increased competition had permitted price negotiation. The GAO made no recommendations about regulating the industry. (USGAO 2007)

Tamara Belinfanti cites the large market share of the top two proxy advisory firms, their influence over shareholder voting and formulation of corporate governance policy, and “mutual funds outsourcing their voting to the industry” to argue for SEC to apply the same sort of regulation. She argues that ISS does not owe fiduciary duties to the companies it is analyzing.³³⁰ (Belinfanti 2009)

The Millstein Center at Yale observed that virtually all investors develop standardized voting policies to deal with most issues, but there is wide variety among them. The largest proxy advisors utilize a combination of external and internal input in reaching their standard recommendations. ISS posts drafts for public comment and has created a Governance Policy Exchange in which institutional investors can compare practices in various areas. The Millstein Center recommends that proxy advisors develop an industry code of ethics which includes a ban on services to companies on which they recommend voting. (Millstein Center 2009)

³²⁸ USGAO (2007) at page 4.

³²⁹ USGAO (2007) at pages 5-6.

³³⁰ Despite ISS being a Registered Investment Adviser subject to federal statutory fiduciary duties.

James Cotter, Alan Palmiter and Randall Thomas found that mutual funds vote in line with ISS recommendations more often than do all shareholders. In addition, mutual funds vote consistently with ISS recommendations more often than with management recommendations. “Whether this is because mutual funds follow ISS recommendations or because ISS tailors its recommendations to track mutual fund voting preferences is difficult to say.”³³¹

Charles Nathan and Parul Mehta³³² argue that proxy voting and corporate governance have become separated from investment management in most institutional investors, and that has led to proxy voting decisions that are based upon standardized criteria which are applied without regard to company performance or company-specific circumstances. They allege that most proxy voting mechanics are outsourced to one of the three proxy advisory firms,³³³ and that many investors rely upon their voting recommendations for almost all matters.³³⁴ A few investors will override their proxy advisor’s recommendations in specific cases (such as mergers and control contests), based upon the intervention of the investees or the investment managers. (Nathan 2010c) According to Nathan, “The universe of voting decision makers is dominated by the activist corporate governance movement.”³³⁵ Nathan questions whether institutional investor voting by corporate governance staffs or proxy advisors meets the prudent man standard of the fiduciary duty of due care, because of the lack of evidence that corporate governance positions increase corporate value. He argues that corporate governance policies tend to be “one size fits all.” His solution is that each institutional investor should be required to consider every corporate election issue on a case-by-case basis. (Nathan 2010a)

The Shareholder Communications Coalition³³⁶ issued a “discussion draft” on the need for regulatory oversight and transparency of proxy advisory firms. They call for advisors to be required to publicly disclose their policies and procedures;³³⁷ a requirement to study each individual company and its particular proposals;³³⁸ elimination of advisors’ conflicts of interest; public disclosure of all votes; and public disclosure of all voting errors. They also call for requirements that companies have the opportunity to review recommendations in advance and to be able to comment on recommendations with which they disagree. (Shareholder Communications Coalition 2010)

³³¹ Cotter (2010) at page 3.

³³² Practicing attorneys with Latham & Watkins.

³³³ They cite Institutional Shareholder Services; Glass, Lewis & Co.; and Proxy Governance, Inc.

³³⁴ They offer no evidence for these propositions, despite their accusation that proxy advisors act without evidence.

³³⁵ Nathan (2010a) at page 1.

³³⁶ A group led by The Business Roundtable.

³³⁷ Considered by proxy advisors to be proprietary trade secrets.

³³⁸ Rather than having standardized policies

Suzanne Stevens and Michael Rudnick interviewed Patrick McGurn³³⁹ regarding the brewing conflict:

“People like to pretend that we lead our institutional clients around with a leash. That’s simply not the case. Our clients drive our processes. We start our process by seeking input from our institutional clients about their views. Nearly all of our guidelines are written based on a case-by-case analysis. We do include information about company performance, board structure and governance performance.”³⁴⁰

The SEC issued a Proxy System Concept Release³⁴¹ soliciting comments about a wide range of issues in the proxy voting system.³⁴² The Concept Release addresses a number of accumulated issues, including: the creation of an audit trail for proxy votes; the monopoly positions of the firms which manage the shareholder ownership data; proxy document distribution and the proxy vote aggregation process; proxy voting by securities lenders; “empty-voting;”³⁴³ improving communications with shareholders; data-tagging the actual proxy document and other issues.

The SEC also points out the growing importance of proxy advisory firms and asks about the need for regulating proxy advisory firms, citing the concerns raised by issuers about increased influence, conflicts of interest, potential problems in accuracy and transparency, use of one-size-fits-all approaches, lack of oversight, absence of an actual economic interest, and industry concentration. While the Concept Release specifically refers to concerns raised by issuers in several places, there is no mention of any concerns raised by institutional investors.³⁴⁴ (SEC Proxy System Concept Release 2010)

Robert Daines, Ian Gow and David Larcker studied the corporate governance indices published by Audit Integrity, RiskMetrics, Governance Metrics International, and The Corporate Library. They found no relationship between their 2005 reported governance results and any of the corporate performance results claimed in their marketing materials.³⁴⁵ There was also very little relationship among the indices, indicating that the indices are

³³⁹ Special counsel to ISS’ Governance Services unit.

³⁴⁰ Stevens (2010) downloaded November 7, 2012.

³⁴¹ Discussed more fully in Chapter 7.

³⁴² Issued July 14, 2010. File Number S7-14-10 and Release Number 34-62495. This document is available on the internet at www.sec.gov/rules/concept.shtml

³⁴³ Empty voting occurs when the party voting does not really own the economic interest in the shares, as when they have borrowed the shares temporarily or have bought or sold derivatives which transfer the economic interest.

³⁴⁴ Since the primary purpose of a proxy advisory firm is to assist institutional investors in proxy voting and since proxy advisory firms generally work exclusively for investors, the imposition of SEC regulation could severely impact institutional investors’ ability to influence corporate governance.

³⁴⁵ This appears to contradict the research discussed earlier showing long-term benefits from a variety of corporate governance practices.

measuring different criteria or that they disagree on the correct corporate governance actions by issuers. (Daines 2010)

Paul Rose found that proxy advisory firms' standardized voting recommendations have an impact on corporate governance decisions. Corporate counsel, officers and directors tell repeated stories of the "tail-wagging-the-dog" with respect to "one-size-fits-all" methodology for evaluating corporate governance. Each firm has its own methodology for determining good governance, as a matter of competitive differentiation. Investors buy ratings to obtain information, for protection against claims of breach of fiduciary duty, because they believe the ratings are valuable, and to support an effort to reduce agency costs. Competition among advisors creates incentive to improve ratings and quality. (Rose 2011)

Charles Nathan argues that the closure of Proxy Governance, Inc. at the end of 2010 left ISS and Glass Lewis as a duopoly whose voting policies drive company decisions in three ways: (1) Compensation policies are tailored to fit their voting policies, (2) Responses to shareholder proposals are determined to conform to their voting policies, and (3) Governance policies are adjusted to fit their voting policies. According to Nathan, these firms don't merely administer votes; they are critical in the development and proliferation of voting policies. Nathan and James Barrall propose to have the SEC and U.S. Department of Labor re-evaluate the fiduciary requirements for proxy voting to eliminate the requirement to vote, but impose a requirement that any votes cast must be based on case-by-case analysis and evidence of the effectiveness of the position taken. (Nathan 2011)

A recent study by The Conference Board, NASDAQ, and the Rock Center for Corporate Governance at Stanford University found that proxy advisory firms have a substantial impact on the design of executive compensation programs. Several companies that experienced failed Say-on-Pay votes have had derivative lawsuits filed against them, making boards particularly sensitive to proxy advisory firm recommendations. ISS and Glass Lewis made the same recommendation 75% of the time, with ISS recommending "against" somewhat more frequently than Glass Lewis. No company that received a positive recommendation from ISS failed its Say-on-Pay vote, while 12% of those that received an "against" recommendation from ISS failed.³⁴⁶ (The Conference Board 2012a)

Michael Schouten points out that a low rate of deviation from proxy advisor recommendations does not prove that investors are blindly following advisors because it does not determine the reason for the association. Investors may decide that they agree with the advisor. Likewise, the

³⁴⁶ Larcker (2012) reached similar conclusions about ISS' influence, but noted that most compensation program changes were minor and only 14.3% of companies losing Say-on-Pay votes intended to reduce compensation.

recommendation may be based on the advisor's understanding of investors' preferences. His study looks only at four funds, but considers the whole range of voting decisions. The finding that funds sometimes do deviate from their proxy advisor's voting recommendations suggests that they do review the recommendations and reach independent decisions. The finding that the rate of deviation varies by type of decision suggests that funds prioritize their reviews. The author finds that funds deviate the most when they hold large stakes in the portfolio firm, when it is performing poorly, and when the proposal has significant value implications.³⁴⁷ (Schouten 2012)

Robert Monks wrote:

“When Big Business brings an elephant to squash a mouse, it's a safe bet money is involved—lots of it. That's certainly the case with the current effort by the Business Roundtable and U.S. Chamber of Commerce to force proxy advisory services under the regulatory authority of the Securities Exchange Commission.”

He notes that customers are the judge of the worth of a product. While BlackRock and Vanguard have chosen to take over the entire proxy voting process, ISS and Glass Lewis are the only independent advice available to most institutional investors on executive compensation decisions. Just as compensation consultants tend to provide the advice corporations want, proxy advisors tend to serve investors' interests. But they are the only threat to the absolute power of CEOs to set their own pay. In this case, corporations are seeking to use the regulatory process that they ordinarily despise, to hobble them.

Will the SEC have the courage to push back? Monks is not hopeful. (Monks 2012)

³⁴⁷ Ertimur (2012) reached similar conclusions about investors' thoughtful analysis of voting decisions.

Chapter 7.

Research Plan & Methodology

The goal of this project is to learn more about how U.S. institutional investors exercise their power as shareholders of U.S. public companies to influence both internal and external corporate governance decisions. “U.S. companies” are defined as those incorporated in any U.S. state and “public” is defined as registered under the Securities Exchange Act of 1934 with the SEC for public trading of their equity securities.³⁴⁸ U.S. institutional investors are defined as those either headquartered in the U.S. or which have a preponderance of their investments or participants in the U.S.³⁴⁹

Other research has surveyed institutional investors. Useem, et. al. is the closest to this project, interviewing a wide range of types of investor about corporate governance activism. (Useem 1993) O’Barr and Conley looked specifically at pension funds and studied their entire organizations. (O’Barr 1992) Choi and Fisch studied pension funds’ corporate governance activities. (Choi 2008) ISS has surveyed all types of investors about their engagement activities and about their corporate governance preferences. (ISS 2011, 2009) This research differs from all of them in asking all types of investors about all types of activism, especially whether they use the same types of political tools commonly available to corporate management and whether they use their market power of selling or pricing corporate shares in order to influence governance issues.

One problem area in specifying the subjects of this study is with the handling of investment managers. These intermediaries are often impossible to distinguish from some types of institutional investors themselves because institutional investors may invest with them alongside individual investors. A common example is mutual fund companies which accept investments from pension funds as well as from individuals. This happens frequently with trust companies and insurance companies as well. Furthermore, it is possible to have multiple layers of investment managers, such as where one of them manages a “fund of funds” which allocates investments to a range of other investment managers. The problem that investment managers create is double-counting of funds under management and confusion regarding the party responsible for determining the voting policy of the shares owned by a given ultimate beneficiary. While I have intentionally not included investment

³⁴⁸ Usually, but not necessarily, common shares.

³⁴⁹ The types of institutional investors covered are discussed in Chapter 6.

managers where that is their predominant business, a number of hybrid firms are included in the lists of institutional investors used for the study.³⁵⁰

The original plan was to perform a mid-sized (n=50-60) survey of a random sample of U.S. institutional investors drawn from a population of “industry standard” lists of the largest of each type of investor. The entire sample was prepared and a “first wave” of twenty-five subjects were targeted. It took four months of near-full time effort to finally reach all twenty-five. Only seven agreed to participate by survey or interview, a response rate of 28%. The respondents were heavily skewed toward mutual funds. Only two pension funds responded and no other categories of investor were represented. None of the participants agreed easily and all required extensive discussion before they could reach a decision either way.

An evaluation of the first wave of subjects resulted in the conclusion that the response rate was inadequate to reach meaningful statistical results and that the resources required to expand the sample to overcome the problem were not available. In later discussions with several industry experts, it became apparent that the financial crisis and recession had resulted in significant cutbacks in the budgets of proxy voting and corporate governance functions of many institutional investors. In many cases, the experienced managers of these functions were replaced with new people, who, although well-qualified, were apparently uncomfortable with assessing the risks of participating in the study. In others, the experienced managers remained, but lost much of their staff support and simply didn’t have time to participate.

As a result, the remaining interviews and surveys of institutional investors were abandoned and the focus shifted to “expert interviews” of people in a position of constant close contact with institutional investors, either as leaders of industry organizations, established researchers, corporate governance leaders or proxy advisory firm staffs. The original institutional investor surveys and interviews are included in the study because they add an important perspective. Finally, the interviews are supplemented by a study of the comment letters submitted to the SEC in response the Proxy System Concept Release.

Institutional Investor Surveys and Interviews

The questionnaire which was utilized for the institutional investor surveys and interviews is included in the Appendix. The questionnaire was created in an iterative process, gathering feedback from a number of academic reviewers, several industry observers and two institutional

³⁵⁰ In theory, they ought to be able to exclude non-individual participants, but all of them stated in my preliminary conversations with them that they do not maintain separate tracking by type of participant.

investors. The initial draft was drawn from an ambitious plan to survey the views of institutional investors on a wide range of corporate governance goals and ideas, drawn from a broad range of governance literature, related surveys by Institutional Shareholder Services and Georgeson, and conference agendas for the AFL-CIO and Council of Institutional Investors. The iterative trials of the questionnaire resulted in successive reductions in the scope of the questionnaire in order to cut the completion time to 30 minutes in ideal circumstances. The nature of the questions shifted from specific corporate governance issues to more “open probes” about their concerns and types of corporate governance activities and efforts.

The first three questions were devoted to broad characteristics of the investor, including type, amount of U.S. equity investments and the percentage indexed (as a means of focusing on how much of their investments could, potentially, be sold in response to corporate governance failures or disagreements). The fourth question regarding proxy voting and corporate governance budgets was intended as a measure of the real level of commitment to corporate governance activism, to be compared to the investor’s self-evaluation of activism.

Questions 5 and 6, regarding corporate governance issues, were intended to obtain a rough agenda of the corporate governance changes desired by the institutional investor. Questions 7 through 15 were the core of the study, looking at what actions institutional investors actually took in furtherance of their corporate governance goals. Questions 8 through 12 were specifically intended to obtain information on tactics and activities which are similar to the documented political activities of corporate management. These are activities that are permissible for most institutional investors and available to them if they chose to commit the resources.

Questions 13 and 14 were specifically addressed to the particular question of actual utilization of the investor’s power to boycott or sell shares, or to make pricing decisions that considered the corporate governance policies of companies or the external corporate governance rules imposed by state government.

Question 15 was added as an open probe to find other actions not specifically addressed. Question 16 was intended to elicit information about how corporate governance activities responded to the corporate management failures which led to the financial crisis and recession.

In order to create the population “frame” for this study, a number of industry surveys and publications were identified. In all but the hedge fund sector, there were multiple possibilities. The selection was made on the basis of the extent of the listings (i.e., top 20 instead of top 10), thoroughness (i.e.,

fewest obvious omissions), and closest size definition to U.S. public equities. The chosen lists (and their sources) are included in the Appendix.

As the planning of this project and the creation of the frame was accomplished in 2007, the data used for the population frame is generally for the year ended December 31, 2006. It was decided not to try to update this information because 2006 represented the last year which was largely unaffected by the financial crisis and recession. A later period would have made the size measurements less comparable because the impact of the crash was uneven across asset classes and investment strategies. Furthermore, several of the surveys and lists ceased publication after 2006 either because of cost-cutting within the publication or because the participants no longer wished to disclose the information.³⁵²

A sampling plan was developed which attempted to balance coverage of the universe of institutional investors while ensuring a reasonable sample of each type of institutional investor. For this purpose, the pension fund category was divided into three stratified groups (top 10, 11-50, and 51-200) because of the wide dispersion of sizes of pension funds. Each investor within each group was assigned a number in order and a random number generator³⁵³ was used to select the intended sample.³⁵⁴ The resulting sample's characteristics were cross-checked against the sampling plan to confirm that it closely approximated the intended sample, which it did.

In order to inquire into institutional investors' preferences, positions and actions on matters of corporate governance of the companies in which they invest, it is necessary to speak with the individuals who are responsible for these topics. Fortunately, I had the assistance of "un-named"³⁵⁵ industry luminaries who had long experience in researching institutional investor issues. These people provided contact information for people in either the corporate governance or investment divisions of nineteen of the twenty-five "first wave" institutions.

In almost every case, the people in these roles had strong professional credentials. Many had experience in large law firms' business practices or one of the four largest international accounting firms. In only two instances I was aware of people who did not have either a law degree or a C.P.A. One

³⁵² Presumably because it would have disclosed the extent of their losses.

³⁵³ The random number generator at random.org was utilized, based on a recommendation from the Lawrence Berkeley National Laboratory.

³⁵⁴ An oversample of 100% was also prepared in order to avoid re-sampling if the initial sample proved inadequate. It was not utilized.

³⁵⁵ I promised anonymity because in many cases they providing private contact information.

was a C.F.A.³⁵⁶ and one was long-time clerical employee who had “outlasted all the experts.”³⁵⁷

Unfortunately, most of these people were extraordinarily “shy” about participating in the study. I would estimate that they spent more time with me on the phone discussing their potential participation than actual participation would have taken. Many of them stressed how busy they were and spent a great deal of time explaining what they were busy working on, but couldn’t afford the time to participate. A number of them wanted to see the questionnaire in advance and asked questions which demonstrated that they had spent a lot of time studying it. Some were candidly reluctant to answer questions about “activism,” or to participate in a study which might imply that they could or should be more actively pursuing corporate governance goals. They were also very concerned about confidentiality and wanted my personal assurance that their information would not be used in any other way, would not be disclosed to anyone else for any reason, would not be used by me in a subsequent career, would not be used subsequently to try to sell them anything, would not be disclosed in any manner that was personally identifiable, and any number of other fears. My overall impression was that they were wary about participating because they could not predict how it might later harm them and did not think it would help them.³⁵⁸

Corporate Governance Expert Interviews

Faced with inadequate resources and access to reach a sufficient institutional investor sample size, this research subject posed a problem of proof. A very large share of legal and social sciences research takes a quantitative approach, and there is a very intense focus on the statistical validity of the results. But the real purpose of research is to learn or validate new information and quantitative methodologies are not the exclusive means of accomplishing this goal. A qualitative approach, such as a focus on the content of written and oral material, may be just as persuasive if the information is reasonably consistent.

³⁵⁶ A Chartered Financial Analyst, one of the most prestigious designations for a securities investment analyst.

³⁵⁷ This person was one of the most knowledgeable and informative people with whom I spoke

³⁵⁸ I later learned that this had been a period of significant internal “turmoil” in institutional investors. Discussions with one of the proxy advisory firms’ research staff indicated that there had been “the biggest turnover in twenty-two years” in the institutional investors’ proxy voting and corporate governance staffs. One “un-named industry luminary” mentioned above told me that the layoffs had disproportionately targeted the most senior, most experienced and most activist people. One of the expert interview participants, in preliminary conversations, said that there had been “an unprecedented reduction in the capabilities of corporate governance staffs to cope with the challenges from corporate management” and that “the poor people who are left are afraid of their shadows.” Professor James Hawley of the Elfenworks Center for the Study of Fiduciary Capitalism at St. Mary’s College of California told me of a contemporaneous corporate governance conference they sponsored which drew virtually no institutional investor participants. Many of the comments in the interviews themselves made clear that cost-cutting and budget constraints were having a significant impact on corporate governance activities of institutional investors.

The problem of small sample size also poses a problem of representativeness. That is, having relatively few sources increases the risk that the information might be true for part of the population, but fails to discover that there is a large segment for which it is untrue. This led to a search for sources which were reasonably comprehensive of the world of institutional investors. Fortunately, there is a group of relatively independent researchers, analysts and leaders who have established lines of continuing contact with a broad range of institutional investors.

First, there were six significant proxy advisory and research firms who are in the business of selling information services to institutional investors to assist them in proxy voting and corporate governance activities. These firms are in regular contact with institutional investors about their corporate governance preferences and goals in order to establish proxy voting guidance for their institutional investor clients. Virtually every institutional investor retains one or more of these firms, even if they also have a large internal staff working to the same purpose. Not included in this group are firms specializing in individual investors and one firm which specializes in Taft-Hartley (union) pension plans.

Second, there are several organizations sponsored by business, which have established a reputation for unbiased and comprehensive research into institutional investors and their corporate governance activities. Institutional investors who declined to be interviewed told me that they regularly respond to these group's surveys and interview requests. Not included in this group are a number of organizations which act as advocates for business (or particular industries) on corporate governance issues.

Third, there are three organizations sponsored by institutional investors which focus on corporate governance issues.³⁵⁹ All three of them conduct research into institutional investor positions on corporate governance issues, as well as sponsor extensive conferences and meetings of institutional investors which provide a forum for the expression of institutional investors' ideas, views, proposals and activism. Not included in this group are the major union groups, AFL-CIO, AFSCMA, SEIU and Teamsters, which have significant corporate governance research and activism programs.

Finally, there is a group of individual "luminaries" who have a long history of leadership in institutional investors' corporate governance activities. These people are the speakers at conferences, witnesses at congressional hearings, published authors of books and articles, and consultants on corporate governance issues for institutional investors. Not included in this group were other academics or current government officials.

³⁵⁹ Interestingly, all three appear to accept participation by corporate issuers as well.

From a list of twelve possibilities drawn from the above categories, seven subjects were selected to be invited to participate in in-depth interviews. In order to insure confidentiality regarding their participation, not all members of any category were included. While it took an elapsed time of six months to persuade, schedule and interview them, all seven ultimately participated.

The questionnaire for the expert interviews is included in the Appendix. It was based on the institutional investor questionnaire, with extensive modification. One consideration was that the experts would be asked to answer for the entire universe of institutional investors, requiring that they be asked for average answers, weighted by the dollar amount of investments in U.S. equities. The experts were treated as qualified experts in the legal sense; that is, they were asked for their judgments and opinions as well as their personal knowledge. In particular, when they did not know specific answers, they were asked to estimate based on their experience and knowledge of institutional investors.

During the institutional investor interviews, it became apparent that proxy advisory firms were playing a key role in coordinating the corporate governance positions of institutional investors (despite the initial impression from the investors' responses to the question about coordination).³⁶⁰ This topic became even more interesting when the SEC included the possibility of regulating proxy advisory firms in its Proxy System Concept Release. This resulted in the addition of Questions 8 through 15 to gain insight into the process of proxy voting and to get some indication of the degree to which proxy advisory firms were inducing activism among institutional investors.

Questions 16 to 25 generally parallel Questions 8 to 12, looking for data regarding corporate governance activism, with the addition of more types of activism and a key follow-up to the questions about the use of actual investment power (i.e., buying or selling shares). Questions 26-28 were "expanded" to create broader "catch-all" open probes to elicit more discussion. In several cases, this served to trigger much deeper comments by the subjects. Finally, Question 29 was added to try to learn more of the background story on how the attempt to regulate proxy advisory firms came about. Questions 30 and 31 were optional and not reached in any of the interviews.

Confidentiality, Recording, Human Subjects Protections and Procedures

The exact process of soliciting the participation of the various subjects was dependent upon the contact information which was available (i.e.,

³⁶⁰ In the course of trying to schedule the investor interviews, many of them mentioned that they were attending meetings and conferences with proxy advisory firms.

addresses, phone numbers, or email). As soon as either a mailing address or an email was available, a cover letter or email was sent with the Human Subjects letter as an attachment. The Human Subjects letter is included in the Appendix. These were sometimes accompanied by a summary description of the project and/or a description of the interviewer's background to establish the level and importance of the project.

The subjects (and potential subjects) were promised confidentiality regarding their identity, participation and potentially-identifying information in any product of the research, in the earliest contact with them. Potential institutional investor subjects were told that they had the option of participating in a written survey or structured interview. Any subject (or potential subject) who requested a copy of the questionnaire was provided it. In almost every case, the interviews which took place were previously scheduled.

The University of California, Berkeley Human Subjects staff granted approval for oral consents to participate based on the need for confidentiality. This was usually accomplished by reference to the previously provided Human Subjects letter.³⁶¹

All interviews were conducted in private from the interviewer's home on a dedicated landline telephone. Each subject was assigned a unique number which was written on their questionnaire and included in their recording. That number was recorded on a separate, handwritten index, along with the subject's contact information, but no other identifying information was included in the questionnaire or recordings. No reference was made to the name of the subject or their organization during the interviews. In a few cases, the subjects, themselves, used their own name or the name of their organization during the interview. Every effort was made to edit these out of the final transcripts of their interviews.

The subjects were asked for their permission to record the interview. In those cases where it was denied, the questionnaire was used to manually record their answers in as much detail as possible without interrupting the interview. When consent to record was granted, both the consent to participate and the consent to record were repeated on the recording. The recordings were made on a portable Olympus digital recorder and immediately transferred to the author's home computer.

The interviews were transcribed by the author and maintained at home. The index is stored at home in a locked filing cabinet. The author's home computer is protected by multiple firewalls and virus protection software.

³⁶¹ In the case of the one subject who consented on first contact, this was accomplished by reading the Human Subjects letter at the beginning of the interview.

Backup copies are kept on an external hard-drive stored in a safe deposit box and encrypted at Carbonite.

The subjects have been assured that the index and the recordings will be destroyed upon publication. No separate confidentiality agreements were made although some of the potential subjects proposed them.

SEC Proxy System Concept Release Comment Letters

On July 14, 2010, the SEC issued a Proxy System Concept Release soliciting comments by October 20, 2010 about a wide range of issues in the proxy voting system.³⁶² This resulted from several decades of concern about the uncertainty of the proxy voting process and a specific campaign beginning in 2004 by the Business Roundtable, acknowledged by the Shareholder Communications Coalition in their comment letter dated August 4, 2009.³⁶³ The Concept Release addresses diverse issues including the creation of an audit trail for proxy votes, the monopoly positions of the firms which manage the shareholder ownership data, proxy document distribution and proxy vote aggregation process, proxy voting by securities lenders, “empty-voting,” improving communications with shareholders, data-tagging the actual proxy document and other issues.

While most of these issues are relatively neutral and non-controversial for institutional investors, there was one topic which could affect their corporate governance activities very directly. The SEC asks about the need for regulating proxy advisory firms, citing concerns about increased influence, conflicts of interest, potential problems in accuracy and transparency, use of one-size-fits-all approaches, lack of oversight, absence of an actual economic interest, and industry concentration. While the Concept Release specifically refers to concerns raised by issuers in several places, there is no mention of any concerns raised by institutional investors. Since the primary purpose of a proxy advisory firm is to assist institutional investors in proxy voting and since proxy advisory firms generally work exclusively for investors,³⁶⁴ the issue of increased regulation of proxy advisory firms appears to be an effort by issuers to use the SEC to intrude on the rights and power of institutional investors.

The issue of regulation of proxy advisory firms presents an opportunity to observe the interplay of the political activities of corporate management and their supporters, with institutional investors and their supporters. The

³⁶² File Number S7-14-10 and Release Number 34-62495. This document is available on the internet at www.sec.gov/rules/concept.shtml

³⁶³ The Business Roundtable is one of the members, and reportedly the founding member, of the Shareholder Communications Coalition.

³⁶⁴ With one major exception. A company owned in parallel with Institutional Shareholder Services is in the business of advising issuers for a fee on how to improve their corporate governance scores and votes.

comments submitted to the SEC, and the meetings held with SEC commissioners and staff, are disclosed on the SEC's website.³⁶⁵ Each comment or meeting notice submitted by December 15, 2011³⁶⁶ was downloaded and reviewed for its source and content. The parties were sorted as follows:

Issuers

Pro-issuer Organizations

Pro-issuer Individuals

Institutional Investors

Pro-investor Organizations

Pro-investor Individuals

Labor Unions

Political Organizations³⁶⁷

In the vast majority of cases, the nature of the party was obvious. In a number of cases, the affiliation of the author was not stated, but was easily determined by internet searches. Likewise, the characterization of some of the organizations was made after a review of their websites and IRS Form 990 filings. Private businesses which primarily serve issuers were classified as Pro-issuer Organizations. The law firms which appeared all represented corporate issuer interests, with the partial exception of a memo prepared by Cleary, Gottlieb on Client Directed Voting which was submitted by the Council of Institutional Investors. In a few cases, the only way to characterize the leaning of an individual was by reference to the positions expressed in the letter. Of the 275 comment letters, only one could not be classified.

The comment letters included 104 which contained positions regarding the regulation of proxy advisory firms. Letters which merely expressed the view that proxy advisory firms should be Registered Investment Advisers were considered to be "Pro-Advisor" because registration, in and of itself, brings with it no particular intrusion on the work of the proxy advisory firm other than requirements for filing annual disclosure statement and the disclosure of conflicts of interest.³⁶⁸ If the letter expressed a view that proxy advisory firms should be regulated in other ways, it was classified as "Pro-Regulation."

³⁶⁵ www.sec.gov/comments/s7-14-10/s71410.shtml

³⁶⁶ The SEC does not appear to have actually imposed their stated deadline of October 20, 2010 and the process is ongoing.

³⁶⁷ Americans for Democratic Action

³⁶⁸ All of the proxy advisory firms profess to disclose conflicts of interest in various ways which probably satisfy existing requirements for Registered Investment Advisers.

Chapter 8.

Study Results

This chapter presents the results of all three elements of the empirical research, summarized from the surveys, interview notes, transcripts and analysis of the SEC comment letters. Every effort has been made to maintain the tone, balance and essential content of the responses. The exact language of the questions may be found in the sample Questionnaires included in the Appendix. The responses support findings (among others) that, despite a fairly low level of trust that boards of directors will act in investors' interests, institutional investors (1) devote very few resources to corporate governance issues; (2) rarely engage in political tactics and make negligible political contributions; (3) rarely investigate director candidates or vote against them; (4) rarely use their economic power to buy or sell shares for corporate governance issues; and (5) do not recognize proxy advisory firms' importance in providing coordination and largely failed to support them against a corporate campaign to impose SEC regulation. Ultimately, the responses lead to the conclusion that there is a substantial mismatch in resources, incentives and personalities between institutional investors and corporate management.

Institutional Investors and Expert Advisers

There were seven responses from institutional investor representatives, consisting of four interviewees who declined to be recorded, two recorded interviews and one survey submitted on an anonymous basis, presumably from one of the potential subjects who requested to see the survey instrument in advance.³⁶⁹ The individual interviewees were all obviously knowledgeable about the proxy voting and corporate governance activities of their respective institutions. Where I was provided their titles, they were usually the director or manager of the proxy voting and corporate governance functions. In two cases, they were members of proxy voting committees which made the decisions on proxy voting positions for their institutions. In one case, the respondent was a Chief Financial Officer who was the sole trustee of the institution.

The two investor interviews which were recorded averaged 33.5 minutes. The others ranged from ten minutes to roughly an hour.

There were seven recorded telephone interviews with a variety of experts in the field of corporate governance who have institutional investors as their primary research subjects, clients or members. They represented

³⁶⁹ My records indicate that there were sixteen potential subjects who requested copies of the survey instrument in advance, in order to understand the questions to be asked, to help them to decide whether to participate at all and whether to participate in the form of an interview or by submission of a survey.

four of the proxy advisory firms and three membership organizations that have major roles in the field. Each of the respondents is well-known in the institutional investor corporate governance world and is either one of the top officers of their organization or leads the research or policy-formation function within it. They are all frequent speakers or authors in the field, and most of them were recommended to me by each other as people who could speak authoritatively about institutional investors' views and activities in the area of corporate governance.

The expert interviews averaged 77.4 minutes and ranged from 47 minutes to 122 minutes.

The *investor* respondents consisted of one public pension fund, one corporate pension fund and five mutual funds.³⁷⁰ The seven *expert adviser* respondents indicated that they serve clients who are public pension funds (7), corporate pension funds (7), union pension funds (7) banks or trust companies (3), insurance companies (4), mutual funds (6), foundations (5), endowments (6), and hedge funds (6).³⁷¹ (Question 1)

The investor respondents' average investment in U.S. public equities markets as of December 31, 2009 was \$305 billion, ranging from a low of \$6.2 billion to a high of \$1106 billion (or \$1.106 trillion). Four of the seven expert advisers responded that they follow investors with total U.S. public equity portfolios ranging from \$2 trillion to \$10 trillion. (Question 2)

The median institutional investor estimated that the percentage of their investment portfolio which was invested in indexing strategies was 25%, with a low of zero and a high of 77%. The median expert adviser estimate was 37.5%, with a low of 25% and a high of 40%. (Question 3)

Corporate Governance Issues and Agenda

The institutional investors were asked directly about their most important corporate governance issues. The expert advisers were asked a related question: what issues were involved when investors choose their own custom proxy voting positions.³⁷² Together these represent a fairly thorough picture of the corporate governance agenda of institutional investors in 2010. The following ranking is in order of the number of times each issue was mentioned by the investors:

³⁷⁰ I was unable to persuade any union pension funds, bank or trust companies, insurance companies, foundations, endowments or hedge funds to participate.

³⁷¹ The number in parentheses is the number of advisers who serve that type of investor client, in most cases many of that type.

³⁷² These would tend to be the subjects where the investors' views differed most strongly from the proxy advisor's standardized recommendations.

Annual election of directors (prevent staggered boards)
 Majority voting for directors (rather than a plurality)
 Proxy access to nominate directors (without being specific about number or mechanics)
 Limit excessive executive compensation (generally)
 Shareholder approval of specific proposed transactions³⁷³
 Permit shareholders to call meetings (without being specific about mechanics)
 Require shareholder approval of golden parachutes
 Align compensation with shareholder results (generally)
 Vote against compensation committee members who approve excessive compensation
 Require Say-on-Pay votes by shareholders (without being specific about mechanics)
 Require long-term incentive compensation
 Use reasonable hurdles for incentive compensation
 Use reasonable peer comparisons for incentive compensation
 Require stock options to be issued at current market value
 Majority independent board
 Require shareholder approval of poison pills
 Shareholder rights (generally)
 Climate risk³⁷⁴
 Board diversity³⁷⁵
 Director qualifications
 Board accountability (generally)
 Reimbursement of cost of successful proxy proposals and director elections
 Limit executive perquisites (generally)
 Eliminate income tax gross-ups for the taxes on compensation
 Limit dilution from equity-based compensation to 15% (10% for S&P 500 companies)
 Require independent compensation and nominating committees
 Prohibit option backdating
 Eliminate supermajority provisions
 Improve compensation disclosure
 None

There is no requirement for institutional investors to conduct an active corporate governance program, but the fact that this study is explicitly about corporate governance creates a bias to overstate corporate governance

³⁷³ All of the respondents would probably have included this, had they thought of it, because these transactions are fundamental (e.g., mergers, acquisitions, dispositions, etc.), often involve conflicts and directly affect the value of their investments.

³⁷⁴ Not a direct corporate governance issue.

³⁷⁵ Not really a corporate governance issue, as presented by this respondent, but could be important in the context of board representation of shareholder interests (vs. management interests).

activity. One would expect investors who have no active program to avoid responding, so it was refreshing to find one investor who responded quite candidly: “We have no corporate governance program. We have delegated all investment management issues to an outside investment manager without instructions, except to vote proxies in the interests of the plan.”

The issues mentioned by the expert advisers tended to be more general categories, again in order of frequency:

- Executive compensation
- Director elections
- Mergers
- Shareholder rights
- Separate chair and CEO
- Takeover defenses

In sum, the responses of both the investors and the expert advisers largely map into the following three general areas:

1. Transaction proposals and anti-takeover devices³⁷⁶
2. Improving board responsiveness to shareholder interests³⁷⁷
3. Controlling compensation and aligning it with shareholder interests

Investors articulated their corporate governance goals as follows:

“Our focus is, first of all, just the structure of compensation plans. Getting rid of some old practices that are not really accepted anymore. Such as excessive perqs that are out of context for the type of company that it is. Big golden parachutes, for instance. Grossing up taxes to pay everything. These are practices that are still quite common, but, in our view, are outdated and are unrelated to the performance of the company, mostly, because we are talking about guarantees. Guaranteed strains of comp instead of performance-related strains of comp. So the structure of comp, and back to board accountability, the notion of holding directors accountable for their compensation related decisions.”

³⁷⁶ Transaction proposals are really a “given” in corporate governance efforts and were probably omitted by investors who presumed that they would require significant attention. It is likely that relatively few investors have standardized goals regarding transactions because they vary so greatly in structure. Likewise, anti-takeover devices are such an old and fundamental issue in corporate governance that relatively few investors mentioned them, despite many of them having well-evolved policies on how they vote or otherwise respond to them.

³⁷⁷ These include efforts to reduce the CEO’s influence over the board and to increase the board’s influence over the CEO.

“We are looking for long-term-oriented compensation. Performance hurdles that are not slam-dunks. We like to see hurdles that make sense for the company, based on competitors as well.”

(Investor Question 6 and Expert Question 12)

Importance of Corporate Governance Reform

The expert advisers were asked what proportion of institutional investors want corporate governance changes. All seven experts responded with a median of 70% and a range of 10% to 85%. (Expert Question 5) Among their comments were those that emphasized the low end of that range:

“I am very cynical. I think that there are very few people that care about this area. I think very few people in institutions really care about it.”

At the other pole, one respondent said:

“I believe that a lot of the larger organizations believe that corporate governance is important. Where it is not practiced particularly well, they want to see change. But I’m not convinced that they all know exactly what kind of change they want to see. That is, I don’t know that they’ve put the time into thinking it through.”

Both the investors and advisers were asked to rate the importance of corporate governance to institutional investors on a scale of 1 to 10, with 10 being most important. The median investor response was 3, with a low of 1 and a high of 10. The median expert response was 5, with a low of 5 and a high of 7. Neither response is particularly intense, but the discrepancy is probably attributable to the over-representation of mutual funds among the investors. (Investor Question 5 and Expert Question 6)

Both the investors and advisers were then asked to rate the *level* of institutional investor *action* on a scale of 1 to 10. The median investor response was 3, with a low of 1 and a high of 6.5. The median expert response was 4, with a low of 2 and a high of 6. Both ratings were in the “somewhat inactive” range, with the experts slightly higher, probably because they see more of the activity of public and union pension funds. While the investors’ ratings show their action in line with their motivation, the experts appear to think the investors are less active than their level of concern would warrant. (Question 7) One of the experts commented:

“There’s a big free-rider problem and a lot of institutions support the causes of others, but the number who are active is pretty small.”

Finally, both the investors and experts were asked to estimate how much the average institutional investor spends annually on proxy voting and corporate governance. According to investors, the average amount spent on proxy voting and corporate governance functions was \$1,029,000, with a low of zero³⁷⁸ and a high of \$2,400,000. Four of the experts responded with an average of just over \$140,000 and ranging from \$100,000 to \$200,000. The huge disparity is probably attributable to most of the investor respondents being large mutual fund groups and the experts' clients including the entire universe of much smaller institutional investors. (Question 4) The experts' comments included:

“I think that there are very few who spend a substantial amount and most spend little or nothing.”

“You know, it is hard to imagine that it is less than in the six figures, except at the very smallest organizations, and easily gets into seven figures at the larger ones if you count the proxy voting staffs that these folks have. The people who are involved in engagement, as well as what they're paying us and our competitors and other service providers. I don't think it gets beyond the low seven figures at very many, but if you're talking about the very largest mutual fund complexes or the very largest public pension funds, it's got to be into the seven figures.”

These amounts appear quite small compared to the cost of a single major lawsuit (\$500,000 or more) or a proxy contest to elect a director or pass a resolution (easily \$1 million or more).

Corporate Governance Actions

Both the investors and experts were asked a series of questions about what percentage of institutional investors had engaged in various actions in furtherance of their corporate governance goals during 2009. Their median responses are summarized as follows:

<u>Action</u>	<u>Investor%</u>	<u>Expert%</u>
Tried to influence legislation	14	22
Tried to influence regulatory agency	29	50

³⁷⁸ This response is somewhat suspect because the respondent was annoyed by the question, thought proxy voting was a waste of time (despite claiming to vote “virtually all” proxies), and conveyed the impression that their institution spent as little as possible on these functions. It is likely that a more correct response would have been approximately \$250,000, which represents the minimum cost of administering the process of reviewing proxies and submitting votes for the roughly 5,000 U.S. public companies. A large institutional investor would typically have investments in a large proportion of these companies. The average is calculated accepting the response of zero, but would be \$1,064,000 if the \$250,000 figure was substituted.

<u>Action (Continued)</u>	<u>Investor%</u>	<u>Expert%</u>
Coordinated with another institutional investor	43	20
Tried to raise political contribution funds	0	7
Participated in litigation	29	5
Retained a lobbyist for corporate governance issues	NA	10
Retained an attorney for corporate governance issues	NA	15

These questions were essentially what percentage had done any of these actions in a given year, not how much of them they had done. The comments are very important to understanding that most investors who did any of a particular action *did very little of it*. (Investor Questions 8-12 and Expert Questions 16-22) For instance, investor comments included:

“I think the principal reason is that we have historically not lobbied our elected officials. We rely on our trade organization, the Investment Company Institute, really to represent the industry on matters that are relevant to us.”

“We don’t support shareholder activism because we don’t believe it serves investors’ interests.”

“We do not believe political activity is appropriate for a large investor.”

“Wrote comment letters on several SEC rule-making proceedings. Supported CII³⁷⁹ meetings and attended several. Supported SEC climate-risk disclosure requirements, compensation disclosure, compensation consultant disclosure, and proxy access proposal.”

“We work with a number of groups of institutional investors, some of them ad hoc, where there would be groups of investors on corporate governance issues.”

“We only coordinate on private contact with management.”

“We feel that political contributions are too dangerous. We believe we are prohibited from influencing contributions where we have a financial interest. We do not consider our client relationships in proxy voting, but follow our published policies consistently.”

“We think it is inappropriate for a pension fund to pursue political contributions.”

³⁷⁹ Council of Institutional Investors

“We’ve worked with and been the lead plaintiff on a number of shareholder lawsuits. And also been part of shareholders suits in some other areas. Many of these have had to do with recovery of assets, but in the settlements, we have been looking at including corporate governance provisions.”

Expert comments included:

“. . . my impression is that they were buried under an avalanche of corporate campaign and lobbying contributions.”

“They are going to be outspent 100 to 1 all the time. Maybe 1000 to 1.”

“Just to give you an idea, there were 800 separate fundraising events scheduled around the vote on Dodd-Frank. None of them were scheduled by institutional investors.”

“I think there was a far more significant push and a far more significant investment on the part of corporate management to influence this legislation . . . I would say it was anywhere between five and ten times as much.”

“There was a time years and years ago, like 20 years ago, where there was a trade association of ERISA funds that made a very gentle and moderate comment about, during the takeover era, about some entrenchment devices that they thought possibly might not be such a good thing. The entire trade association was taken apart.”³⁸⁰

“. . . it’s almost like we don’t trust our fellow shareholders to act in their interests. Therefore, we don’t want these people to get the ability to nominate candidates because we don’t trust that our fellow shareholders won’t elect them . . . Proxy access just gets you onto the ballot. It doesn’t guarantee that anyone’s elected. And if you, as a board candidate, are able to win the support of a majority of shareholders, are you really a special interest candidate anymore? Are you really representing just the hedge funds anymore?”

“For the most part, what they’ve done, I would say, is comment letters. They’re likely, in addition, to engage in discussions about these issues.”

“A lot of the large institutions will not comment directly. They will use trade associations, so it is really hard to tell whose hand is behind some of the comment letters . . . I think it is principally the blowback risk. Especially financial services firms, they are in the eye of the

³⁸⁰ The Council on Investment of Employee Benefit Assets.

hurricane with the SEC all the time and the last thing they want to do is poke a finger in the eye of the SEC, who they believe has particular views on some of these issues and they just don't want to get in the crosshairs of anybody there. Institutional investors often are regulated entities as well or they're investment companies or investment advisers and they just want to stay out of the limelight."

A followup question to the investors asked what other actions they had taken to advance their goals. Two of the seven responded "None" and the other five responded that they had done "Engagement" with companies. This is the most common form of institutional investor action and consists, in most cases, of polite letters, telephone calls and meetings in which the investor expresses whatever concerns they have, usually in a one-on-one context. It does not appear to put much pressure on management to make changes. (Investor Question 15) Investor comments included:

"We have no formal corporate governance goals. We vote our proxies and react to management proposals."

"I would just point to our engagement program with corporate issuers. We write about 20 letters a year, for instance. We have some follow-up meetings with individual directors or committees on boards where we have concerns."

"Our corporate governance activism consists of voting and engaging in dialogue with companies."

A followup question to the expert advisers asked what other actions investors *should* be taking. Five experts responded. (Expert Question 26) The list, in order of frequency, is as follows:

- Use director voting to enforce their goals
- Use governance as an investment screen (tie)
- Focus on impact of excessive compensation on risk (tie)
- Exercise due diligence in proxy advisor selection (tie)
- Coordinate with other institutional investors
- Increase engagement with management
- Publicize problem companies
- Lobby IRS to permit stock options indexed to peer performance (tie)
- Initiate shareholder proposals (tie)

It seems telling that the experts' response comes down to "pay attention and use the tools they already have." Most of these actions are so basic that it is alarming that the experts are telling us that most institutional investors are not doing the monitoring and corporate governance functions which beneficiaries would expect. It appears that corporate governance is not very

important to institutional investors and that much of their corporate governance activity may actually be “window dressing” to be able to say that they have a program and take action. Only the last three items, two mentioned by one adviser each, would put any pressure on management.

Most important is that the responses to these questions indicate that most institutional investors do not use the political tools routinely deployed by management, and those which do seem to use them infrequently and with little commitment. And they don't appear to have an alternative arsenal of tools³⁸¹ which might create more balance in the competition for corporate governance rules.

Director Election Voting

The expert advisers were asked a series of questions intended to learn whether institutional investors use their voting power in director elections to try to advance their corporate governance goals. *The first question was what percentage of institutional investors trust boards of directors to act in the investors' best interests. The median response was 45%, with a low of 20% and a high of 77.5%. This relatively low level of trust would lead to a prediction that there would be widespread voting against directors nominated by the board. But there is not. (Expert Question 13)*

Next, expert advisers were asked how they obtain the information they need to make their director voting recommendations. The overwhelming response (first by six of the seven expert respondents) was that their primary source is the SEC mandated disclosure in the annual proxy statement and other filings. Two added their own impressions from meetings with the company and one mentioned internet searches. *None of them indicated that they or their investor clients use any form of background investigation, of the sort that would be used to vet a political, governmental, academic or corporate job. Because of the secrecy surrounding board discussions and decisions, this is the only opportunity to have meaningful information about the people who become directors. It is a bit surprising that the director voting decision process is not more rigorous. (Expert Question 14)*

Finally, the experts were asked what proportion of board nominees were opposed by institutional investors. The median response was 15%, with a low of 5% and a high of 25%. Georgeson³⁸² reported that only 748 nominees, out of almost 12,000, had 15% or more negative votes in 2010, making this estimate appear quite high. (Georgeson 2010) In any event, even 15% appears quite small, relative to the estimated 55% of institutional investors

³⁸¹ E.g., a program of communication to motivate their beneficiaries to vote or contribute in support of corporate governance reform.

³⁸² The largest proxy solicitation firm, which tracks annual meeting data for the S&P 1500 companies.

who do not trust boards to act in their best interests noted above. (Expert Question 15)

Expert comments on this subject included:

“I can point to any number of companies where, if you just look at the stock price and ask investors if they are satisfied, they would say yes, but if you probe a bit and ask has the board been overly deferential to the CEO or has the board allowed the CEO to benefit excessively through the compensation program, they might say yes, that’s happening.”

“ . . . we’ve been flooded with new disclosure over the last couple of years with regard to compensation, board structure, qualifications of directors, primarily because of how they are told to disclose information, what they are allowed to disclose, what they feel they are allowed to disclose. But I think it is unfortunate that companies haven’t found a way to be more creative getting information presented well. I think that will change over time. I hope it will change over time.”

“[A recently released report shows] that 81 directors this year have failed to receive majority votes from shareholders.”³⁸³

Exercise of Economic Power

Both the institutional investors and the expert advisers were asked questions about the extent to which investors buy or sell shares, or adjust the values in their pricing models, as a result of corporate governance considerations. This is a key element to understanding whether market forces could guide the development of corporate governance law, regulations and practices.

Five of the seven investors (71%) responded “no” to the question of whether they buy or sell shares and six of the seven investors (86%) responded “no” to the question of whether they take governance considerations into account in their pricing models. The experts’ median estimate was that 5% of investors had bought or sold shares due to governance issues, with a low of 0 and a high of 10%. The experts’ median estimate was that 12.5% of investors

³⁸³ This addresses a different question from the percentage opposed. These are the directors who failed to get at least 50% of the votes actually cast. Given the Georgeson (2010) data cited above, this represents 0.675% of director candidates. There are thousands of directors up for election each year and a few investors may be opposing many of them, but without coordinated targeting, the vast majority of directors are re-elected because the opposition is spread very thinly.

considered corporate governance in their pricing models, with a low of 10% and a high of 25%.

It is important to bear in mind that these responses only mean that the investor might have bought or sold based on a corporate governance issue once during the year. Likewise, the issue might have been a theft of corporate property by a senior corporate officer. Similarly, the inclusion of corporate governance as a factor in the pricing model could range from a comprehensive assessment of all of a company's corporate governance practices and behavior, or it could be an adjustment for individual cases of rare governance problems (such as a dual class stock structure which guarantees that control remains with a founder). *It is likely, based on the comments, that the real level of market feedback on corporate governance is much smaller than these estimates:*

"We prefer to work with the company instead of having to sell the stock."

"We don't sell shares for corporate governance reasons because it conflicts with our indexing strategies. Some of our active portfolio managers consider corporate governance, but it is not initiated by our corporate governance group."

"Proxy voting is kept independent of the investment team and no decisions are initiated from our corporate governance activities."

"Governance is considered only as a minor factor in the overall assessment. It has no quantifiable effect on our valuations. There are no formal adjustment factors."

"Investment managers are asked to consider corporate governance issues."

"No formal process, but investment team might consider governance issues on an ad hoc basis."

"I would say that the "Wall Street walk" is getting harder to do as passive investing, indexed investing, spreads, but there's still a fair number of active managers out there and there are the pure "quants" who only look at numbers and nothing else, but there are also investors who do take governance factors into account, I believe. Even if it's not a majority. Even if they don't do it all the time."

"No, this isn't something that I've seen a lot of. I don't get the impression that that is a tactic that many will use."

In addition, the expert advisers were asked what proportion of investors bought or sold shares, or adjust pricing, based on the state of incorporation or any state law provisions affecting corporate governance. The median response was 0, with a high of 2%. One commented:

“I’ll bet most investors have no idea where the corporation is incorporated.”

Based on these responses, it appears that there is almost no market price feedback to companies about their corporate governance and no meaningful market price input to states about their corporate governance laws and decisions. (Investor Questions 13-14, and Expert Questions 23-25)

Proxy Voting Behavior

The expert advisers were asked a series of questions about the proxy voting positions of institutional investors. These were intended to elicit further information about the activism of investors and to compare their voting with their political and economic actions.

The experts’ median estimate of the proportion of investors whose positions were more activist than proxy advisers was 20%, with a low of 10% and a high of 50%. This response was inconsistent with their median estimate of the portion of investors who actually implement customized voting policies which are more activist than proxy advisers, which was 25%, with a low of 10% and a high of 50%. One would expect fewer activist positions to be implemented than the investors’ ideal. (Expert Questions 8 and 10)

A question about the proportion of institutional investors who specify their own custom voting policies obtained highly disparate results. Three advisers estimated 30% and three made estimates that closely bracketed 60%. (Expert Question 9)

The question about the proportion of the investors’ portfolio to which the custom voting policy was applied yielded a median estimate of 85%, with a low of 50% and a high of 100%. (Expert Question 11) This appears to be inconsistent with the experts’ comments on Question 8:

“. . . basically, the answer would be almost none, unless it is a highly visible and controversial topic, in which case, the higher the visibility and the more controversial the subject put to a vote, the less likely investors are to follow the advice of the proxy advisor, and both ways.”³⁸⁴

³⁸⁴ The reference to “both ways” presumably means that they might be more or less activist than the proxy advisory firm.

“In general the answer is zero, except when it matters. I mean, the issues where it counts are the ones where they vary.”

If investors were targeting their votes for such exceptional cases, one wouldn't expect their custom proxy voting positions to be applied to such a large proportion of their portfolio. Because of the inconsistent responses to this group of questions, they are not considered further.

Explanations for Minimal Activism

The institutional investors and expert advisers were asked about the effects of the Financial Crisis and Great Recession of 2008 on corporate governance programs. The question was asked with the expectation that investors would have responded to such tremendous financial losses with a significant increase in their corporate governance activities, aimed at reforms which would try to prevent the management decisions and behavior leading to the crash.

The answers were surprising. The response to the crisis was quite limited. Many investors' programs were cut back. While some of the advisers thought governance activism had increased, the overall impression of the comments tended to show a decrease. A related question to the expert advisers only, regarding why institutional investors do not use their power to force the adoption of their corporate governance goals, is combined here to fill in the reasons why institutional investor activism on corporate governance issues is minimal. (Investor Question 16 and Expert Questions 27-28)

The investor comments included:

“The biggest result has been that our operating budget has been constrained. Travel is limited, networking opportunities are reduced, and we have less presence at company annual meetings. We haven't lost any staff and our effectiveness isn't reduced in the short-run, but we are more focused on local companies.”

“ . . . it is partly because of the budget problems. When the overall stock market goes down and budgets are being slashed, everybody is in belt-tightening mode and not in “let's put aside a few million dollars to start a new PAC” mode. I think that is as much an explanation as anything. Not that there isn't outrage, not that there isn't interest in these issues, but it comes down to resources and institutions feel that they don't necessarily have the resources to be creating new organizations.”

“We haven’t been able to travel as much as we want. We’ve had to do a lot more of it over the phone. It has limited our ability to network in person, not only with organizations. I think we’re going to fewer annual meetings. When we have a shareholders resolution, instead of going ourselves, we’ll find somebody else who is closer to go and present our resolution. The limitations have mostly been in terms of travel and being able to meet in person. There has not been a staff cutback or any cutback for any of our consultants.”

One expert said:

“It has definitely increased. In the past, institutions were more in the camp of ‘let’s just sit back and let the companies run themselves’ without realizing that they need to pay more close attention to the companies in their portfolio, particularly about risk control.”

But the majority of the experts felt that corporate governance activity was constrained:

“They are trustees and they have a kind of collective choice problem,³⁸⁵ which is that anybody who is out in front is going to be spending 100% of the money for the lobbyist or the ad in the paper or whatever it is that they are doing, for only a prorata share of any benefits. And that’s really an insurmountable hurdle.”

“They were shell-shocked themselves. They were struggling. Look at CalPERS; they were on furloughs a couple of days a month. They’re facing bigger problems of their own and certainly any state or municipal public employee fund has budget concerns. The big mutual funds were facing huge drops in their portfolio values. And labor unions and other concerns, as well, probably ranked higher than corporate governance for them.”

“I think the whole resource issue is part of it. I think part of it is just a desire not to attract attention. A preference for flying under the radar. Sort of recognition that their influence has been questioned or criticized . . . For the public employee funds, they exist in such an intensely political environment that they are subject to criticism for everything they do . . . Hedge funds tend to be secretive by nature . . . As to the mutual funds, to the extent that they tend to be more management friendly than would be warranted in the hopes of winning corporate business, they certainly don’t want to get into those discussions and have that issue come up. They have certainly been criticized for that repeatedly.”

³⁸⁵ The respondent presumably means a free rider problem.

“Lack of expertise, I think, is a big part of it. The people with the most expertise go to work on Wall Street. Right now, at CalPERS or CalSTRS, as far as I understand, right now there is a hue and cry over paying investment managers \$300,000 a year or whatever it is, which is cab fare for Wall Street. There is a big expertise gap.”

Thus, lack of resources is fairly consistently the reason for institutional investors’ minimal activism. Even in the face of one of their greatest opportunities to bring about change, by becoming politically active at a time when both public and government attention was focused on corporations as a central cause of the financial crisis, institutional investors were unable to respond because they couldn’t devote the necessary resources. It is ironic that even the lack of expertise cited in the last comment comes back to a lack of financial resources at two of the largest, and historically activist, institutional investors.

Why Proxy Advisory Firms Were Included in the SEC Proxy Voting Project

The expert advisers were asked an open question about the reasons why proxy advisory firms were included in the SEC’s Concept Release on Proxy Voting problems.³⁸⁶ Briefly, the Concept Release requested comments on a proposal to impose proxy advisory firms to SEC regulation, based on a coordinated campaign by corporate management which asserted a number of problems in the industry, including excessive influence on corporate voting, conflicts of interest, and a flawed decision-making process. The question sought “insider” perspective on the motivations for this effort. The responses included:

“ . . . there is an orchestrated effort on the part of the issuer community to grind the proxy advisory services under their heel.”

“ . . . this has been an effort on the Business Roundtable’s part for quite a long time and it’s just shocking to me that it has proceeded as far as it has.”

“ . . . this is another example of corporate managers whose rhetoric is all about the free market, but who want to protect themselves from its variability.”

³⁸⁶ The background for this is discussed more fully in Chapters 6 and 7. The responses might be more easily understood if read after the following section, reporting on the Comment Letters submitted to the SEC by both corporate management and institutional investors (and their respective proponents and representatives).

“I think that they don’t always appreciate the extent to which our largest clients are not following the recommendations. They don’t seem to appreciate the whole custom policy aspect of what we do.”

“I reject the notion that we apply a one-size-fits-all policy. But there are certain principles that we do believe have universal application, for example, if a board ignores a shareholder proposal that has received majority support from shareholders and refuses to take action, we are going to recommend withholding from, or voting against, members of the board. Is that one-size-fits-all? Well, I would turn that around and ask the critics [in] which companies is it acceptable for a board to ignore the wishes of its owners?”

“There are certainly some companies that probably didn’t like the recommendations that we issued. When we recommend against directors or when we recommend against comp plans, a lot of companies take it personally. And they get upset with us and a lot of the time they don’t like the result and they try to figure out how they reached this result and they must have had bad information, they must have gotten the facts wrong, when it is not really a question of our getting the facts wrong, it is our applying a policy that they did not like.”

“I think [issuers’] goals are to decrease the reliance upon proxy advisory firms for what they perceive as an inflexible analysis of their corporate governance practices.”

“I think it is an unhealthy distrust of shareholders. I think shareholders use their votes judiciously. There were only three Say-on-Pay votes that got defeated this year, out of over several hundred, and I think that is a clear indication that shareholders will use their power like spider-man, with great restraint and responsibility. I don’t think there is any evidence that shareholders have been irresponsible with the power that they have.”

While some of these responses come from the research staff of proxy advisory firms, they constituted a comprehensive factual denial of the assertions of corporate management. Their tone was generally surprised, indignant and defensive. But only the first two responses indicated an awareness that proxy advisers were faced with an organized campaign and none of them mentioned a coordinated effort to respond in kind.

SEC Proxy Process Comment Letter Study

There were 295 comment documents submitted to the SEC in connection with the Proxy System Concept Release³⁸⁷ through December 31, 2011.³⁸⁸ The SEC sought comment on a wide range of proposals related to proxy voting, many of them dealing with mechanical and administrative problems. Embedded in the Concept Release were proposals made by corporate management to regulate the proxy advisory firms which serve institutional investors; this study will focus on the comments on those proposals after it summarizes the overall responses. This study demonstrates the large disparity in levels of representation of institutional investors and the comments themselves show us the superior organization and framing of corporate management's campaign to force regulation on proxy advisory firms, which appears to be intended to reduce their independence.

Twenty of the responses were internal memoranda reporting meetings held with SEC commissioners and staff, which offered nothing more than the parties who attended. Those parties (and the number of meetings with them) can be summarized as follows:

U.S. Chamber of Commerce (CCMC) ³⁸⁹	5
Proxy Servicing Firms	3
Law Firms	3
Other Issuer Organizations	3
Proxy Governance Inc. (a proxy advisor) ³⁹⁰	2
Council of Institutional Investors	1
Merrill Corporation	1
Moxy Vote ³⁹¹	1
A group of eight public interest organizations	1

The remaining 275 comment letters were submitted by the following types of writers:

Corporate issuers	73
Pro-issuer Organizations	73
Pro-investor Individuals	66
Pro-investor Organizations	31
Institutional Investors	19
Pro-issuer Individuals	10
Labor Unions	2

³⁸⁷ The background for this is discussed more fully in Chapters 6 and 7.

³⁸⁸ All but 17 were submitted before December 31, 2010 (the stated deadline for submissions was October 20, 2010).

³⁸⁹ The U.S. Chamber's Committee for Capital Markets Competitiveness.

³⁹⁰ Proxy Governance Inc. went out of business in late 2010.

³⁹¹ A proxy advisory firm intending to develop a business of advising individual "retail" investors.

The corporate issuers' letters were almost entirely individual letters from a wide variety of sizes, industries, listing exchanges, etc., and no patterns of participation emerged. The signers were usually senior officers or general counsel. While many of them appeared to follow a similar outline, there were no obvious form letters and many of them omitted one or another of the components of the outline. Most of them contained individualized complaints, data, and anecdotal accounts regarding proxy voting problems. A significant number noted their support for the Shareholder Communications Coalition.

The issuer-oriented organizations included the following which made multiple submissions:

Securities Transfer Association	9
Law Firms	9
Society of Corporate Secretaries ³⁹²	7
U.S. Chamber of Commerce (CCMC)	4
Shareholder Communications Coalition ³⁹³	3
HR Policy Assn. Center on Executive Compensation	3
Securities Industry and Financial Markets Assn.	2

More than half of the pro-investor *individuals* were not responsive to the Concept Release; they were principally incoherent anti-corporate screeds and complaints about personal losses. Twenty three of the remainder were an electronic form letter which I was able to trace to the AFL-CIO Action website, although they did not identify the source. Six were submitted by law and business professors from a large variety of academic institutions.

The investor-oriented organizations included the following which made multiple submissions:

Foreign institutional investor organizations	7
Proxy advisory firms	6
Council of Institutional Investors	3

The nineteen institutional investors were made up as follows:

Pension funds ³⁹⁴	10
Mutual funds	7
Institutional investment managers	2

³⁹² Society of Corporate Secretaries and Governance Professionals

³⁹³ According to its website, made up of the Business Roundtable, National Investor Relations Institute, Securities Transfer Association and Society of Corporate Secretaries and Governance Professionals.

³⁹⁴ All but two were public pension funds.

Interestingly, six of the nineteen institutional investors expressed a preference for regulation of proxy advisory firms,³⁹⁵ although most of the six wanted the SEC to address only the conflict of interest problem and explicitly stated that they did not want regulation of their process or methodology.

Of the ten pro-issuer individuals, seven were law and business professors from a large variety of academic institutions.³⁹⁶

The vast majority of writers, 170, did not clearly address the question of regulation of proxy advisory firms.³⁹⁷ A vast majority of the writers who did comment on the question of regulating proxy advisory firms, 80 of the 104, favored increased regulation. Many of them favored quite stringent and intrusive regulation, as depicted in the selected excerpts from their letters. The letters favoring increased regulation of proxy advisory firms came from the following sources:

Issuers	38
Pro-issuer Organizations	26
Pro-issuer Individuals ³⁹⁸	7
Institutional Investors	6
Pro-investor Organizations	2
Pro-investor Individuals	1

Only 24 of the writers argued that regulation of proxy advisory firms should not be increased.³⁹⁹ Only three of those were institutional investors.⁴⁰⁰ No issuers expressed that view. The remarkable imbalance in support (80 for regulation and 24 against) indicates that the proxy advisory firms, institutional investors and their supporters failed to organize and mobilize, even in the face of an organized campaign by corporate management.

The numbers of writers and their positions regarding regulation of proxy advisory firms are only part of the useful information from the comment letters. Excerpts from a representative sample of the letters are included in the appendix. Their arguments made can be summarized as follows:

³⁹⁵ Including CalPERS, Florida and TIAA-CREF.

³⁹⁶ Thus, a bare majority of academic writers (seven to six) appeared to favor more intense regulation of proxy advisory firms, but two of them were submitting the same article (Choi and Fisch).

³⁹⁷ They dealt instead with the various mechanical and administrative problems also covered in the Concept Release.

³⁹⁸ Predominantly legal and business academics.

³⁹⁹ One writer addressed regulation of proxy advisory firms, but their conclusion was so ambiguous as to make classification impossible, bringing the total to 274.

⁴⁰⁰ All three were public pension funds, those of Connecticut, Colorado and New York City.

Pro-regulation positions

Almost all of the letters from issuers and their organizations made the point that proxy advisory firms have too much influence over corporate elections. A few offered examples of their own experience showing that director candidates or management proposals, which once would have received routine approval, lost in the face of a negative recommendation from a proxy advisory firm. Most, however, cited more general information, such as ISS having a majority of the largest institutional investors as clients or large numbers of votes following ISS' recommendations in the days after their reports are issued. Many cited academic research, notably Choi (2009), which was subsequently acknowledged to document only correlation, not causation. Choi (2011) Some of the writers noted a fear of undue pressure to follow ISS' recommendations and concern about their "monopolistic influence." Some writers also asserted that proxy advisory firms suffer undue influence of "activists, unions, pension funds and hedge funds," without offering any factual support.

Most of the writers complained about the apparent conflict of interest at ISS, where both investors and issuers are served. Several noted that this creates pressure for issuers to pay to obtain advice about how to improve their governance ratings and how to structure their compensation proposals. Most suggested that this merits regulation which should require complete independence and prohibit services to both sides by the same firm. Some suggested disclosure requirements, despite there being substantial evidence that investor clients receive routine disclosure and issuer clients are required to sign acknowledgements that they understand that investors will be informed of their services and that no other influence will be obtained. Some writers suggested that proxy advisers and their employees be prohibited from having any financial relationship with any issuers.

Most of the issuers and their organizations complained about the application of standardized proxy voting policies, which they attacked as imposing "one-size-fits-all" rules on companies which have individually varied circumstances, strategies and needs. They suggested that proxy advisers should be required to justify the rationale for any standard policies and to perform issuer-specific analysis of all voting recommendations. One of them asserted that issuers are damaged by arbitrary votes which were not based on facts.⁴⁰¹ None of the issuers acknowledged how aggrieved they would be if there were no standards and all voting recommendations were made *ad hoc*.

A number of issuers complained about the quality of the work and analysis performed by proxy advisory firms. Several questioned the adequacy of advisers' reviews of shareholder proposals, implying that they lacked

⁴⁰¹ Even where the facts are not available to either the adviser or the investors because of the secrecy of corporate activities and decisions.

understanding of their consequences. Several suggested that proxy advisers fail to adequately consider the financial performance of the issuer in making individual voting recommendations. Their suggested regulatory responses were to require research support for all voting positions, to require disclosure of the skills and qualifications of the advisers' staff, and to require publication of errors and error rates,⁴⁰² as well as the number of issuer appeals and revisions. Many of the writers attributed the asserted quality problem to a lack of liability, accountability and oversight, implying that this led to irresponsibility and negligence.

Almost all of the issuers and their organizations called for issuers to have the right to review advisers' voting recommendations before they are issued. They called for issuers have the opportunity to comment or to meet with the adviser, for advisers to be forced to respond to issuers comments, and for issuers to have the right to force the inclusion of the issuer's dissent in the adviser's report.

Almost all of the issuers and their organizations called for advisers to be required to disclose all of their models, guidelines, processes, assumptions, methodologies and anything else that goes into making their proxy voting recommendations. They assert that there is currently a "lack of transparency," as though this is a process in which they have some inherent right to know how voting decisions are reached. Many of them argued that the current standards and decisions are made arbitrarily by employees, and that all stakeholders should have the right to provide input.

A significant number of issuers assert that there are frequent errors in advisers' work, including the selection of improper peers and data, erroneous analysis of the long-term effects of incentive plans, and reference to plan provisions which are no longer in place. They argue that these errors require SEC oversight and a requirement for an audit of the entire proxy voting process, including advisers' internal decisions.

Many of the issuers charge that the advisers' work is suspect because they have no economic interest in the subject company or decisions. Leaving aside their earlier complaints about conflicts of interest, this charge appears to be an attempt to align with an entirely different concern raised by the SEC about empty voting.

A few issuers complained that there is inadequate competition among proxy advisory firms, presumably giving ISS too much power to impose voting standards. While ISS does have a commanding market share, it does not appear that this was acquired through mergers. To the extent that it might have been achieved by offering particular proxy voting results, this would be a

⁴⁰² None of them made any suggestion as to how an error would be defined or determined.

“selling point” for investors who could have made the same voting decision. It appears that this complaint relates somehow to a desire for smaller advisers over which an issuer might have greater advantages.

A few issuers and their organizations suggested that proxy advisory firms impose decisions which do not maximize the economic value of the corporation. They call for the imposition of a duty that all voting recommendations must be justifiable in terms of their impact on economic value.

Included in the issuer letters were calls for a number of new requirements for investors. They want disclosure of the proxy advisory firm retained by the investor and whether the investor followed all of the adviser’s recommendations. They want all investors who use proxy advisers to be required to certify that they received all proxy materials and that they have reviewed each proxy adviser vote. One issuer suggested that investors be required to substantiate the links between voting standards and corporate performance.

Issuer letters also called for a number of other requirements for proxy advisers, including the disclosure of all of their institutional investor clients and all of their compensation. Several wanted a ban on proxy voting by proxy advisory firms. They called for proxy advisers to be regulated like credit rating agencies, despite the fact that credit rating agencies are hired and paid by the issuer and proxy advisers are hired and paid by the investor. One suggested that ERISA fiduciary duties should be imposed on proxy advisers.

Anti-regulation positions

Most of the institutional investors, investor groups and proxy advisory firms pointed out that the influence of proxy advisory firms is grossly overstated because proxy advisers do not control voting. Even if they are formally granted proxy authority in order to execute the voting instructions, investors always retain the right to make the final voting decision. Most investors have multiple sources of input on voting decisions and frequently vote differently than the proxy adviser’s recommendation. Proxy advisory firms frequently offer differing recommendations. Several pointed out that there is a stronger tendency to vote routinely with management than to vote routinely as proxy advisers recommend.

In addition, most proxy advisory firm services involve applying custom voting policies developed by each investor client. ISS estimates that a majority of its votes are made under custom policies.

Perhaps most important, almost all of the anti-regulation writers noted that proxy advisory firm voting recommendations reflect investor preferences, not some arbitrary decision of proxy advisers or their employees. The process

of developing their recommendations involves obtaining the input of the investors about how they would vote.

Investors point out that they are in a better position than issuers to assess errors. Investors said that they provide constant feedback to advisers about errors, but none of them noted that errors were a significant problem. They point out that market competition is effective in forcing improvement. One summed up the issuers' claim of errors: "In some cases . . . what issuers call factual inaccuracies may fairly be characterized as different conclusions drawn from the same facts."

Investors also point out that they are fully aware of the purported conflicts of interest and review each firm's conflict policies regularly. Several of them would prefer that proxy advisory firms not serve corporate issuers as well, but none of them noted any impairment in the work performed for investors. One of them cited services to corporate issuers as their reason for changing advisers, to a firm which has an explicit policy to serve only investors. No impediments to switching firms were noted.

Several investors suggested that the remedies proposed by issuers would interfere with the independence and quality of proxy advisers' work. In their view, allowing issuers greater involvement in the process of evaluating board candidates and election proposals would create pressure and bias in a process which should be designed to insulate the investors and advisers, and permit them to reach conclusions independent of corporate management.

As noted earlier, some of the issuers suggested that proxy advisory firms should be regulated in the same manner as credit rating agencies. Several investors and investor organizations point out that the analogy to credit rating agencies is faulty because issuers pay credit rating agencies and the agencies have no duties to investors, whereas investors pay proxy advisers and proxy advisers have exclusive duties to investors. The unstated point appears to be that proxy advisers work exclusively for investors and that issuers have no right to be involved in that work.

Other issuers suggested that proxy advisory firms should be regulated as registered investment advisers.⁴⁰³ Investors and advisers commented that proxy advisers' voting recommendations are not subject to the registration requirement because they are not investment advice, due to the fact that they do not purport to evaluate the investment characteristics of the companies they cover. One of the advantages of imposing registered investment adviser status on proxy advisory firms would be that they would have an annual disclosure requirement which could inform their clients of conflicts of interest,

⁴⁰³ In fact, several of them (including ISS) are registered investment advisers through a provision allowing optional registration.

qualifications of the principal advisers, fee arrangements and other matters. One disadvantage is that this annual disclosure is quite costly to produce, which might serve as an impediment to entry by new firms.

The outcome of this proposal is unknown at this time. The arguments in favor of regulation are clearly stronger in preparation, numbers, severity, supporting organizations, research background, and force. They have been carefully crafted and coordinated to create the appearance of a serious problem. They presume that investors or their advisers owe duties to the corporate issuers and that the corporate issuers are somehow the victims of the violation of various social and policy norms (e.g., lack of transparency, lack of notice of standards and policies, lack of opportunity for a fair hearing, lack of mechanisms to publicize opposition, etc.). Many of the issuer's letters are vehement and alarmist in tone.

The arguments, principally from investors, against regulation are clear and direct in their rebuttal of the threshold arguments of the issuers about the voting power of proxy advisory firms. But they lack systematic evidence, assertions about the investors' size and importance in the market, research support, coordination or reference to important social or policy norms. They generally fail to defend against the one-size-fits-all accusation and their defense against the procedural claims is weak. Most of the investors' comments are gentle and respectful, and do little to point out the inherently radical idea that issuers should have the right to be involved in a service designed to assist investors in making their private voting decisions. They do relatively little to defend proxy advisory firms or to assure the SEC that there is not a problem.

As with the investor and expert adviser interview responses, the SEC comment letters demonstrate a significant imbalance in resources, political skill and tactics, coordination, and intensity or aggressiveness.

Chapter 9.

Observations & Comments

The challenge in working with a more sociological/anthropological research approach, such as an interview study like this one, is that the results are not easily reducible to a number. Neither is it possible to calculate a confidence interval for the results. And the problem of drawing meaning from the interviews is made even more difficult from the disjoint nature of the sample: a fairly good sample of one of the types of institutional investors (mutual funds) and a broad view of virtually all institutional investors through second-hand observers (the expert proxy voting and corporate governance researchers and advisers).

The institutional investor respondents were highly skewed toward larger institutions in their sectors. This is probably the result of a response bias, in that only larger investors have the resources and staff to be able to respond to a time-consuming research request. In most cases, smaller institutional investors simply did not respond to letters, emails and telephone calls inviting their participation, whereas larger investors would at least respond, even if they eventually declined to participate. But this lack of resources may also address the fundamental question of this research project: these smaller investors are unlikely to have engaged in any form of corporate governance activism and probably have limited awareness of the issues involved. The probable bias from this data would thus be to overstate the level of activism.

The over-representation of mutual funds has a less clear impact on the results. Mutual funds are thought⁴⁰⁴ to be less activist because they are highly conflicted, both by their tendency to be corporate-owned and by their interest in obtaining additional business from corporate pension plan sponsors. But they are also required by law to publicly disclose their proxy votes, which probably causes them to invest more resources in corporate governance and proxy voting.

In any event, the wider involvement of the expert advisers (and their constant surveys, meetings and conferences with their clients and potential clients) means that they are more likely to represent the weighted average of institutional investor views and activities.

⁴⁰⁴ See, e.g., Rothenberg (2006), AFSCME (2007), Davis (2007), ICI (2010), Cremers (2011), and Ashraf (2012).

1. Institutional Investors Devote Minimal Resources to Corporate Governance

The institutional investor respondents⁴⁰⁵ reported spending an average of \$1,029,000 in 2009 on proxy voting and corporate governance activities. This amounted to 0.0003% of their average portfolios of U.S. equity investments. To put this in perspective, they would typically spend between 0.1% (for a pure indexing strategy) and 0.5% (for an active management strategy) annually for investment management services. While a budget over \$1,000,000 sounds generous, it really only covers the cost of a qualified leader, a couple of analysts, an outside proxy advisory firm, and the cost of transferring the requisite stock ownership data for actually voting the proxies. It leaves very little for membership fees of organizations, travel to conferences or meetings, the cost of re-calling shares loaned out in order to vote them on the record date, or for any sort of active campaign for the improvement of corporate governance in the investee companies.

In answering the same question (i.e., estimating what institutional investors spend on corporate governance), the expert adviser respondents offered a weighted⁴⁰⁶ average of \$140,000 annually, much smaller than the institutional investor's own figure. This is almost certainly the result of their inclusion of expenditures by the many thousands of smaller institutional investors who were not proportionately represented among the institutional investor respondents. In reaching these estimates, the expert advisers are plainly aware of how much these investors pay for proxy advisory and corporate governance research services, which probably consumes most of the estimated amount. These results are consistent with the views of the expert who said, "I think that there are very few who spend a substantial amount and most spend little or nothing."

It would be reasonable to conclude that very, very few institutional investors have the resources to meaningfully oppose management on any corporate governance issue, except through voting on a proposal already put forth by others. We know from media coverage and some previous research that a few institutional investors devote more resources to corporate governance, but these appear to be rare outliers. The California Public Employees Retirement System (CalPERS), California State Teachers Retirement System (CalSTRS), Teachers' Insurance Annuity Association-College Endowment Retirement Fund (TIAA-CREF), Fidelity Companies, Vanguard Group and BlackRock are each believed to have staffs of at least ten people in proxy voting and corporate governance, giving them the size necessary to systematically advocate corporate governance changes and to

⁴⁰⁵ See Chapter 8 for a discussion of the investor respondents, whose average investment in U.S. equities was \$305 billion.

⁴⁰⁶ As noted in Chapter 8, the expert respondents were asked to weight their responses by the dollar amount of their clients' investment portfolios.

coordinate widely with other investors. Other institutional investors periodically initiate shareholder proposals or participate in joint meetings or letters to management, but these efforts appear to be sporadic and focused on single issues.

It is ironic that institutional investors (who own the preponderance of the residual equity positions in the public corporations) feel highly constrained to minimize their expenditures for corporate governance activities, while corporate management appears to feel relatively unlimited in using corporate resources to participate in a number of organizations that oppose corporate governance activism,⁴⁰⁷ using executive time, paying for proxy solicitors, attorneys and lobbyists, travelling, conducting public relations campaigns, and making political expenditures to accomplish their goals.

2. Institutional Investor Corporate Governance Goals are Modest and Careful

Institutional investors exhibit no interest in making major changes in corporate governance. None of them indicated that they wanted to take over corporate management or make business decisions. Likewise, none of them indicated that they wanted to control the board or director nominations on an ongoing basis. Their goals indicate that they are cautious about not imposing corporate governance rules which might be too expensive or interfere with maximization of their investment returns. What the investors appear to want is simply for managers and directors to run the company in the investors' best interests. They *did* mention a number of desired reforms, summarized below, that relate to that goal.

The experts estimated that a median of 70% of investors want corporate governance changes. Many experts' comments, however, indicated that they harbored some skepticism about *how much* the investors really wanted them. One expert said, "I am very cynical. I think that there are very few people that care about this area. I think very few people in institutions really care about it." Nevertheless, the supposedly conflicted mutual fund investors all mentioned corporate governance changes that they wanted; only the sole corporate pension plan respondent mentioned no corporate governance goals.

The corporate governance goals mentioned most frequently by the institutional investors included the following (in order of frequency):

- *Annual election of directors.* This is part of a larger effort to "repeal" anti-takeover devices which have the collateral effect of entrenching

⁴⁰⁷ Such as the U.S. Chamber of Commerce Center for Capital Markets Competitiveness, the Business Roundtable, the Conference Board, the National Investor Relations Institute, the Center on Executive Compensation, and the Society of Corporate Secretaries & Governance Professionals.

management. Staggered boards (typically elected to three year terms) were widely adopted in the 1980's as a mechanism to slow any hostile party trying to take over a company. While this protection is important to management, eliminating staggered boards would represent only a return to the *status quo ante* and to an only slightly more responsive corporate democracy.

- Majority voting for directors. Boards of directors typically nominate only one candidate for each open board seat. Historically, corporate bylaws provided that a candidate only needed a plurality of votes to win election. That meant that a candidate in an uncontested election could be elected with as few as one vote, regardless of the number of shares opposed. While replacing this with a majority vote requirement sounds like a big change, it is only a modest shift away from management's almost absolute control over director selection because the cost of mounting a proxy contest for a competing candidate is frequently well over \$1,000,000, and hence would only be attempted rarely. But it does restore director elections to the rules that most investors would have expected.
- Proxy access to nominate directors. This reform proposal is an attempt to reduce the cost of nominating competing director candidates by forcing management to include them in the proxy materials mailed by the company. The goal is to try to make directors more responsive to shareholders. The SEC adopted rules implementing shareholder proxy access in 2011, but the rules were blocked by the U.S. Circuit Court of Appeals for the D.C. Circuit.⁴⁰⁸ The SEC responded by adopting rules permitting shareholder proposals to implement proxy access on a company by company basis. This is a very contentious issue for management because it would give investors the actual power to replace directors.
- Limit excessive executive compensation. The Dodd-Frank Act required that shareholders be given the opportunity to approve executive compensation and most companies now face an annual "Say-on-Pay" vote; however, there is no sanction for failing to respond to a negative vote. Relatively few pay proposals have failed to get a majority,⁴⁰⁹ so this reform appears to be only a mild or remote threat to management's influence on compensation policy. It is too soon to tell whether there will be a deterrent effect that actually restrains compensation growth.

⁴⁰⁸ *Business Roundtable and Chamber of Commerce of the United States of America v. Securities Exchange Commission*, 647 F.3d. 114 (2011).

⁴⁰⁹ See discussion in Chapter 3.

- Shareholder approval of specific proposed transactions. Most bylaws require shareholder approval of mergers, reorganizations, sales of substantially all assets, charter amendments and other types of fundamental changes to the corporation. Some companies have amended bylaws to avoid these requirements and others have “stretched” the definitions to avoid shareholder votes. Institutional investors are merely urging companies to return to the previous limits on the power of boards and managers.
- Permit shareholders to call special meetings. This proposed bylaw amendment would allow shareholders to force early action on shareholder proposals and potentially would permit them to initiate actions which previously required board action. This is common in corporations in Europe and Asia, but would be a radical departure in the United States. Some investors suggested that there is likely to be little support for this reform if it came to a shareholder vote because it would trigger investors’ concerns about its possible use by other shareholders or “raiders” to their disadvantage.
- Require shareholder approval of “golden parachute” agreements. It has long been an investor concern that boards can and often do enter into agreements which bind the corporation to pay compensation upon resignation, termination, change in control, change in rank or authority, or other circumstances. Investors are generally offended that corporate officers can be rewarded without providing ongoing services or for poor performance. This proposed imposition of a shareholder approval requirement is an attempt to limit conflicts of interest and unjust pay which boards have failed to block.
- Align compensation with shareholder results. This is more of a generalized goal than a specific proposal, but an important ideal.
- Require Say-on-Pay votes by shareholders. As noted above, this goal has been achieved by inclusion in the Dodd-Frank Act.
- Require long-term incentive compensation. Incentive compensation is usually designed to reward short-term profits without regard to the long-term consequences to the company. There is little likelihood of its adoption because of the lack of consensus regarding the specific rules to be implemented and the need for simultaneous implementation at all companies.

The expert advisers were asked a similar question to determine investors’ corporate governance priorities. Their responses to the question

about the most common subjects of investors' customized proxy voting policies tended to be broader and more generalized:

- Executive compensation
- Director elections
- Mergers
- Shareholder rights
- Separate chair and CEO
- Takeover defenses

These echo the subjects mentioned in the investor interviews, with the exception of separation of chair and CEO. This reform is intended to cause the CEO to report to the board, but does not appear to be accepted very often or to be particularly effective when it is adopted. Several of the expert advisers mentioned that many investors (though not a majority) view compensation issues as immaterial in the context of the whole company, possibly explaining why compensation votes rarely lose. This implies that the investors either have a short investment horizon or that they fail to recognize the problem of rising compensation as a percentage of company value.

While these goals sound important, the preponderance of them would have little effect on boards or management even if they were adopted. They really amount to incremental improvements, many of which would only restore the customary rights of shareholders. The underlying goals of improving board representation of investors' interests and making pay more effective at maximizing investors' results are hardly bold or radical ideas. Investors are clearly not trying to do anything which would jeopardize their investments, their returns or the stability of corporate operations.

What is important is that these changes would signal a shift in the balance of power away from management and toward investors. These types of changes need to occur gradually, but steadily, in order to induce boards of directors and managers to recognize that they must act in investors' interests. Incremental shifts in the balance of power will also serve to make less forceful activism more effective because management will pay more attention.

3. Almost Total Absence of Market Power Utilization

Given the number of times the "Wall Street Walk" appears in articles and talks, one would expect that institutional investors often exercise their market power to sell stocks of companies that fail to meet their corporate governance expectations. The fact that institutional investors own so much of the equities markets would imply that even a small proportion of them could force companies to adopt the practices that they prefer by selling their stock. Based on both the investor and adviser interviews, it is clear that even though a few investors may do this sometimes, it is rare and exceptional for them to

do so. The only circumstances where most investors would actually sell appear to be when the company does not respond appropriately to shareholder votes that express a clear choice or when the company has engaged in a particularly egregious behavior. This is underscored by the responses to the questions about the effects of corporate governance issues on the purchase and sale of investments.⁴¹⁰

Investors which use indexing strategies make this problem worse. The responses to the questions about indexing⁴¹¹ show a median estimate that 29% of institutional portfolios are invested in indexed strategies. An indexing strategy all but prohibits selling a stock included in the index because the performance of the portfolio would no longer track the index. But the problem of indexing extends far beyond portfolios which are actually indexed. Virtually all institutional investment portfolios are compared to various indices and to each other as a mechanism to measure the performance of the investment managers. While investment managers frequently attempt to outperform the index by deviating from the index weightings, they are usually reluctant to completely exclude particular stocks for fear that the particular stock might suddenly outperform their expectations and cause their results to fall short of the index. Thus, it takes extraordinary circumstances for an institutional investor to exercise the “Wall Street Walk” and corporate managers are usually sheltered from the discipline of this type of pressure.

Another impediment to exercising market power by selling a stock is in the typical structure of investment management of the portfolio. The vast majority of institutional investors do not have the in-house capability to manage their actual investments and, therefore, retain outside investment managers to execute their strategies. Most of these investment management arrangements involve a base fee⁴¹² and a performance fee based on investment results. In order to insure that they have the opportunity to actually earn a performance fee, most investment managers insist on having discretion over the investments. This means that the institutional investor would not have the ability to order (or, in the language of institutional investors, to “mandate”) the sale of a particular stock for corporate governance reasons.

Furthermore, institutional investors appear to be unaware of the differences between the corporate laws of various states. The expert advisers responded that fewer than 1% made investment and sale decisions based on state law differences. One said “I’ll bet most investors have no idea where the corporation is incorporated.” This would indicate that the research results

⁴¹⁰ See Institutional Investor Questions 13 and 14, and Expert Adviser Questions 23 and 24, in Chapter 8.

⁴¹¹ See Institutional Investor Question 3 and Expert Adviser Question 3 in Chapter 8.

⁴¹² Typically a percentage of assets under management, usually well below 1% and stated in “basis points” which are hundredths of 1%.

showing that incorporation in particular states (usually Delaware) is associated with better financial performance are measuring something other than the investor preference for the laws of those states. It suggests that it is more likely that the corporate laws of any state competing for corporate franchises are designed to appeal to the managers who select them.

The other area where market power could be expressed is in the design of the valuation models used by institutional investors. Most of them create models of the future financial performance of the investee companies and apply various valuation formulas to determine when the stock price is attractive enough to buy or overpriced enough to sell. If these models reflected premiums and discounts for various corporate governance characteristics, that could affect the market price and signal investor preferences. Only one investor said that they would adjust pricing for control issues:

“I would say that there are only a few [corporate governance issues] that have an explicit effect on the model. Those would be controlled companies. Where you are buying into a company that is family-controlled or controlled by another entity, you know that there is going to be a discount, generally speaking, for that lack of control. A dual class structure, for example, would be one. But there would be few that would actually be explicitly included in the model.”

In sum, it appears from this research that institutional investors very infrequently use the most powerful tool available to them to achieve their corporate governance goals (i.e, selling their holdings in the company in question).

4. Institutional Investor Activism is Relatively Mild

Corporate governance activism is easy to understand intuitively, but is extremely difficult to define objectively. In a general sense, it could be defined as “the use of resources to bring about specific changes in corporate governance rules, policies and behavior.”⁴¹³ But this does not give us a useful scale to measure the *level* of activism, which in principle could range anywhere between purported activists who are “passive lapdogs of management” and “power hungry maniacs who want to control the economy.” There appear to be at least three elements to activism: (1) the type and extent of change advocated, (2) the effort and resources devoted to accomplishing the change, and (3) the level of commitment to forcing the desired changes. Perhaps corporate governance activism can best be understood in a *relative* sense and maybe that is sufficient to understand the dynamics of corporate governance. The real question is whether institutional investors use resources and power in a

⁴¹³ The author’s suggestion.

manner which is comparable to the countervailing efforts of corporate management?

The median response to Question 7 (regarding institutional investors' corporate governance activism) was "3 on a scale of 10." The experts rated institutional activism at a median of "4 on a scale of 10." Given the natural human reluctance to rate oneself below average in anything, this is a relatively passive result. One of them noted "There's a big free-rider problem and a lot of institutions support the causes of others, but the number who are active is pretty small." Based on the interviews, most institutional investors consider "engagement" (the expression of their preferences through letters, phone calls and meetings with management) to be activism. For the vast majority of institutional investors, their only exercise of power or pressure is their voting on proposals presented to them in the annual proxy.

The use of engagement appears to be increasing, based both on the responses to this research and the report of the Conference Board (Conference Board 2010b). But all indications are that these contacts are polite exchanges of preferences and views, except when pursued by hedge funds.⁴¹⁴ Absent any action by investors to force management to respond, management is unlikely to act because they know that the chances of facing any effective pressure are extremely small.

The relative absence of activism is probably best substantiated by considering what actions the institutional investors do not mention or appear to have taken. There are quite a few institutional investors which are large enough to comfortably take over corporations which fail to meet their governance expectations. Except for hedge funds and a recent attempt by a mutual fund to behave like a hedge fund⁴¹⁵, this almost never occurs and provides no significant discipline on management. The most powerful natural advantage that most institutional investors possess is their direct relationship to their beneficiaries, yet there is no evidence that they try to mobilize them for protests, boycotts, letter-writing or other "shows of force," except in the case of union pension funds. Despite shareholders frequently having the right to inspect corporate records, there is no history of conducting investigations of corporations. Although CalPERS is apparently creating a database of potential board candidates,⁴¹⁶ there appears to be no systematic "blacklist" of board members and CEOs who have been associated with litigation, accounting, management or company failures or who have failed to respond to governance problems.

⁴¹⁴ Who reputedly have few reservations about stating clearly what they will do if management does not make their desired changes.

⁴¹⁵ Fairholme Fund recently abandoned an effort to take over St. Joe Paper Company, a land and timber company in the Southeast which Fairholme judged to be mismanaged.

⁴¹⁶ This database appears to be more focused on improving board diversity than finding candidates who could be more effective monitors of management.

5. The Disparity in Resources and Tactics is Most Pronounced in the Political Domain

Much of the survey and interview program focused on institutional investors' activities in the political domain, intending to learn whether they use the same tactics as management in trying to advance their governance goals through governmental action. Without repeating the summary of their responses in Chapter 8 or the literature on corporate political activity discussed in Chapter 4, it is abundantly clear that institutional investors are significantly less active in politics than corporate managers.

Only one of seven institutional investor respondents does any legislative lobbying, and that effort consisted only of writing or co-signing letters to Congress. Only two of the seven lobbied the SEC through comment letters. The experts thought that a median of 22.5% of institutional investors had done legislative lobbying and 50% had done regulatory lobbying, but their comments indicated a vast disparity in financial resources compared to management. One said “. . . my impression is that they were buried under an avalanche of corporate campaign and lobbying contributions.” Another said, “They are going to be outspent 100 to 1 all the time. Maybe 1000 to 1.” One expert noted: “Just to give you an idea, there were 800 separate fundraising events scheduled around the vote on Dodd-Frank. None of them were scheduled by institutional investors.”

The experts estimated that a median of 10% of institutional investors engage lobbyists on corporate governance issues and 15% seek the advice of counsel on corporate governance issues. When they do engage in lobbying, their activities lack the carefully-crafted positioning, coordinated messaging, academic research support, and the publicity which corporate management uses. The Center for Responsive Politics web site shows that CalPERS, the largest U.S. public pension plan, reported lobbying expenditures of slightly over \$150,000 in 2008, but less than \$20,000 in 2011.⁴¹⁷

Institutional investors apparently make almost no political contributions. None of the investor respondents made political contributions and the experts thought that a median of 7% of investors tried to raise contributions, with labor unions being the most active. None of the investors or experts mentioned sponsoring PACs or fundraisers, providing private jet transportation to legislators, providing hospitality suites at conferences and conventions, building personal relationships with legislators and regulators, or any of the other “access”-building activities that accompany active political involvement programs.

⁴¹⁷ www.opensecrets.org as of August 29, 2012

Institutional investors are also reluctant to engage in litigation programs to accomplish their governance goals. Where corporate management often participates in long-term strategic litigation campaigns to develop the law in their favor, institutional investors are largely absent in even the most important cases. For the most part, their litigation activity consists of acting as lead plaintiff under the Private Securities Litigation Reform Act of 1995. This is essentially a passive role, in which they are approached by plaintiffs' class action securities lawyers and agree to participate in order to try to recover stolen assets. There was no indication that institutional investors have larger litigation goals or that investors sought the appointment of judges who would favor their interests.

6. Investors Have Significant Information Disadvantages

One of the most perplexing aspects of corporate governance is the lack of information available to institutional investors as they make fundamental decisions regarding their votes in the annual proxy. Board meetings and corporate strategies are secrets that are respected by the courts. The business judgment rule protects companies from inquiry about the reasons for their actions and how most decisions are made. Investors are generally forced to use the little information mandated by SEC rules and the information that management chooses to disclose in support of their positions. The business press faces the same problem. Most business news is based on press releases and public relations backgrounders, and direct access to management is usually carefully controlled and scripted.

When asked how investors obtained the information they needed to vote on board candidates, most responded that they used the company's proxy statement and recent news reports. A few mentioned meetings with company representatives. None of the investors or the expert advisers mentioned conducting any sort of background investigation into the board candidates. None mentioned tracking candidates' performance at other companies or as company officers, or checking public records about them, or any other sort of attempt to obtain information that might better predict how they would perform or how they would protect investors.

7. There Is Remarkably Little Coordination Among Investors

Three of the seven institutional investor respondents participated in organizations, attended conferences, and cooperated with others on an ad hoc basis, but most of this activity is reactive rather than proactive, and one only coordinates on private contact with management. The experts' median estimate was that 20% of investors had coordinated on corporate governance issues. There are annual conferences put on by the Council of Institutional Investors, labor unions and proxy advisory firms. These activities do provide an opportunity for a broad range of investors to become aware of the issues

and the activities of the few institutions that actively pursue their governance goals. They also provide an opportunity for discussion. The interviewees gave the impression that institutional investors often speak with one another about their engagement with management and that it is fairly common for them to co-sign letters or meet jointly with management.

But there are no organizations on the investor side which are comparable to the trade, industry or advocacy groups that corporate management funds, guides and supports. There is no Business Roundtable, U.S. Chamber of Commerce, Conference Board, CEO Council for Growth, National Association of Realtors or American Bankers Association on the investor side. There are no investor-funded research institutes or public relations campaigns. There is no proactive legislative or regulatory campaign.

The one significant organization that exists for institutional investors interested in corporate governance reforms is the Council of Institutional Investors (“CII”), which was founded in 1985 by California Assembly Speaker, State Treasurer and CalPERS Board Member Jesse M. Unruh and a group of twenty other public pension funds. It was formed in an era of corporate takeovers which deprived investors of the long-term value of the companies involved. Their web site states that they have more than 125 members representing more than \$3 trillion in invested assets.⁴¹⁸ This is down slightly from more than 130 members in 2010, when the interviews were done. In a telephone call to CII in 2010, a staff person would not confirm the total operating budget, but said it was “less than the dues of a single corporate member of the U.S. Chamber of Commerce.” One of the institutional investor respondents (which is also a member of CII) said that the total operating budget of CII was about \$3,000,000 per year. The web site shows nine employees in a single Washington, D.C. office.

CII follows events in Washington, puts on two conferences each year, publishes a continuous stream of white papers about corporate governance issues, issues an official statement of preferred corporate governance policies, lobbies corporate governance issues in Congress and at the SEC, files *amicus* briefs in important litigation, and sends weekly bulletins to its members about current issues. CII also maintains a Research and Education Fund which sponsors a small amount of outside activity. In the past, CII targeted particular companies and particular issues for attention and publicity, but this has become rare. They accomplish an amazing amount for such a small organization, but do not have a significant political presence.

⁴¹⁸ www.cii.org as of August 29, 2012.

8. The Response to the Financial Crisis and Great Recession of 2008 Was Muted

One of the most surprising results of this research is to learn that the Financial Crisis of 2008 did not cause a significant increase in corporate governance activism. By 2010, when the interviews were done, there was a great deal of attention to the possible corporate governance weaknesses involved in causing the Financial Crisis. The Congress, the SEC and the White House all initiated investigations and the process of making improvements in corporate governance rules. This would have been a perfect environment for corporate governance activists to make the case for important changes.

Four of the seven institutional investors reported no change in their corporate governance programs. The other three mentioned cutbacks in their travel budgets. One investor said, “The biggest result has been that our operating budget has been constrained. Travel is limited, networking opportunities are reduced, and we have less presence at company annual meetings. We haven’t lost any staff and our effectiveness isn’t reduced in the short-run, but we are more focused on local companies.”

There are a number of possible causes for this result. Public pension funds are limited by annual operating budgets that do not respond quickly to problems or opportunities, and tend to be cut when the asset values fall. Almost all institutional investors faced budget cuts to match their declining income and portfolios. While CII and a few pension funds wrote letters and appeared at hearings, there was no coordinated agenda to take advantage of the rare moment of Congressional action and public support for steps to improve corporate governance.

9. The Greatest Impediment to Corporate Governance Activism is a Personality Difference

The people interviewed were all highly-qualified, knowledgeable and professional. They were careful and measured in their responses, and very reluctant to estimate or speculate or guess about anything. Just like the many institutional investment people who declined to participate, they were extremely risk-averse. Given the large amounts of money involved, and the ease of losing it, and the number of people who are trying to find ways to “share” in the wealth of institutional investors, risk-aversion is exactly the trait we should want in their people.

Risk-aversion is also the opposite of the personality type prized in business today. Corporate managers, and especially CEOs, are expected to be fearless in imagining the possibilities and trying to achieve them. In order to rise to the top of large business organizations, CEOs must be master salesmen and negotiators. They must be willing to make the best case they possibly can for what they and their company want. They talk in terms of battles and wars

and vanquishing their opponents. They have little respect for people who see problems or limits or risks.

With few exceptions, corporate governance professionals are no match for the people who manage large corporations. They lack the ability and the confidence to plan a battle with managers, and therefore tend to avoid conflict. They send letters and have polite meetings, while management is willing to spend large amounts of company time and money to try to stop any threat to their pay and their autonomy. Governance professionals appear to focus on process and consensus, while management pursues strategy, mobilization and results. Their risk-aversion makes them particularly susceptible to personal and political threats from management interests.⁴¹⁹

10. Proxy Advisory Firms are the de facto Point of Coordination for Investors

The rise of the proxy advisory business has created a *de facto* mechanism for coordination and activation of institutional investors. By “pooling” their resources and outsourcing the process of studying corporate proxy voting decisions to a few firms, institutional investors have accidentally concentrated their power. Even though they do not vote in lockstep, they now tend to be aware of the same issues and proposals, and the best interests of the beneficiaries are clarified by the proxy advisors. Institutional investors now tend to have to justify proxy voting positions that differ from proxy advisor recommendations. Proxy advisors have become the most important mechanism coordinating institutional investor pressure on corporate management to make the changes in corporate governance rules.

The proxy advisory business is probably far more important to institutional investors and their beneficiaries than they seem to know. But corporate management is instinctively aware of the threat and is actively trying to weaken proxy advisory firms by seeking to impose SEC regulation on them.

Observations on the SEC Proxy Process Study Comment Letters⁴²⁰

The comment letters of several of the industry groups made clear that they had been advocating regulation of proxy advisory firms for a number of years before the SEC included the issue in its Proxy Process Study. Issuer groups also initiated the reports by the Government Accountability Office (2007) and the Inspector General of the U.S. Department of Labor (2011) that were critical of proxy advisory firms.

⁴¹⁹ Several interviewees mentioned the risk that corporate managers would “go over their heads” and complain to the investment portfolio managers or threaten to withhold private access to company executives or information. Public employees’ pension plans are particularly susceptible to political pressure on behalf of corporate management, especially when they are run by an elected official.

⁴²⁰ See discussions of this proposal and process in Chapters 6 and 8 for background.

It certainly appears that proxy advisory firms are in business primarily to serve the needs of institutional investors and are paid exclusively by them for these services. All of the firms appear to operate on a confidential basis, providing their research and reports exclusively to their paying investor clients, with limited public responses only when someone else has publicized their recommendations. A search for public complaints about proxy advisory firms by institutional investors prior to 2010 yielded nothing. The complaints about proxy advisory firms arose entirely from the corporate issuer side.

When asked about the source of the issue, one expert adviser said “. . . there is an orchestrated effort on the part of the issuer community to grind the proxy advisory services under their heel.” Another said “. . . this has been an effort on the Business Roundtable’s part for quite a long time and it’s just shocking to me that it has proceeded as far as it has.” These are very strong sentiments compared to their measured responses on other topics.

The mismatch in resources between corporate management and institutional investors in this key corporate governance struggle is demonstrated fairly clearly in the comment letters to the SEC concerning the proposal to regulate proxy advisory firms. Corporate issuers appeared 73 times, but institutional investors appeared 19 times. Pro-issuer organizations appeared 73 times, but pro-investor organizations appeared 31 times. The mismatch in number of appearances is matched by a mismatch in vehemence and accusations.⁴²¹

Corporate management and their organizations have framed their complaints to appear as the victims and to argue that their rights are being infringed. But nothing they have complained about could colorably be viewed as a problem if it were done by the institutional investors, exercising their own voting rights, instead of by the proxy advisory firms retained by institutional investors to assist them. The first complaint is that institutional investors vote in accordance with the proxy advisors’ recommendations in a large portion of elections. What corporate management frames as a problem of concentration of voting power can just as easily be viewed as great customer satisfaction and a huge endorsement by institutional investors of the care and quality of the proxy advisory firms’ work. The underlying complaint may be that management feels that the proxy advisory firms have become too effective in serving institutional investors’ interests.

Corporate issuers make a significant issue of a small number of anecdotal reports of factual errors in proxy advisors’ work. In many of these

⁴²¹ This mismatch is considerably less dramatic than the mismatch in resources, appearances, and arguments made in the issuers’ efforts to defeat the SEC rule-making to require companies to include investor nominations for director elections in the company proxy statements.

cases, the issue turned out to be a difference of opinion between management and the proxy advisor. Inevitably, there are going to be errors in a process which evaluates over 100,000 individual voting decisions in a proxy season which lasts 3-4 months. Given that there were no complaints of errors before the issuers' campaign against proxy advisors, this is not likely to be a serious problem or a valid reason to impose regulation. The one issue which could actually be a problem--the fact that one firm has an apparent conflict of interest because it serves both institutional investors and issuers--relates to a firm, Institutional Shareholder Services ("ISS"), which is already registered with the SEC as an Investment Adviser and already subject to regulation. The issuers' real complaints appear to be that proxy advisors enhance investor coordination and that they do not want to have to pay for information that their competitors are paying for. They are asking to be given the proxy advisory firms' proprietary systems, procedures, models and standards for free.

The issuer side did a much better job of coordinating their messages. The similarity of the arguments and the "catch-phrases" in the letters from issuers, their organizations and their supporters was striking. The idea that "one-size-fits-all" solutions are bad was repeated so many times that it becomes accepted truth.

The most striking part of the contest over regulation of proxy advisory firms is the very ineffective defense of proxy advisory firms by institutional investors. It is not clear why, unless they really have not realized how much their power increases when they act in concert. But given their very passive behavior in other areas, it is entirely possible that they simply do not seek more power or value being more effective in corporate governance.

Thus, we see from the interviews and the SEC comment letters that institutional investors' corporate governance activity is characterized by their minimal resources (relative to corporate management), modest goals and mild activism. It is striking to realize that they almost never use their economic market power, rarely coordinate with other institutional investors in a meaningful way, and suffer such a large disparity in their political and legal efforts, compared to corporate management. Perhaps most surprising is that institutional investors appear to have reduced their corporate governance efforts during the Financial Crisis and Great Recession of 2008, a time when they had the "political wind" at their backs, the public was blaming corporate managers, and legislators were initiating changes. Finally, the two most interesting insights from this project are that much of the ineffectiveness of the corporate governance efforts of institutional investors is derived from a personality difference between institutional investment managers and corporate managers, and that proxy advisory firms have evolved to become the primary source of coordination among institutional investors.

Chapter 10.

Conclusions

The fundamental question is whether and how the agency problem can be ameliorated. The problems noted by Berle and Means were observed at a time when individual investors made purchases of individual stocks and provided their own monitoring, imperfect as it might have been. Today, individual investors have largely been replaced by institutional investors who act for them. But the expectation that institutional investors would so concentrate the interests of those individual investors that they could counter management interests appears unlikely to be fulfilled.⁴²²

1. The collective action problem is a significant impediment to institutional investor mobilization.

Just as individual investors lacked the resources and incentives to carefully analyze corporate governance issues and exercise control over companies, institutional investors appear largely disengaged on corporate governance. It isn't that there aren't people within many institutions who are knowledgeable, even expert, on corporate governance issues, but the institutional investors themselves devote very little in resources, lack effective goals, and don't strongly support efforts to change management behavior, except in extreme cases or for brief periods.

The ownership of U.S. corporations is so atomized that no institutional investor can afford to monitor the whole market or even any significant number of companies. Problems of corporate governance are generally pervasive, rather than specific to any particular company, making reform an enormous task that no single institutional investor is able to tackle. Even if they monitored a few companies, they cannot afford to act on the information. Even if they acted on the information, they cannot generate enough pressure to cause change. And the free-rider problem makes it irrational for any institutional investor to invest in improving corporate governance because everyone else will benefit in the same proportion. This clearly results in a less than optimal level of monitoring. (Admati 1994)

It is not clear, however, *why* institutional investors have been unable to overcome the collective action problem while corporate management has been so successful at organizing and cooperating to achieve common political and legal goals. Each group has approximately equal challenges, resources and

⁴²² As noted in Chapters 5 and 6, this is not a new idea. Numerous perceptive observers have commented about the surprising passivity of institutional investors and the apparent disinterest of many of them to pursue corporate governance reform.

numbers of members. If anything, the reputed diversity, competitiveness, innovation, creativity, differences in interests, drive and ego of the corporate environment might be expected to create greater barriers to collective action for corporations.

2. Individual interests are far more important than institutional interests in contests over corporate governance.

It is very easy to fall into the habit of thinking of institutions as autonomous entities, able to make their own decisions based on the interests of the institution. But no institution acts for itself. They are always dependent upon one or more individuals who act as directors, officers, employees, or contractors of various sorts. And there are almost always conflicting interests among these individuals, and between the individuals and the institutions for which they act.

Bernard Black captured this problem when he characterized the dynamic as “Agents Watching Agents.” He was pointing out that the people doing the monitoring are not the actual investors who stand to gain or lose, but merely employees of an intermediary institutional investor acting as their agent in monitoring the activities of corporate managers, who are themselves agents for the shareholders. But this understates the problem.

First, the managers are not legally agents for the shareholders,⁴²³ as their fiduciary duties have been loosened and courts have found that their remaining duties are to the corporation itself. But more important, managers have become parties in the conflict. They have strong, personal, financial interests in the outcome of corporate governance reforms. These are business people whose primary skill and interest is making money, and in the context of corporate governance issues related to managerial compensation, tenure and freedom, they are primarily concerned about making money for themselves.⁴²⁴ It is also quite natural for corporate managers to genuinely believe that retaining managerial freedom for themselves is good for the corporation and for the owners. Their individual interests are strong motivation for them to act to protect their interests with all the resources at their disposal.⁴²⁵

Second, the agents doing the watching, the corporate governance staffs of institutional investors, do not have the same level of incentive to engage in conflict with managers. Rather than defending their interests or proposed policies by rational argument alone, corporate managers often engage in

⁴²³ As discussed in Chapters 2 and 3, managers and directors are agents of the corporation, not the shareholders.

⁴²⁴ This isn't to say that they aren't also motivated to improve corporate profits or by their own power, prestige, etc., but status in the corporate world is often determined by how much one makes and compensation of senior corporate executives is a matter of public record because of SEC disclosure requirements.

⁴²⁵ Especially if they can use resources that cost them little, as is the case when they use corporate political resources.

intimidation against proponents of changes in corporate governance. They mobilize as a group and systematically over-react, as if they believed that even minor restrictions on their autonomy would start them down a slippery slope to greater restrictions. They indulge in manipulative framing of investors' motives and character, as when they call them "activists" or suggest that they want to take over the corporation or its board. This appears to be a particularly successful tactic in dealing with institutional investors, given the investors' comments about avoiding conflict and criticism.

At the Harvard Law School Symposium on Corporate Elections held October 3, 2003, Sarah Teslik explained:

"Why aren't institutional investors more active given the current rules we have? Two reasons: one is that the current restrictions on shareholder actions are much more substantial than most people understand, and although a Michael Price⁴²⁶ might be willing to undertake both the costs and the reputational risks of being sued by submitting a slate of directors, if you are a public pension plan, and you file a slate of directors and you are sued – and it's technically a suit for securities fraud – and the paper runs the headline, 'Iowa State Pension Fund Sued for Securities Fraud,' you don't keep your job."⁴²⁷

Orin Kramer, speaking at the same conference, said:

"The real problem is not that institutional investors en masse will support some social agenda, which is not going to happen, but that it is difficult to induce most institutional shareholders to act against management even when the purely economic incentives are clear. There's a reason the sleeping giant is sleeping – because the sleep makes the conflicts⁴²⁸ disappear. That's a serious problem, so it's going to be hard enough to motivate institutional activism under any set of circumstances, but at least we need a regime that removes the friction cost when some institutions are actually willing to do the work."⁴²⁹

The significant imbalance of interests makes it worthwhile for corporate managers to fight hard and bully and take risks; the much smaller interests of institutional investment managers make the conflict and personal discomfort not worth it.

⁴²⁶ A well-known mutual fund manager.

⁴²⁷ Bebchuk (2003c) at page 60.

⁴²⁸ Kramer is presumably referring to the conflicts which arise with corporate managers when corporate governance staffs of institutional investors support or advocate for corporate governance reforms.

⁴²⁹ Bebchuk (2003c) at page 53.

3. *The economic value of corporate governance is very difficult to determine.*

Behavioral economics and psychology have shown that humans are remarkably poor at analyzing rare events. We have a tendency to overestimate the likelihood of frightening events up to a point and then to suppress them. We underestimate the likelihood of smaller losses, especially cumulative ones. We do a surprisingly poor job of estimating the probable costs of these events. We systematically under-invest in precaution against these risks. We are also unable to rationally consider multiple factors in making important decisions. (Thaler 2005) Nobody has good data on the frequency of occurrence or the loss experience of corporate governance risks and, therefore, nobody has a useful pricing algorithm to use in valuing the risk. The flip side of this problem is that nobody can accurately value the benefits of corporate governance improvements.

The idea that corporate governance rules and laws which protect shareholders cannot easily be shown to increase the value of the corporation should not be a surprise. But this is the wrong way to view the question. All regulation is costly to comply with; in the short run, it might even be expected to cause a short term decrease in value. *The value of corporate governance is not necessarily in increasing the value of the corporation, but in increasing the portion of that value received by shareholders and the probability that they will receive it.* Much of corporate governance is oriented toward preventing misconduct or limiting behavior or changing the response to rare events.⁴³⁰ As a result, it is not surprising that there is little immediate, measureable change in the limited periods studied.⁴³¹ The benefits of effective prevention do not show up, except in those rare but crucial cases where they are necessary to control the fraud or rent extraction of management. The market “forgets” the risk. Part of the value of choosing good governance rules may also be in “bonding;” the market or individual company signals its commitment to take good care of investors and thereby builds the trust that makes investment possible in the first place.

A good example of this problem is the value of auditing. Audits are quite expensive, especially when the cost of designing and implementing the related internal controls is included. The widespread use of audits, as required by the securities laws for public companies and banking regulations for significant borrowers, has reduced the frequency of financial statement errors and fraud to the point that they are rare events. But focusing on those rare events is misleading. The real value of audits is not in the financial statement errors discovered by auditors. It is the aggregate value of financial statement errors,

⁴³⁰ Or hidden events; the legally-respected custom of secrecy makes it very difficult to know what conduct is being prevented or changed by corporate governance rules and, therefore, to measure the costs and benefits.

⁴³¹ At best, event studies only measure what the market thinks about a corporate governance change, not its actual value.

fraud, and theft losses which would have occurred if the deterrent of the audit was not present. This amount is not measureable. If the cost-benefit analysis standard set out in *Business Roundtable and Chamber of Commerce of the United States of America v. Securities Exchange Commission*⁴³² was applied to the financial audit requirement, it would be unlikely to survive.

Corporate governance rules are frequently preventatives for rare events that appear unlikely in normal operations. Corporate governance reforms appear to add little value if measured in these circumstances, especially if measured over short periods. But if corporate governance reforms could prevent, or reduce the losses caused by, major financial crises, they might appear to be worth far more. If a corporate governance reform could deter the sort of short-term risk-taking that resulted in the millions of bad mortgage loans or the pervasive over-leveraging of companies, it might prevent the crisis from occurring in the first place. If proxy access for institutional investor nominations for corporate directors could cause boards to serve investors' interests in preventing the behavior that led to the crisis, it might appear well worth the minor costs caused by a few more proxy contests.⁴³³ But since these are benefits that are not easy to quantify, and it is not possible to predict when and how often the precautions will be necessary, reformers carry a difficult burden of proof.

4. *The market for corporate governance appears to be weak.*

The argument is frequently made that government should not interfere in corporate governance because the market will guide us to more effective solutions, will foster more creative solutions and will preserve freedom is very appealing. But markets rarely structure themselves, and often need outside guidance to acquire and disseminate the necessary information, as well as to aggregate a usefully accurate measure of preferences.

As we have seen, corporate directors and managers are the primary decision-makers in corporate governance matters. They choose the state of incorporation (or re-incorporation), the charter and bylaw provisions, the operating rules of the board, the attorneys who guide decisions, the conduct of elections, and essentially every other aspect of corporate operation.

As noted in the preceding chapter, the responses of institutional investors to the questions about buying, selling and pricing corporate stocks based on corporate governance issues indicate that they are not sending any significant pricing signals about corporate governance. Without such a price effect, there is essentially no clear benefit for good corporate governance and no penalty for bad corporate governance.

⁴³² 647 F.3d. 114 (2011), which vacated the SEC's proxy access rule.

⁴³³ The rationale used by the court in *Business Roundtable* to overturn the SEC proxy access rule.

It is not likely that there are other investors sending stronger corporate governance price signals. Few investors are as aware of corporate governance issues as institutional investors. Only a few hedge funds actively search for acquisition targets based on corporate governance characteristics, and the ones who do are most often looking for companies with weak takeover defenses that would be considered positive corporate governance characteristics by institutional investors.

Even if there were a price effect from investors' consideration of corporate governance issues in their buying, selling or pricing decisions, the impact of that price effect on the managers making the decisions is likely to be very limited. The manager's share of the ownership⁴³⁴ of the company is often less than one percent and rarely as much as five percent. Thus, managers would receive a very small share of the benefits of any corporate governance improvement. Jesse Fried pointed out that there is a great deal of noise in stock prices, thus making it very difficult to see the price impact of any corporate decisions. (Fried 2006) The effect of a given corporate governance choice would have to be very clear and very large for managers to even consider the share price effect.

If the decision is about a corporate governance matter that affects directors and managers in any direct manner (e.g., their compensation or job security), their possible benefit from the choice almost certainly exceeds their share of the benefit from a positive market price effect from adopting a rule which sacrifices their direct interest. Thus, managers will almost always have an economic incentive to choose to incur the negative stock price effect, if any, from any decision which enhances their compensation or job security, including new anti-takeover devices, because they receive 100% of the benefit and only incur a small fraction of the resulting cost.

There has been an enormous effort by economists to measure the value of corporate governance ideas, practices, efforts and changes. In many cases they discern a positive or negative effect, as when they seem to prove that Delaware law is better for investors than other states because companies which choose to re-incorporate in Delaware have higher stock prices. With the evidence that investors are almost never making stock price decisions based on corporate governance, one must search for other factors which might have appeared in the measurements. It is quite plausible that the network or standardization benefits of being a Delaware corporation might be more important than the possibility that Delaware law is more favorable to investors.

⁴³⁴ Directly through shares owned and indirectly through equity incentive compensation mechanisms.

5. Institutional investors view boards of directors as weak monitors, but management resists reforms which would strengthen them.

Despite the debate among the commentators about whether corporate governance should be director-centric or shareholder-centric, institutional investors appear convinced that it is management-centric or even CEO-centric. Many of their most important corporate governance issues distill down to the lack of an effective monitor to restrain the actions of management, and to efforts to increase the chances that the board will serve that function. Their top three issues (annual elections, majority votes and proxy access) are all oriented toward having greater influence over director elections, which is clearly a step intended to make directors more effective representatives of shareholder interests, especially in matters related to management.

Likewise, four of the top ten corporate governance goals of institutional investors relate to compensation (limiting excessive compensation, aligning compensation with shareholders' interests, Say-on-Pay votes,⁴³⁵ and long-term compensation). These issues are really derived from the problem of boards failing to adequately monitor management. If boards fully represented shareholders' interests, they would act more like a proprietor in actually negotiating the compensation of the corporation's management.

Many institutional investors have concluded that boards are not adequately protecting their interests, either by their responses that they do not trust boards to act in their interests or by the types of improvements they are seeking. They voice approval for reforms that would give investors more power in nominating and electing directors to make directors more dependent upon shareholders for their positions. They favor annual elections of directors to reduce entrenchment and the period of time necessary to remove a director who has failed to act in the shareholders' favor. They support majority voting to increase the importance of the shareholders' votes. Proxy access makes the threat of removal more meaningful because it is accompanied by the ability to choose the replacement. Even the threat of these efforts to take more power, some institutional investors believe, may make directors think more about shareholders' interests. But management, as we have seen, has fought these reforms, or when they have been enacted, worked to minimize their impact in practice.

6. Corporate management's resistance to corporate governance reform is reflected in their campaign to regulate proxy advisory firms, which they appear to believe would diminish institutional investor coordination.

Much of corporate management's initial campaign for regulation of proxy advisory firms was based on research which showed that these firms appeared

⁴³⁵ Already accomplished, although the effectiveness remains uncertain at this point.

to have a significant effect on the voting decisions of institutional investors. The argument was that they had “conflicts of interest” and “too much power,” “made too many mistakes,” “had too little financial interest,” and “didn’t offer corporations fair access to the process.”⁴³⁶ Seen from the interests of the institutional investors, these arguments appear absurd. Proxy advisory firms work for institutional investors, not issuers, assisting them in exercising their proxy voting rights. The investors have the right to exercise their vote in any way they see fit, including to make mistakes. Investors have not argued that proxy advisory firms have too much influence over their voting decisions. Perhaps the real problem is that institutional investors have become a threat to corporate management on internal corporate governance matters because more investors are voting in their own interest against management.

The argument that proxy advisory firms have too much power over shareholder voting was based on data which was subsequently found substantially overstated. But one would expect there to be a high correlation between proxy advisers’ recommendations and institutional investors’ votes if the proxy advisers were doing their job well. The fact that the voting positions of proxy advisers and institutional investors are converging on many issues related to corporate governance indicates that the advisers are successful in identifying the positions which are most advantageous to their clients. This is what their clients want, pay for, and have the right to receive. If this coordination increases the opposition to management’s positions, perhaps the problem is not with the proxy advisory firms but with management’s questionable fidelity to their shareholders’ interests and views.

The fact that management interests started out complaining about the apparent influence of proxy advisory firms is direct evidence that proxy advisory firms were in fact coordinating the corporate governance positions of institutional investors. That is a tacit admission that corporate management is very concerned about that coordination and is seeking regulation of proxy advisory firms as a strategy to impede coordination.

One of the most consistent complaints in the campaign to regulate proxy advisory firms is that they apply “one-size-fits-all” standards. Management, their attorneys, and the organizations which represent them all point out that each company is unique, and requires customized solutions, and that this leads to innovation that is stifled by standardized voting positions imposed by proxy advisory firms.⁴³⁷ This is the same argument used against public regulation in general, although it is being used here against private ordering being imposed by investors.⁴³⁸ Management offers very little evidence in favor of this argument.

⁴³⁶ The author’s characterization.

⁴³⁷ This is an excellent example of the superior coordination of management interests over institutional investors.

⁴³⁸ This is an excellent example of management’s superior framing and communication skills.

Standardization serves a critical purpose in corporate governance by making the rights of ownership, and the probability of receiving the benefits implied by those rights, reasonably predictable without having to make a difficult and expensive study of the question every time an investor considers buying a particular stock. The real essence of standardization of corporate governance is in reduced transaction costs. In a market characterized by trillions of shares traded and billions of transactions and millions of investors, there is a substantial network value in standardization and predictability. In fact, arguing in favor of the right to customize is tantamount to arguing for the right to take from the unwary, who reasonably presume that each company conforms to an assumed standard. Forcing everyone to investigate the customized corporate governance options of every investment that is considered, just so that a few can customize, could freeze the market for corporate equities. (Gordon 1989)

Perhaps most important is that the vehemence, coordination, exaggeration, and overkill being applied by corporate issuers and their representatives to this attempt to bring regulatory oversight to the proxy advisory industry show this to be an attempt to intimidate both the proxy advisers and their institutional investor clients.

7. Institutional investors' disadvantages in the legal and political realms make it unlikely that they can reform external corporate governance.

There is no doubt that we are in a period of corporate governance reform, much of it imposed by the government. The Sarbanes-Oxley Act and the Dodd-Frank Act have forced a number of important changes. Some of these have kindled successful efforts to reform internal corporate governance as well, including the widespread "repeal" of anti-takeover devices such as staggered boards and moves toward greater board independence. However, many of these changes have yet to be reflected in regulations and the interviews indicate that many institutional investors still have long agendas of important corporate governance changes which have not been addressed. And the mismatch in resources, incentives and personalities between institutional investors and corporate management, shown in both the interviews and the study of SEC comment letters on the proposal to regulate proxy advisory firms, indicates that institutional investors continue to have substantial disadvantages in using political influence or legal action to reform corporate governance.

The fact that so little progress has been made by institutional investors in solving their corporate governance complaints, in a time of recurring crises caused by corporate governance failures, does not bode well for their eventual success. Even if investors succeed in getting the right to replace directors whom they suspect are not representing their interests, there is no assurance

that they can change the fact that boards are dominated by CEOs and CEO interests. Even if they could break the CEO influence, investors cannot force directors to represent their interests. It is essentially impossible for investors to know whom to target because there is so little information about the internal deliberations of boards, even in cases where the deliberations involve direct conflicts of interest between shareholders and management.

Likewise, institutional investors are a long way from being able to impose meaningful limitations on compensation. The advent of Say-on-Pay voting is far less important than it sounds. Yes, investors obtained the right to vote in an annual referendum on pay, but there are no rules about how pay should be corrected if it fails to get a majority. The board is free to make small, incremental improvements and to put the pay up to a vote again the next year. Investors have no mechanism to impose an overall cap on incentive compensation or to deal with the problem of CEOs who take too much of the total incentives available. They cannot force the board to properly align the structure of the incentives.

Government intervention is one of the few forces powerful enough to reverse this entrenched situation. More important, government action is the only mechanism that could bring about parallel, simultaneous change so that the laggards are not rewarded with unfair advantages while the leaders adopt new rules.⁴³⁹ But elected government officials (often including judges) are more dependent than ever on the campaign contributions and lobbyist support provided by management and business interests. Politicians know that they are dependent upon political contributions to be elected and that business interests have been the most reliable sources of those contributions. The decisions of the U.S. Supreme Court that “money is speech” and that “corporations are persons” make it difficult for investors’ interests to overcome the political power of managers. Even a shift to a completely publicly-financed electoral system would still be “swamped” by the amplified political speech of business interests. Only a populist movement embraced by politicians against corporate and managerial influence would be able to offset this contribution gap or to force a change in the corporate free speech rules through a Constitutional amendment or a shift in court attitudes.

Institutional investors have not shown the inclination to devote the resources necessary to counter the political influence of corporate management. The claimed problems of budget limitations or return pressures or conflicts of interest are largely artificial. One of the unique political advantages of institutional investors is that a great number of citizens depend upon them to manage their personal and retirement investments. This is the sort of trust relationship which makes the beneficiaries likely to pay attention and to be persuaded to support actions and programs in their interests. The

⁴³⁹ Otherwise this “first mover” problem will tend to prevent action.

fact that institutional investors appear not to use this opportunity is almost inexplicable.

Institutional investors' interests are no more diverse than the interests of the corporations which manage to cooperate to fund and act under the umbrellas of the Business Roundtable or the U.S. Chamber of Commerce. Investors do not seem to understand that their common interests are much more important than the small differences between them. There is no reason why a broad effort of the sort envisioned in the Lewis Powell memorandum could not serve the interests of institutional investors at least as effectively as it has served management interests. Perhaps the problem of institutional investor motivation could be cured by a radical restructuring of institutional investor management compensation, creating individual incentives to serve their beneficiaries' interests comparable to those of corporate management.

Finally, nothing is likely to happen without a politically-savvy and persuasive "policy entrepreneur" of the sort envisioned by James Wilson.⁴⁴⁰ (Wilson 1980) The role once filled by Jesse Unruh from California⁴⁴¹ or Robert Monks from Boston⁴⁴² is clearly available. Inertia will limit corporate governance reform until someone with exceptional political skills, leadership and vision finds it advantageous to lead institutional investors to wage a campaign for change.

In the absence of such a tectonic political shift, the coordination effects of proxy advisory firms are very important to our society, as they are the only mechanism that appears to coordinate countervailing pressures on boards to represent shareholders' interests, to temper the relentless pressure for more compensation, and to force corporations to adopt compensation structures which actually align managers' incentives with the interests of shareholders. It would be ironic if the SEC, an agency formed to protect individual investors against corporate misconduct, was used as the mechanism to restrict the effectiveness of proxy advisory firms in protecting the interests of institutional investors' individual beneficiaries.

⁴⁴⁰ See also Vogel (1996) and Kingdon (2002).

⁴⁴¹ Unruh, as California State Treasurer from 1975-1987, was an *ex officio* member of the board of the California Public Employees Retirement System and was instrumental in establishing its leading role in corporate governance reform efforts, as well as the formation of the Council of Institutional Investors.

⁴⁴² Monks was a well-known corporate governance activist and critic, while Chairman of The Boston Company and Administrator of the U.S. Department of Labor Office of Pension and Welfare Benefit Programs, and went on to found Institutional Shareholder Services.

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**Largest U.S. Pension
Funds**

**Appendix
A-1**

Pensions & Investments January 22, 2007
2/2/2013 12:01

	Sponsor	Assets \$M	DB \$M	DC \$M	Stocks %	Stocks \$M
1	California Pub Emp	218,214	217,648	566	62.50%	136,030
2	Fedl Retire Thrift	188,086		188,086	60.40%	0
3	Calif State Tchrs	149,008	148,868	140	64.00%	95,276
4	N Y State Comm Fd	144,289	144,289	0	60.90%	87,872
5	Florida State Retire	124,450	121,871	2,579	66.10%	80,557
6	General Motors	118,992	98,612	20,380	49.00%	48,320
7	N Y City Retire	114,598	100,030	14,568	70.30%	70,321
8	Texas Teachers	100,717	100,717	0	66.50%	66,977
9	N Y State Tchrs	94,347	94,347	0	69.80%	65,854
10	Wisconsin Invest Bd	80,853	78,935	1,918	64.00%	50,518
11	IBM	79,567	50,797	28,770	57.00%	28,954
12	General Electric	76,039	51,736	24,303	62.70%	32,438
13	New Jersey	75,544	74,500	1,044	67.10%	49,990
14	Ohio Public Emp	73,572	73,416	156	64.90%	47,647
15	Boeing	72,848	45,508	27,340	55.00%	25,029
16	AT&T	71,556	49,368	22,188	55.00%	27,152
17	North Carolina	70,016	70,016	0	56.00%	39,209
18	Ohio State Tchrs	67,965	67,736	229	69.00%	46,738
19	Verizon	62,639	45,075	17,564	60.40%	27,225
20	Washington State	60,045	52,422	7,623	47.30%	24,796
21	Michigan Retire	59,988	55,483	4,505	60.00%	33,290
22	Oregon Public Emp	58,549	57,647	902	59.00%	34,012
23	Penn Sch Empl	58,490	58,490	0	63.60%	37,200
24	Ford Motor	57,282	45,412	11,870	60.40%	27,429
25	University of Calif	54,433	44,814	9,619	67.00%	30,025
26	Virginia Retire	51,340	50,311	1,029	66.60%	33,507
27	Georgia Tchrs	48,675	48,675	0	61.10%	29,740
28	Minnesota State	48,214	43,892	4,322	63.60%	27,915
29	Lucent Tech	44,825	37,172	7,653	60.40%	22,452
30	Lockheed Martin	44,721	24,828	19,893	61.00%	15,145
31	Mass PRIM	44,535	44,535	0	57.00%	25,385
32	Colorado PERS	37,868	36,451	1,417	59.00%	21,506
33	Illinois Teachers	37,361	37,361	0	61.20%	22,865
34	L A County	35,877	35,877	0	54.90%	19,696
35	Maryland Retire	35,430	35,430	0	56.20%	19,912
36	U N Joint Staff	34,419	34,419	0	60.40%	20,789
37	Northrop Grum	33,434	19,973	13,461	58.20%	11,624
38	Penn Empl	31,978	30,372	1,606	58.40%	17,737
39	Tenn Consol	30,699	29,704	995	44.00%	13,070
40	Teamsters West	30,158	30,158	0	44.90%	13,541
41	Natl Railroad	29,383	29,383	0	68.00%	19,980
42	Alabama Retire	29,103	28,098	1,005	61.60%	17,308
43	United Tech	29,032	15,542	13,490	60.00%	9,325
44	Chrysler	28,584	22,528	6,056	60.40%	13,607
45	DuPont	27,515	17,978	9,537	56.80%	10,212
46	S Carolina Retire	27,129	26,652	477	53.20%	14,179

47	Exxon Mobil	26,721	7,091	19,630	71.00%	5,035
48	Missouri Pub Sch	26,229	26,229	0	59.20%	15,528
49	Bank of America	25,867	13,344	12,523	60.40%	8,060
50	Bell South	24,972	16,797	8,175	60.00%	10,078
51	Arizona Retire	24,863	24,863	0	75.00%	18,647
52	Texas Empl	23,890	22,613	1,277	63.40%	14,337
53	Raytheon	23,563	13,060	10,503	60.40%	7,888
54	Conn Retire	23,528	23,528	0	63.00%	14,823
55	Citigroup	23,494	11,549	11,945	40.30%	4,654
56	Utah Retire	22,705	20,282	2,423	60.40%	12,250
57	Altria	22,045	11,984	10,061	70.90%	8,497
58	JP Morgan Chase	21,921	9,634	12,287	55.00%	5,299
59	UPS	21,395	13,853	7,542	60.40%	8,367
60	Illinois Municipal	21,143	21,143	0	61.00%	12,897
61	Honeywell	21,080	12,880	8,200	65.00%	8,372
62	Iowa Public Emp	21,027	21,027	0	45.90%	9,651
63	Mississippi Emp	20,428	19,488	940	74.00%	14,421
64	Nevada Emp	20,334	20,334	0	58.40%	11,875
65	Teamsters Cen	19,652	19,652	0	69.00%	13,560
66	Chevron	18,983	7,469	11,514	66.00%	4,930
67	American Air	18,641	8,128	10,513	54.00%	4,389
68	FedEx	18,333	10,611	7,722	60.40%	6,409
69	Shell Oil	17,010	7,367	9,643	60.40%	4,450
70	Dow Chemical	16,920	11,123	5,797	60.40%	6,718
71	Procter & Gam	16,778	1,754	15,024	60.40%	1,059
72	Alaska Retire	16,776	14,192	2,584	55.10%	7,820
73	State Farm	16,746	10,990	5,756	60.40%	6,638
74	BP America	16,600	7,400	9,200	75.00%	5,550
75	San Francisco	16,359	14,944	1,415	51.20%	7,651
76	3M	16,155	9,557	6,598	59.00%	5,639
77	Wells Fargo	15,883	4,813	11,070	62.00%	2,984
78	Hewlett-Pack	15,700	6,600	9,100	60.40%	3,986
79	Prudential	15,562	10,205	5,357	34.00%	3,470
80	Kentucky Retire	15,493	15,943	-450	64.00%	10,204
81	Georgia Emp	15,433	15,433	0	61.70%	9,522
82	Kaiser	15,325	9,082	6,243	69.20%	6,285
83	Ill Universities	15,106	14,635	471	67.40%	9,864
84	Untd Meth Ch	15,096	0	15,096	60.40%	0
85	Indiana Emp	15,054	15,033	21	65.00%	9,771
86	Caterpillar	14,623	10,227	4,396	60.40%	6,177
87	Texas Cnty & Dist	14,524	14,524	0	58.10%	8,438
88	Delphi	14,444	10,537	3,907	60.40%	6,364
89	Kentucky Tchrs	14,431	14,431	0	62.00%	8,947
90	Illinois St Board	14,252	11,485	2,767	57.00%	6,546
91	L A Fire & Police	14,111	14,111	0	61.70%	8,706
92	General Dynam	13,951	7,171	6,780	60.40%	4,331
93	Louisiana Tchrs	13,938	13,938	0	67.50%	9,408
94	Pfizer	13,636	8,497	5,139	60.40%	5,132
95	Eastman Kodak	13,440	6,440	7,000	60.40%	3,890
96	Qwest	13,347	9,980	3,367	60.40%	6,028
97	Texas Mun Retire	13,343	0	13,343	60.40%	0
98	PG&E	13,291	8,646	4,645	60.40%	5,222
99	Wachovia	13,269	5,966	7,303	51.00%	3,043
100	National Electric	13,258	11,098	2,160	59.00%	6,548
101	World Bank	13,122	13,122	0	32.90%	4,317

102	Johnson & John	12,862	5,844	7,018	76.50%	4,471
103	Kansas Pub Emp	12,703	12,703	0	54.40%	6,910
104	Exelon	12,600	9,300	3,300	60.40%	5,617
105	Alcoa	12,380	8,382	3,998	58.00%	4,862
106	Deere	12,195	9,140	3,055	57.00%	5,210
107	New Mexico PERS	12,029	11,748	281	68.00%	7,989
108	Chicago Sch Tchrs	11,649	11,649	0	67.60%	7,875
109	International Paper	11,405	7,061	4,344	59.00%	4,166
110	Merrill Lynch	11,218	2,577	8,641	60.40%	1,557
111	Ohio Police & Fire	11,155	11,155	0	69.40%	7,742
112	ConocoPhillips	10,400	2,500	7,900	72.00%	1,800
113	MetLife	10,350	6,000	4,350	60.40%	3,624
114	Con Edison	10,330	8,132	2,198	67.00%	5,448
115	Fed Reserve Emp	10,298	6,095	4,203	63.50%	3,870
116	Ohio Sch Emp	10,277	10,277	0	64.80%	6,659
117	Idaho Public Emp	10,267	10,029	238	66.80%	6,699
118	Hawaii Emp	10,200	10,200	0	61.90%	6,314
119	Southern Co	10,191	6,551	3,640	61.70%	4,042
120	Delta Air Lines	10,122	6,321	3,801	43.00%	2,718
121	Motorola	10,103	4,262	5,841	75.00%	3,197
122	U.S. Steel	10,068	9,032	1,036	63.00%	5,690
123	Maine Retire	10,029	10,023	6	65.90%	6,605
124	L A City Emp	9,945	9,945	0	65.30%	6,494
125	Siemens	9,900	3,850	6,050	49.00%	1,887
126	Northwest Air	9,831	6,298	3,533	60.40%	3,804
127	Koch Ind	9,660	4,881	4,779	60.40%	2,948
128	Weyerhaeuser	9,555	6,027	3,528	60.40%	3,640
129	Wal-Mart	9,461	0	9,461	60.40%	0
130	Arkansas Tchrs	9,446	9,446	0	60.40%	5,705
131	Sears Holdings	9,324	4,513	4,811	60.40%	2,726
132	Eli Lilly	9,187	5,621	3,566	50.00%	2,811
133	Oper Engs Intl	9,116	9,116	0	51.00%	4,649
134	Abbott Labs	8,905	3,711	5,194	75.00%	2,783
135	SEIU National	8,895	8,883	12	60.40%	5,365
136	Episcopal Ch	8,875	8,554	321	52.70%	4,508
137	J.C. Penny	8,851	4,670	4,181	69.20%	3,232
138	N Y St Def Comp	8,788	0	8,788	60.40%	0
139	Morgan Stanley	8,781	2,212	6,569	60.40%	1,336
140	Aetna	8,766	5,335	3,431	66.00%	3,521
141	Xerox	8,722	4,137	4,585	66.00%	2,730
142	Natl Rural Elec	8,659	4,627	4,032	71.00%	3,285
143	PepsiCo	8,657	5,564	3,093	60.40%	3,361
144	Merck	8,592	4,649	3,943	60.40%	2,808
145	So Baptist Conv	8,590	1,913	6,677	53.00%	1,014
146	TVA	8,535	7,241	1,294	57.00%	4,127
147	New Mexico Ed	8,468	8,468	0	73.90%	6,258
148	Oklahoma Tchrs	8,408	8,088	320	69.50%	5,621
149	SUPERVALU	8,332	1,675	6,657	60.40%	1,012
150	Intel	8,303	232	8,071	13.40%	31
151	Boiler-Blacksm	8,221	7,327	894	60.40%	4,426
152	Allstate	8,155	4,181	3,974	62.00%	2,592
153	Nebraska Invest	8,138	7,071	1,067	63.40%	4,483
154	Indiana Tchrs	8,073	4,835	3,238	67.00%	3,239
155	Duke Energy	8,068	4,413	3,655	65.00%	2,868
156	Louisiana Emp	8,044	8,044	0	63.50%	5,108

157 I.A.M. National	8,001	7,951	50	70.60%	5,613
158 Time Warner	7,854	3,112	4,742	60.40%	1,880
159 GlaxoSmithKl	7,748	3,576	4,172	71.00%	2,539
160 Rhode Isl Emp	7,694	7,512	182	65.60%	4,928
161 San Diego Cnty Emp	7,612	7,612	0	52.90%	4,027
162 Bristol-Meyers Sq	7,601	4,294	3,307	70.00%	3,006
163 EDS	7,596	4,136	3,460	78.00%	3,226
164 N Y City Def Comp	7,570	0	7,570	60.40%	0
165 Montana Bd Invest	7,516	7,237	279	63.50%	4,595
166 CBS	7,421	3,716	3,705	33.00%	1,226
167 Unisys	7,416	4,947	2,469	60.40%	2,988
168 Presbyterian Ch	7,290	7,070	220	67.10%	4,744
169 Dominion Res	7,237	4,795	2,442	51.00%	2,445
170 Missouri Emp	7,150	7,150	0	54.70%	3,911
171 Cook Cnty Emp	7,100	7,100	0	53.00%	3,763
172 ITT	7,081	4,914	2,167	60.40%	2,968
173 American Elec	6,968	4,200	2,768	65.70%	2,759
174 Textron	6,964	4,972	1,992	57.00%	2,834
175 South Dakota Emp	6,950	6,845	105	0.00%	0
176 Oklahoma Emp	6,898	6,394	504	64.70%	4,137
177 Tyco Intl	6,871	1,958	4,913	60.40%	1,183
178 Los Angeles DWP	6,856	6,856	0	63.30%	4,340
179 First Energy	6,820	4,605	2,215	63.00%	2,901
180 Wyeth	6,743	3,812	2,931	70.40%	2,684
181 Elec Ind Jt Bd	6,716	2,038	4,678	60.40%	1,231
182 UMWA Hlth & Ret	6,707	6,434	273	60.20%	3,873
183 Target	6,697	2,014	4,683	55.00%	1,108
184 West Virginia Inv	6,596	6,596	0	58.00%	3,826
185 Delaware Emp	6,527	6,527	0	65.80%	4,295
186 Ohio Def Comp	6,493	0	6,493	60.40%	0
187 So Cal Edison	6,485	3,320	3,165	60.40%	2,005
188 Orange County	6,484	6,484	0	45.80%	2,970
189 Reynolds Am	6,458	4,744	1,714	61.90%	2,937
190 Chicago Muni	6,438	6,438	0	67.50%	4,346
191 Walt Disney Co.	6,421	3,884	2,537	53.70%	2,086
192 Cal Savings Plus	6,265	0	6,265	60.40%	0
193 Arizona Pub Safe	6,272	6,272	0	70.10%	4,397
194 Wyoming Retire	6,174	5,927	247	61.70%	3,657
195 Am Express Co.	6,060	2,308	3,752	60.40%	1,394
196 Fed Dptmt Stores	6,047	2,423	3,624	62.00%	1,502
197 Hartford Fin	6,008	3,240	2,768	60.40%	1,957
198 Evang Lutheran	6,001	0	6,001	60.40%	0
199 Sacramento Cnty	5,997	5,400	597	58.00%	3,132
200 UFCW Industry III	5,957	5,957	0	60.40%	3,598
	4,911,999	3,871,157	1,040,842	60.40%	2,369,479

Appendix A-2**FDIC Largest Trust Companies (11-27-2006)**

<u>Assets</u>			<u>Trust Assets</u>	<u>Managed</u>
1.	State Street Corp.	Boston	\$4,928B	\$1,398B
2.	Northern Trust Co.	Chicago	2,914	625
3.	Mellon Financial	Pittsburgh	1,881	170
4.	JP Morgan Chase	New York	1,157	170
5.	Fidelity Mgmt Trust	Boston	1,037	141
6.	Citigroup	New York	735	92
7.	U.S. Bancorp	Minneapolis	676	70
8.	Barclays PLC	San Francisco	637	637
9.	Bank of New York	New York	593	91
10.	Wells Fargo & Co.	San Francisco	383	90
11.	Wachovia	Charlotte, NC	294	108
12.	Bank of America	Charlotte, NC	270	190
13.	ABN AMRO La Salle	Chicago	198	8
14.	Deutsche Bank	New York	151	41
15.	General Motors Trust	New York	123	0
16.	Merrill Lynch	New York	116	28
17.	Mitsubishi Financial	San Francisco	111	11
18.	SunTrust Banks	Atlanta	93	53
19.	Wilmington Trust	Wilmington, DE	82	26
20.	PNC Financial	Pittsburgh	66	48

Largest Insurance Companies

Insurance Information Institute 2006 (by Assets)

1.	MetLife	New York	\$527.7B
2.	Prudential Financial	Newark, NJ	454.3
3.	TIAA-CREF	New York	413.0
4.	Lincoln National	Hartford, CT	178.5
5.	New York Life	New York	165.7
6.	Massachusetts Mutual Life	Boston	154.1
7.	Northwestern Mutual Life	Milwaukee	145.1
8.	Principal Financial	Des Moines	143.7
9.	Genworth Financial	Richmond, VA	110.9
10.	Pacific Life	Newport Beach, CA	99.3
11.	AFLAC	Columbus, GA	59.8
12.	Thrivent Financial for Lutherans	Appleton, WI	56.5
13.	Unum Group	Portland, ME	52.8
14.	Guardian Life of America	New York	39.5
15.	Conseco	Carmel, IN	32.7
16.	Western & Southern Financial	Cincinnati	30.3
17.	Assurant	New York	25.2
18.	American National	Galveston, TX	17.9
19.	Mutual of Omaha	Omaha, NE	17.1
20.	Torchmark	McKinney, TX	15.0

Appendix A-4**Largest Mutual Fund Families**

Morningstar.com 7-10-07

				<u>U.S. Stock Market</u>	
1.	Vanguard	Valley Forge, PA	\$1034.9B	57.3%	593.0B
2.	American Funds	Los Angeles	998.7	43.8	437.4
3.	Fidelity	Boston	922.2	60.4	557.0
4.	Franklin/Templeton	San Mateo, CA	314.9	22.6	71.2
5.	T. Rowe Price	Baltimore	226.7	61.5	139.4
6.	PIMCO	Newport Beach, CA	191.1	7.6	14.5
7.	Oppenheimer	New York	158.8	29.4	46.7
8.	Dodge & Cox	San Francisco	142.4	47.9	68.2
9.	Columbia	Boston	135.8	50.7	68.9
10.	John Hancock	Boston	103.5	59.2	61.3
11.	Blackrock (Merrill)	Plainsboro, NJ	98.5	42.2	41.6
12.	Dimensional Invstmnt	Santa Monica, CA	94.9	50.8	48.2
13.	Legg Mason	Baltimore	92.0	78.5	72.2
14.	Janus	Denver	89.5	73.9	66.1
15.	MFS Investment Mgmt	Boston	88.8	46.5	41.3
16.	JP Morgan Chase	New York	81.9	51.5	42.2
17.	American Century	Kansas City	80.1	72.8	58.3
18.	Alliance Bernstein	New York	69.7	27.1	18.9
19.	AIM Investments	Houston	64.0	73.0	46.7
20.	DWS Scudder	Chicago	63.3	50.3	31.8

Largest Foundations

The Foundation Center based on 2006 FYE Audited Financial Statements

1.	Bill & Melinda Gates Foundation	Seattle	\$29.2B
2.	Ford Foundation	New York	11.6
3.	J. Paul Getty Trust	Los Angeles	9.6
4.	Robert Wood Johnson Foundation	Princeton, NJ	9.4
5.	William and Flora Hewlitt Foundation	Menlo Park, CA	8.5
6.	Lilly Endowment	Indianapolis	8.4
7.	W. K. Kellogg Foundation	Battle Creek, MI	7.8
8.	David and Lucile Packard Foundation	Los Altos, CA	5.8
9.	Andrew W. Mellon Foundation	New York	5.6
10.	John D. and Catherine T. MacArthur	Chicago	5.5
11.	Gordon E. and Betty I. Moore Foundation	San Francisco	5.3
12.	Howard Hughes Medical Institute	Chevy Chase, MD	4.8
13.	Pew Charitable Trusts	Philadelphia	4.1
14.	Rockefeller Foundation	New York	3.2
15.	The Kresge Foundation	Detroit	2.7

Appendix A-6

Largest Endowment Funds

NACUBO (National Association of College & University Business Officers)
2006

1.	Harvard University (Management Co.)	Cambridge, MA	\$28.9B
2.	Yale University	New Haven, CT	18.0
3.	Stanford University	Palo Alto, CA	14.1
4.	Princeton University	Princeton, NJ	13.0
5.	Massachusetts Institute of Technology	Cambridge, MA	8.4
6.	Columbia University	New York	5.9
7.	University of Michigan	Ann Arbor, MI	5.7
8.	University of Pennsylvania	Philadelphia	5.3
9.	Northwestern University	Evanston, IL	5.1
10.	Emory University	Atlanta	4.9
10.	University of Chicago	Chicago	4.9
12.	Washington University at St. Louis	St. Louis	4.7
13.	Duke University	Durham, NC	4.5
14.	University of Notre Dame	South Bend, IN	4.4
15.	Cornell University	Ithaca, NY	4.3
16.	Rice University	Houston, TX	4.0
17.	University of Virginia	Charlottesville, VA	3.6
18.	University of Southern California	Los Angeles	3.1
18.	Dartmouth College	Hanover, NH	3.1
20.	Vanderbilt University	Nashville, TN	2.9

Largest Hedge Funds

Alpha Magazine (sponsored by Institutional Investor) May 23, 2007

1.	JP Morgan Chase (includes Highbridge)	New York	\$33.1B
2.	Goldman Sachs	New York	32.5
3.	Bridgewater Associates	Westport, CT	30.2
4.	D.E. Shaw Group	New York	27.3
5.	Farallon Capital Management	San Francisco	26.2
6.	Renaissance Technologies	East Setauket, NY	26.0
7.	Och-Ziff Capital Management Group	New York	21.0
8.	Barclay's Global Investors	San Francisco	19.0
9.	Man Investments	London	18.8
10.	ESL Investments	Greenwich, CT	17.5
11.	GLG Partners	London	15.8
12.	Tudor Investment Group	Greenwich, CT	14.8
13.	Citigroup Alternative Investing	New York	14.1
14.	Lansdowne Investments	London	14.0
15.	Campbell & Co.	Towson, MD	13.6
16.	Atticus Capital	New York	13.5
16.	Caxton Associates	New York	13.5
18.	Citadel Investment Group	Chicago	13.4
19.	Cerberus Capital Management	New York	12.8
20.	Moore Capital Management	New York	12.5

Largest Private Equity Firms

Private Equity International 2007 List (by capital)

1.	Carlyle Group	Washington, DC	\$32.5B
2.	Kohlberg Kravis Roberts	New York	31.1
3.	Goldman Sachs	New York	31.0
4.	Blackstone	New York	28.4
5.	Texas Pacific Group (TPG)	Fort Worth, TX	23.5
6.	Bain Capital	Boston	17.3
7.	Providence Equity Partners	Providence, RI	16.4
8.	Apollo Management	New York	13.9
9.	Warburg Pincus	New York	13.3
10.	Hellman & Friedman	San Francisco	12.0
11.	CCMP Capital	New York	11.7
12.	General Atlantic	Greenwich, CT	11.4
13.	Silver Lake Partners	Menlo Park, CA	11.0
14.	First Reserve Corporation	Greenwich, CT	10.1
15.	American Capital	Bethesda, MD	9.6
16.	Lehman Brothers	New York	8.5
17.	Fortress Investment	New York	8.3
18.	Sun Capital Partners	Boca Raton, FL	8.0
19.	Thomas H. Lee Partners	Boston	7.5
20.	Leonard Green & Partners	Los Angeles	7.1

Largest Venture Capital Firms

National Venture Capital Association 2006 (by invested capital)

1.	Warburg Pincus	New York	\$7.8B
2.	TA Associates	Boston	5.0
3.	New Enterprise Associates	Menlo Park, CA	4.5
4.	Summit Partners	Boston	3.1
5.	Accel Partners	Palo Alto, CA	3.0
6.	Menlo Ventures	Menlo Park, CA	2.8
6.	Softbank Venture Capital	Newton Center, MA	2.8
6.	Spectrum Equity Investors	Menlo Park, CA	2.8
9.	Technology Crossover Partners	Palo Alto, CA	2.6
9.	Oak Investment Partners	Westport, CT	2.6
11.	Kleiner, Perkins, Caufield & Bayers	Menlo Park, CA	2.4

Largest U.S. Institutional Investment Managers

Pensions & Investments October 1, 2007 (as of 12-31-2006; edited to eliminate advisers operating primarily outside the U.S. and those focused primarily on mutual funds)

1.	Barclays Global Investors	San Francisco	\$1,813.8B
2.	State Street Global	Boston	1,748.7
3.	AXA Group	New York	1,740.0
4.	Allianz Group/RCM	San Francisco	1,707.7
5.	Deutsche Bank	New York	1,273.5
6.	BlackRock	New York	1,124.6
7.	JP Morgan Chase	New York	1,013.7
8.	Mellon Financial	Pittsburgh	995.2
9.	Legg Mason	Baltimore	957.6
10.	AIG Global Investment	New York	730.9
11.	Northern Trust Global	Chicago	697.2
12.	Goldman Sachs Group	New York	693.0
13.	Prudential Financial	Newark, NJ	616.0
14.	Morgan Stanley	New York	606.5
15.	Bank of America	New York	543.0
16.	Hartford Financial	Hartford, CT	327.5
17.	Northwestern Mutual	Milwaukee	307.6
18.	Wells Fargo Bank	San Francisco	306.2
19.	Principal Financial Group	Des Moines	256.9

20.	Lehman Brothers	New York	228.8
21.	New York Life Investment Mgmt.	New York	223.6
22.	Marsh & McLennan	New York	205.6
23.	GE Asset Management	Stamford, CT	196.5
24.	Bank of New York	New York	190.0
25.	SEI Investments	Oaks, PA	181.5
26.	General Motors Asset Management	New York	170.5
27.	Bridgewater Associates	Westport, CT	169.1
28.	Grantham, Mayo & Otterloo	Boston	141.0
29.	Eaton Vance	Boston	128.9
30.	Brandes Investment Partners	San Diego	117.7
31.	Lazard	New York	110.4
32.	Trusco Capital	Atlanta, GA	75.0
33.	LSV Asset Management	Chicago	70.5
34.	MBIA Asset Management	Armonk, NY	63.9
35.	Geode Capital Management	Boston	60.7
36.	Waddell & Reed	Overland Park, KS	48.4
37.	LaSalle Investment Management	Chicago	44.3
38.	Brown Brothers Harriman	New York	43.7
39.	Bear Stearns Asset Management	New York	41.4
40.	Commonfund	Wilton, CT	39.5

Institutional Investor Sampling Plan

Category	Number Intervwd	Category Total	Total U.S. Equities	Avg U.S. Equities	\$B Covered	% Covered
Top 10 Pension Fund	5	10	701.8	70.2	350.9	50%
Next 40 Pension Fund	5	40	949.1	23.7	118.6	13%
Bottom 150 Pension Fund	5	150	718.6	4.8	24.0	3%
Bank Trust Companies	10	20	3997	199.9	1998.5	50%
Insurance Companies	10	20	2739.1	137.0	1369.6	50%
Mutual Fund Families	10	20	2542.9	127.1	1271.5	50%
Foundations	5	15	121.5	8.1	40.5	33%
Endowments	5	20	148.8	7.4	37.2	25%
Hedge Funds	5	20	389.7	19.5	97.4	25%
Totals	60	315	12308.5	39.1	5308.1	43%
Organizations	5					
Total Interviews Planned	65					

S. DAVIS CARNIGLIA, C.P.A.(INACTIVE), M.A., J.D.

CORPORATE GOVERNANCE RESEARCH PROJECT
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**Law, Politics and Markets of Corporate Governance:
Institutional Investors' Influence**

Survey

Consent for Participation

Thank you for your willingness to consider participating in this research project, which inquires about institutional investors' views and actions in the area of corporate governance. I am a graduate student conducting this research under the guidance of Professor Robert A. Kagan. Your participation in this research is entirely voluntary and you may withdraw your participation at any time. I am paying for the costs of this research personally and there is no compensation for participation. You may participate by written survey or oral interview, as you prefer.

The purpose of my research is to learn how organizations such as yours think and behave with respect to corporate governance issues, choices and decisions. By corporate governance, I mean the laws, rules and policies that govern how the corporation is managed, how it handles the relationships between it and the shareholders, directors and management, and not the specific management decisions it makes. I am looking for your best understanding of what your organization thinks or does. If I use the word "you" I really mean your organization, to the extent that you know what your organization does. If you don't know for sure what it thinks or does, I would like your best guess of what your organization thinks or does. My research consists of 16 questions and I expect that it will take 15 to 30 minutes.

Because candor is absolutely essential to this research, your participation and responses will be kept as confidential as possible. I will not identify you or your organization, and will do my best to insure that no identifying facts are disclosed. I will track your responses by a reference number, and will destroy the index to it when I complete my research and before I publish it in

any way. I plan to retain any written responses and statistical compilations of the results for up to ten years, but will not share them with others.

Federal regulation requires the University of California at Berkeley to maintain a system of protections for human subjects in research. One of the requirements is that each participant must give their informed consent to participate. I have obtained permission to use an oral consent process to help maintain confidentiality. There aren't any particular risks to you of participation, other than the possible loss of confidentiality, but you should be aware that there is no legal privilege that protects disclosure of illegal conduct to an academic researcher. No direct benefit to you of participation is anticipated; however, we hope that this research will lead to a better understanding of the views and actions of institutional investors in the area of corporate governance and, hopefully, to contribute to improvement in the regulation of corporate behavior.

Participation in this research is completely voluntary. You are free to decline or withdraw at any point without penalty or loss of any benefits to which you would otherwise be entitled. If you have any questions about this study, please contact me, S. Davis Carniglia, at 510-923-0898 or carnigli@berkeley.edu. If you have any concerns about your participation as a research subject, you may contact the office of the Committee for the Protection of Human Subjects at the University of California, 2150 Shattuck Avenue, Suite 313, Berkeley, CA 94704, or call them at 510-642-7461, or email subjects@berkeley.edu

Your completion of this survey constitutes your consent to participate in this research.

**Law, Politics and Markets of Corporate Governance:
Institutional Investors' Influence**

Survey Questionnaire #_____

Please feel free to explain or supplement your answers, either by adding pages or writing on the back of the survey.

There should be no implication that your organization should do any of the actions inquired about; we are seeking a measure of the true level of activity among institutional investors.

Preliminary Information

1. What type of institutional investor is your organization? (Circle one)

- Public pension fund
- Corporate pension fund
- Union pension fund
- Bank trust company
- Insurance company
- Mutual fund
- Foundation
- Endowment
- Hedge fund
- Other (describe)

2. What was the market value of your organization's investments in U.S. public equities markets, as of December 31, 2009?

\$_____

3. What percentage of your U.S. public equity investments as of December 31, 2009 were invested in indexing strategies in which you invest in substantially all companies that are included in the index?

_____%

4. How much (roughly, if not known precisely) did your organization spend in 2009 on proxy voting and corporate governance issues (including outside consultants, services or other costs, total cost of staff time, and the value of senior management time devoted to these issues)?

\$_____

Corporate Governance Issues

5. How important are investee corporate governance issues to your organization, using a scale of 1 to 10, with 10 being vital to the success of your investment program?

_____ (1 to 10)

6. What are the investee corporate governance issues or improvements that are most important to your organization? (Please list in the order of importance to you and, if it is not clear, state what your preferred result would be)

Corporate Governance Actions

7. How would you describe your organization in terms of corporate governance action, using a scale of 1 to 10, with 10 being the most activist institutional investor you are aware of?

_____ (1 to 10)

8. Has your organization done anything in 2009 to try to influence the U.S. Congress, Delaware or any other state legislature on investee governance matters?

Yes or No (Circle one)

- a. If yes, please describe efforts and results, and indicate how much you spent on these efforts?
- b. If no, why not?

9. Has your organization done anything in 2009 to try to influence the SEC or any other government regulatory agency on investee corporate governance matters?

Yes or No (Circle one)

- a. If yes, please describe efforts and results, and indicate how much you spent on these efforts?
- b. If no, why not?

10. Has your organization tried to coordinate with other institutional investors to achieve your investee corporate governance goals?

Yes or No (Circle one)

- a. If yes, please describe efforts and results, and indicate how much you spent on these efforts?
- b. If no, why not?

11. Has your organization tried to generate political contributions to candidates in support of your investee corporate governance goals?

Yes or No (Circle one)

- a. If yes, please describe efforts and results, and indicate how much you raised in political contributions to support your corporate governance goals?
- b. If no, why not?

12. Has your organization tried a strategy of litigation to achieve your investee corporate governance goals?

Yes or No (Circle one)

- a. If yes, please describe the cases, issues and results?
- b. If no, why not?

13. Are there any corporate governance issues, actions or decisions that would cause you to sell a stock or refuse to buy it (either directly or through mandates to your investment managers)?

Yes or No (Circle one)

- a. If yes, how many different stocks in 2009 and what total value sold?

b. If no, why not?

14. Does your pricing or valuation model (either directly or through mandates from you to investment managers) account for differences in corporate law, corporate governance or compensation practices of companies in which you invest?

Yes or No (Circle one)

- a. If yes, please describe how it works and how much it might adjust the price?
- b. If no, why not?

15. What other actions did your organization take during 2009 to try to advance its investee corporate governance goals?

16. How has your organization's investee corporate governance program changed as a result of the financial crisis and Great Recession of 2007-2009? (If not clear, please indicate by what percentage it has increased or decreased)

Thank you very much for your time and your thoughts. Your participation is a big help in understanding and documenting what institutional investors actually do in response to corporate governance problems. If you have any further thoughts, I would love to hear from you.

And one final request: do you have any suggestions of other knowledgeable people in the institutional investment world who might consider being interviewed for this project? I will keep these names and who suggested them confidential.

Please return the completed survey in the envelope provided or to:

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**Law, Politics and Markets of Corporate Governance:
Institutional Investors' Influence**

Expert Interviews

Consent for Participation

Thank you for your willingness to consider participating in this research project, which inquires about institutional investors' views and actions in the area of corporate governance. I am a graduate student conducting this research under the guidance of Professor Robert A. Kagan. Your participation in this research is entirely voluntary and you may withdraw your participation at any time. I am paying for the costs of this research personally and there is no compensation for participation. You may participate by written survey or oral interview, as you prefer.

The purpose of my research is to learn how institutional investors think and behave with respect to corporate governance issues, choices and decisions. By corporate governance, I mean the laws, rules and policies that govern how the corporation is managed, how it handles the relationships between it and the shareholders, directors and management, and not the specific management decisions it makes. I understand that you and your organization do not represent the universe of institutional investors, but I am seeking the benefit of your experience and observations about them. My research consists of a number of specific questions, but I hope that you will expand upon them in your answers. Thus, I cannot estimate how long each interview will take.

Because candor is absolutely essential to this research, your participation and responses will be kept as confidential as possible. I will not identify you or your organization, and will do my best to insure that no identifying facts are disclosed. I will track your responses by a reference number, and will destroy the index to it when I complete my research and before I publish it in

any way. I plan to retain any written responses and statistical compilations of the results for up to ten years, but will not share them with others.

Federal regulation requires the University of California at Berkeley to maintain a system of protections for human subjects in research. One of the requirements is that each participant must give their informed consent to participate. I have obtained permission to use an oral consent process to help maintain confidentiality. There aren't any particular risks to you of participation, other than the possible loss of confidentiality, but you should be aware that there is no legal privilege that protects disclosure of illegal conduct to an academic researcher. No direct benefit to you of participation is anticipated; however, we hope that this research will lead to a better understanding of the views and actions of institutional investors in the area of corporate governance and, hopefully, to contribute to improvement in the regulation of corporate behavior.

Participation in this research is completely voluntary. You are free to decline or withdraw at any point without penalty or loss of any benefits to which you would otherwise be entitled. If you have any questions about this study, please contact me, S. Davis Carniglia, at 510-923-0898 or carnigli@berkeley.edu. If you have any concerns about your participation as a research subject, you may contact the office of the Committee for the Protection of Human Subjects at the University of California, 2150 Shattuck Avenue, Suite 313, Berkeley, CA 94704, or call them at 510-642-7461, or email subjects@berkeley.edu

**Law, Politics and Markets of Corporate Governance:
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Expert Interview #_____ Date _____, 2010

May I have your permission to participate in this interview and to record it?

Before we begin, I want to reiterate that I am seeking your judgment and opinions about these questions. It is not expected that you have personal knowledge on each subject and I would appreciate your impressions, estimates and educated guesses when you don't have a concrete answer.

Preliminary Information

1. What types of institutional investors do you deal with? (Check all that apply)

- Public pension fund
- Corporate pension fund
- Union pension fund
- Bank or trust company
- Insurance company
- Mutual fund
- Foundation
- Endowment
- Hedge fund
- Other (describe)

[Clarify inclusion in the study of any exceptional types]

2. What was the aggregate market value of your member or client investors' investments in U.S. public equities markets, as of December 31, 2009?

\$_____

3. What percentage of those U.S. public equity investments as of December 31, 2009 was invested in indexing strategies?

_____%

[In this and all subsequent questions regarding proportions, we are looking at the total universe of institutional investment in U.S. equities by all types of institutional investors, weighted by the dollar amount of investments.]

4. How much does an average institutional investor spend annually on proxy voting and corporate governance issues (including outside consultants, services or other costs, total cost of staff time, and the value of senior management time devoted to these issues)?

\$ _____

Corporate Governance Issues and Actions

5. What proportion of institutional investors wanted changes in corporate governance rules, regulations or laws as of December 31, 2009?

_____ (%)

6. How important are corporate governance issues to average institutional investors, using a scale of 1 to 10, with 10 being vital to the success of their investment programs?

_____ (1 to 10)

7. How would you describe the average institutional investor in terms of their level of action in furtherance of their corporate governance goals, using a scale of 1 to 10, with 10 being the most activist institutional investor you are aware of?

_____ (1 to 10)

8. What proportion of institutional investors would choose more activist proxy voting positions than the standardized recommendations of proxy advisory firms?

_____ (%)

9. What proportion of institutional investors specify their own customized proxy voting positions and standards, as opposed to adopting those of a proxy advisory service or investment manager?

_____ (%)

10. What proportion of customized proxy voting positions are more activist than the standardized voting positions?

_____ (%)

11. What is the proportion of the average institutional investor's portfolio to which these customized proxy voting positions and standards apply?

_____ (%)

12. What are the most common issues for which institutional investors specify their own customized proxy voting positions and standards?

13. What proportion of institutional investors trust boards of directors to act in the shareholders' interests, especially on matters where the interests of management and shareholders may conflict?

_____ (%)

14. How do institutional investors and their outside advisors obtain the information needed to vote on director nominees?

15. What proportion of all director nominees for all companies are typically opposed by institutional investors in proxy voting?

_____ (%)

16. What proportion of institutional investors have done anything in 2009 to try to influence the U.S. Congress, the state of Delaware or any other state legislature on investee governance laws?

_____ (%)

- a. Could you please describe the efforts and their results, and indicate what proportion of institutional investors were involved?
- b. If institutional investors wanted to match the efforts of corporate managements, what more could they have done?
- c. What causes institutional investors to fall short of their potential powers in this area?

17. What proportion of institutional investors have done anything in 2009 to try to influence the SEC or any other government regulatory agency on investee corporate governance rules, regulations or policies?

_____ (%)

- a. Could you please describe the efforts and their results, and indicate what proportion of institutional investors were involved?
- b. If institutional investors wanted to match the efforts of corporate managements, what more could they have done?
- c. What causes institutional investors to fall short of their potential powers in this area?

18. What proportion of institutional investors have coordinated with other institutional investors during 2009 to achieve their investee corporate governance goals?

_____ (%)

- a. Could you please describe the efforts and their results, and indicate what proportion of institutional investors were involved?
- b. If institutional investors wanted to match the efforts of corporate managements, what more could they have done?
- c. What causes institutional investors to fall short of their potential powers in this area?

19. What proportion of institutional investors retain lobbyists to advise or represent them on investee corporate governance issues?

_____ (%)

20. What proportion of institutional investors retain outside law firms to advise or represent them on investee corporate governance issues?

_____ (%)

21. What proportion of institutional investors have tried to generate political contributions to candidates in 2009 in support of their investee corporate governance goals?

_____ (%)

- a. Could you please describe the efforts and their results, and indicate

what proportion of institutional investors were involved?

- b. If institutional investors wanted to match the efforts of corporate managements, what more could they have done?
- c. What causes institutional investors to fall short of their potential powers in this area?

22. What proportion of institutional investors have tried a strategy of litigation in 2009 to achieve their investee corporate governance goals?

_____ (%)

- a. Could you please describe the efforts and their results, and indicate what proportion of institutional investors were involved?
- b. If institutional investors wanted to match the efforts of corporate managements, what more could they have done?
- c. What causes institutional investors to fall short of their potential powers in this area?

23. What proportion of institutional investors have sold a stock or refused to buy it in 2009 (either directly or through mandates to investment

managers) in order to further their investee corporate governance (as opposed to business or investment strategy) goals?

_____ (%)

- a. What proportion (roughly) of their portfolios were involved?
- b. What issues caused these “Wall Street Exits”?
- c. What changes in management behavior resulted from these efforts?
- d. Why don’t these “Wall Street Exit” events occur more frequently?

24. What proportion of institutional investors use pricing or valuation models (either directly or through mandates to investment managers) which account for differences in corporate law, corporate governance or compensation practices of companies in which they invest?

_____ (%)

- a. If yes, please describe how it works and how much it might adjust the price?
- b. If no, why not?

25. Now I'd like to narrow the last two questions. What proportion of institutional investors have sold shares, blocked purchases or made explicit price adjustments as a result of the state of incorporation or particular provisions of state corporate law?

_____ (%)

26. What actions did institutional investors fail to take which would have advanced their corporate governance interests?

27. What are the reasons why institutional investors don't exercise as much political or economic power as they could to advance their corporate governance interests?

28. How has institutional investors' corporate governance activism changed as a result of the financial crisis and Great Recession of 2007-2009?

29. What is the background on the inclusion of proxy advisory firms in the SEC's recently announced study of proxy voting mechanics?

[If there is time]

30. What else can you tell me about institutional investors' use of economic, political or legal power to further their corporate governance goals?

31. Could you tell me more about what your organization does in the area of institutional investors' corporate governance efforts?

Thank you very much for your time and your thoughts. Your participation is a big help in understanding and documenting institutional investor behavior. If you have any further thoughts, I would love to hear from you.

SEC Proxy Voting Comment Letter Excerpts

Issuers

In a comment letter dated October 15, 2010, **IBM Corporation** made extensive complaints about proxy advisory firms:

“As noted by the SEC, over the past twenty-five years, institutional investors have ‘substantially increased their use of proxy advisory firms.’ This has resulted in shareholder votes that have become increasingly affected by the power of these firms that, in many instances, exert significantly more influence on the outcome than an issuer’s largest shareholder. Despite the evidence of their influence over the election of directors and other votes at U.S. public companies, the proxy advisory industry remains largely unregulated. The SEC must take action now so that these firms are subject to the necessary checks and safeguards to ensure that companies and their shareholders are adequately protected.

It is important as an initial step to recognize the significant influence that proxy advisory firms have over corporate matters. As of December 31, 2009, one such firm, Institutional Shareholder Services (“ISS”) (formerly known as RiskMetrics Group) had approximately 3,500 clients, including 70 of the 100 largest investment managers, 43 of the 50 largest mutual fund companies, and 42 of the 50 largest hedge funds (in each case measured by assets under management) . . . The SEC notes that as of June 2007, ISS’s client base was more than the four other major firms in the industry combined.

. . . within one business day after ISS releases its report on a particular company, a significant number of shares held by institutions are voted in a lock-step manner (i.e., 100% in accordance) with the ISS recommendation. We submit that this phenomenon is evidence of *de facto* control by ISS of these votes and of how institutional holders outsource their voting decisions to ISS.

. . . Firms like ISS provide governance ratings to issuers based on ISS’s perceptions of the issuers’ corporate governance practices, but also provide consulting advice to the same issuers on how to improve the score. Commentators have raised concerns about whether this allows companies to influence ISS’s ratings if they are willing to pay for it.

We believe that because of the significant role and influence of proxy advisory firms, they should be subject to oversight similar to that of

nationally recognized statistical rating organizations (i.e., credit rating agencies) . . . proxy advisory firms should be prohibited by rule from providing consulting services to an issuer about which it makes voting recommendations.”

Likewise, IBM wants proxy advisory firms to be prohibited from making voting recommendations if they or related parties buy or sell the securities of the issuer, or recommend securities to clients in which it has any ownership interest, or if employees who work on the recommendation own any of the issuer’s securities. IBM wants any institutional investor that retains a proxy advisory firm to disclose it. Perhaps most significant is IBM’s conclusion that proxy advisory firms should be considered beneficial owners for purposes of the Securities Exchange Act because of their *de facto* control, requiring Rule 13d filings in any case in which it “shares” voting power exceeding 5%.

IBM wants proxy advisory firms to be required to disclose their models, guidelines, processes, assumptions, methodologies, and sources at least annually, and to justify its rationale for any “one-size-fits-all” policy. They also want proxy advisory firms to have their work audited annually, citing examples of errors in transmitting votes.

IBM wants proxy advisory firms to be required to give issuers an opportunity to comment on draft recommendations and to publish any unresolved disagreements. They also assert that institutional investors may be violating a duty to vote in a manner which maximizes economic value of their funds when they outsource their proxy voting decisions to proxy advisory firms. They also raise a concern noted in an SEC Compliance Alert that certain registered firms of all types might not have adequate controls to ensure that voting is in compliance with clients’ guidelines. Finally, IBM wants the SEC to add disclosure requirements to show the proxy advisory firms used by investors and whether they voted with or against their recommendations on each item on each company’s proxy.

In a comment letter dated October 15, 2010, **Ball Corporation** (an S&P 500 manufacturer) focused entirely on proxy advisory firms:

“Due to the institutional investor’s increasing reliance on the recommendations of proxy advisory firms and what we feel is a lack of transparency by the proxy advisory firms on how they reach voter recommendations, we support the idea of imposing a stronger regulatory framework in order to ensure that proxy advisory firms are providing shareholders with complete and accurate information and that shareholders are using such information to inform their vote while still honoring their fiduciary obligations. We are also concerned that proxy advisory firms often focus unduly on a small handful of narrow governance issues, without giving due consideration to corporations’

overall governance performance as well as their financial performance and shareholder returns, and we would welcome the Commission's oversight in this area as well.

The failure of proxy advisory firms to conduct adequate research on shareholder proposals before publicly issuing reports or recommendations on such proposals often results in recommendations by proxy advisory firms that are based on erroneous or incomplete information. The result of these flawed reports is that shareholder value is undermined when shareholders vote by relying, in whole or in part, on the recommendations of a third party who has provided inaccurate or incomplete information and who has little liability for such inaccuracies . . . Proxy advisory firms, however, do not face the same kind of liability [as corporate issuers] and therefore there is no assurance that such firms will take the time and effort needed to develop and convey a fully informed recommendation.

We are also concerned that proxy advisory firms do not appear to evaluate each proposal from an issuer-specific perspective . . . Issuer input is essential to a case-by-case analysis and it is our experience that proxy advisory firms all too frequently rely on a firmly established set of criteria rather than seeking valuable issuer input. A 'one size fits all' kind of approach is insufficient to protect shareholder economic interests . . .”

Ball wants the SEC to require comprehensive issuer feedback in advance of publication and public disclosure of standards, methodologies, policies, procedures and whether the issuer has been consulted. They further want institutional investors to be required to certify that they have been provided with all relevant proxy materials, have reviewed the voting decisions and agree with the voting decisions as being consistent with their fiduciary obligations. They ask that proxy advisory firms be prohibited from acting as proxies for institutional investors and that proxy advisory firms be required to disclose relationships with, and compensation from, institutional investors and others, “just as corporations are required to disclose relationships with related persons.”

In a comment letter dated October 19, 2010, **Leggett & Platt, Inc.** (an S&P 500 manufacturer) focused on the issues related to proxy advisory firms, saying that:

“We are concerned that the increasingly prominent role of proxy advisors, without proper accountability and oversight, is interjecting a layer of bureaucracy and uncertainty between issuers and investors, rather than fulfilling the role of trusted intermediary that the industry promises. Unless the proxy advisory industry can be structured in a manner that

assures unbiased, accurate and timely information and services, its roles of interpreting public disclosure, influencing corporate policy and handling delegated proxy votes are seriously misplaced . . .

First [there is no second], the market dominance of ISS brings with it substantial pressure on small and large issuers alike to conform to a check-the-box, one-size-fits-all form of corporate governance that fits the ISS mold . . .

Nowhere is ISS's monopolistic influence more intense than its recommendations on shareholder approvals for equity [compensation] plans. And it's in this area that ISS's policies and practices are least transparent, relying on a proprietary "black box" formula to award a thumbs up or down to a proposed plan . . .

As a case in point, ISS recommended that its clients vote against four of Leggett's Compensation Committee members this past proxy season. In correspondence objecting to the recommendation, we referenced ISS's own voting guidelines and governance policy update which were contrary to the recommendation. ISS neither responded to our appeal nor provided any justification for its conclusions."

In a comment letter dated October 20, 2010, **FedEx Corporation** "joins the U.S. Chamber of Commerce and the Business Roundtable in their comments regarding the concept release . . . and we concur with the views expressed in those letters." FedEx cites the fact that institutional investors own over 80% of their shares and that academic studies suggest that proxy advisory firms "sway up to 20% of any given shareholder vote" to conclude that "FedEx strongly believes that proxy advisory firms have entirely too much influence and power over public companies, and thus the shareholders of public companies, especially given that these firms have no direct economic interest in the companies that they follow." "At a minimum, proxy advisory firms should not be exempt from the proxy rules and should be required to register as investment advisers, and the Commission should develop a unique regulatory framework for these firms . . ."

FedEx went on to paint an extremist view of proxy advisory firms:

"Because of the general lack of transparency currently required of proxy advisory firms, we are concerned that a small, but vocal, group of activists, unions, pension funds and hedge funds have the ability to unduly influence the voting policies and recommendations of proxy advisory firms.

In recent years, union-sponsored groups, hedge funds and other activist investors have become increasingly vocal in attempting to effect change

through the shareholder meeting process – either through their own shareholder proposals or through proxy fights or communications campaigns against management proposals such as the election of directors.”

“Proxy advisory firms, on the other hand, purport to make voting recommendations that are in the best interests of all shareholders. However, if these firms are allowed to maintain relationships with activist groups whose agendas and goals are not shared by the silent majority of shareholders, the resulting conflict of interest poses a significant risk to these firms’ institutional investor clients and thus to the U.S. capital markets . . .”

FedEx cites, as an example of undue influence, their experience of having the Teamsters make a shareholder proposal to separate the positions of chairman and CEO, which was supported for four years by ISS voting recommendations.

“Accordingly, the Commission should prohibit these firms from maintaining any relationship (other than as a subscriber to such firm’s proxy advisory service) with shareholder proponents (or instigators of “vote no” campaigns) – activists, unions, pension funds, hedge funds or otherwise.”

FedEx goes on to critique the operations of proxy advisory firms:

“Presently, voting recommendations of proxy advisory firms appear to be reached through an entirely arbitrary process left to the sole discretion of the advisory firms’ employees.” “Accordingly, proxy advisory firms should be required to establish and publish objective guidelines, procedures and evaluation standards . . . These policies should include the use of statistical and other evidence, and should also require the solicitation and fair consideration of input from all stakeholders, including issuers.”

But FedEx also complains about the apparent standardization of proxy voting positions:

“Proxy advisory firms should understand that all companies are unique, and that the existence of certain factors should be considered in different lights depending on each particular company. Thus, if the proxy advisory firm does not evaluate specific facts related to particular companies in their evaluations, then the proxy advisory firm should be required to disclose this lack of consideration.”

FedEx seeks regulations which make all aspects of the proxy advisory firms' work public and transparent to all parties, but oppose requirements to provide data-tagging in their proxy material which would facilitate analysis and comparisons.

In a comment letter dated October 20, 2010, **Kinross Gold Corporation** (a NYSE Canadian gold mining company) focused on the issues of proxy advisory firms. Based on the experience of ISS recommending a vote against a merger proposed by management, Kinross supports increased disclosure of the skills, process, standards and appeal process for proxy advisor recommendations. They estimate that ISS serves between 38% and 40% of Kinross' shareholders and "[m]any such fund managers appear to have effectively outsourced [the proxy voting] function to ISS, resolving the regulatory pressure to exercise their voting rights by finding a relatively cheap and simple one-stop solution that requires no further input or effort on their part other than the payment of a monthly fee, and confident in the knowledge that the regulators appear to be satisfied with such an approach." The effect "appears to have been not to empower them as shareholders, but rather to empower ISS in its capacity as an unaccountable intermediary."

"While Kinross was ultimately successful in being able to successfully convince a requisite majority [66.4% of the acquirer and 99% of the target] of its shareholders that the ISS recommendation in respect of the [merger] was both misguided and ill-informed and to instead vote in favor of the transaction, it represented a very significant hurdle to overcome, and put at risk a multi-billion transaction of enormous importance to the shareholders of both companies." Kinross attributes much of the problem to the lack of expertise in proxy advisory firms to perform the complex financial analysis and valuation work needed to evaluate a merger proposal. They also raise the possibility that there are arbitrageur-clients of proxy advisory firms who are manipulating the information being used in formulating recommendations.

In a comment letter dated October 20, 2010, **tw telecom** (a Nasdaq public company) focused on proxy advisory firms and these issues:

"The increasing power of proxy advisory firms to influence a significant percentage of a company's vote despite having no direct economic interest.

The potential conflicts of interest that arise from . . . providing voting recommendations to institutions on the one hand while offering consulting services to issuers on the same matters.

The lack of accountability to issuers for recommendations that may be based on inaccurate information and non-comparable peers.

The lack of transparency provided into the models used by these advisory services, which is curious given the advisory services' espoused desire for transparency by issuers to the public."

They call for a prohibition on consulting services by proxy advisory firms in order to eliminate the "subtle form of pressure to avail themselves of these services to decrease the risk of an adverse recommendation," especially with respect to equity compensation plans. They also support public disclosure of models for approval of executive compensation plans and rating systems for governance practices. They want both SEC review and issuer involvement in the issuance of voting recommendations, and elimination of standardized voting policies.

In a comment letter dated October 22, 2010, **United Health Group** argues that "The Commission should expand the regulation of proxy advisory firms to better ensure accuracy of information published about issuers, as well as transparency of rating and recommendation methodologies." They cite the marketing material of ISS and Glass, Lewis to demonstrate their "undeniable" influence. ISS issued proxy research and voting recommendations for 37,000 shareholder meetings in 108 countries, including more than 10,000 for U.S. companies. ISS says it serves over 2,200 clients which have over \$25 trillion in equity assets under management. Glass, Lewis covered more than 20,000 companies in 100 countries.

United Health says that "many proxy advisory firm customers have delegated actual voting authority to certain proxy advisory firms" and quotes ISS as saying that 15-20% of its clients used a service that automatically voted in accordance with its recommendations in 2006. United Health complains about Glass, Lewis for publishing biased and incomplete information leading to a recommendation against several of their directors, and complains that they have no effective recourse. Accordingly, they ask for a review process to be made mandatory at every advisory firm and disclosure of the number of shares for which they have voting discretion.

Issuer Organizations

In a comment letter dated August 5, 2010, the **U.S. Chamber of Commerce Center for Capital Markets Competitiveness** ("the world's largest business federation, representing more than three million businesses") said:

"With the increased weight of the institutional investor vote and the heavy reliance of institutional investors on proxy advisory firms, the CCMC believes that the lack of transparency, balance, and oversight of proxy advisory firms is a troubling regulatory gap that needs to be addressed. Accordingly, the CCMC believes that the [SEC] should put in place appropriate supervision to ensure the transparent development of

voting policies and issuance of recommendations to prevent disruptions and lack of confidence in the systems governing the election of directors and consideration of shareholder proposals . . .

The CCMC believes that proxy advisors may fail to reliably represent the investors they purport to serve for the following reasons:

Final voting recommendations and voting policies appear to be determined at the sole discretion of proxy advisors firm employees with no set guidelines or parameters . . .

Proxy advisors have an economic incentive to standardize and commoditize proxy voting, as a higher quality process that focuses on a vote-by-vote and company-by-company basis demands greater corporate resources . . .

It appears a small vocal group of activists are able to influence the development of voting policies and recommendations . . .

Too often, the policy pronouncements fail to be backed up by extensive analysis or how one policy inter-relates with another . . .”

The CCMC wants the SEC to require proxy advisors to establish and disclose written standards for making recommendations, including sources of data, to solicit input from all stakeholders in a balanced and transparent process, and to make their internal deliberations transparent to the public. The CCMC asks the SEC to require that proxy advisors have a process which takes into account the unique context of each company and to make clear whether their recommendations proved to be “correct.” They want the SEC to focus on the final product and encourage advisors to compete on the basis of the quality of their voting recommendations. CCMC asserts that voting recommendations amount to “solicitations” under the proxy rules and suggest that they should be amended to require disclosure of conflicts of interest and that votes are cast with “due care.” Finally, the CCMC wants the proxy advisory firm issues to be considered on a “fast track” basis.

In a comment letter dated October 20, 2010, the **Business Roundtable** (an organization of CEOs more than 12 million employees and more than \$6 trillion in annual revenue) acknowledges that it “has been urging consideration of these issues since it filed a rulemaking petition with the SEC in April 2004 . . .” and its participation in the Shareholder Communication Coalition, whose comments it supports. The Business Roundtable calls for proxy advisory firms to be covered by the proxy rules unless they register as Investment Advisers. Furthermore, they recommend that they be regulated like credit rating agencies. “In order to ensure accuracy and transparency with respect to voting recommendations, the Commission should at a minimum require proxy

advisory firms to publicly disclose conflicts of interest, voting errors and the data, methodology, and rationales underlying their proxy voting recommendations. The Commission also should require advisory firms to disclose if they use methodologies that do not evaluate the specific facts and circumstances of each company with respect to the matters being voted on.”

They also call for disclosure of any relationship with proposal sponsors, opportunity for advance review, inclusion of issuers’ responses, requirements of greater oversight by investment managers, and exemption from data-tagging requirements which would ease the proxy advisory firms analytical processes.

In a comment letter dated October 20, 2010, the **National Investor Relations Institute** (made up of investor relations professionals from over 2,000 public companies) argues that many of the problems of proxy advisory firms stem from the separation of the investment process and proxy voting. They argue that this creates the possibility of opportunistic profits at the expense of individual investors, who are not privy to private voting recommendations from proxy advisory firms. They also argue that companies are damaged by “vote no” recommendations which are based on presumptions of culpability of directors without any basis and governance votes that are based on unsubstantiated assumptions about the value of good governance. “NIRI is not aware of any empirical evidence that supports any governance best practice that leads to superior or even improved financial performance. The one-size-fits-all paradigm employed by these firms seems unsupportable.”

“NIRI views the proxy advisory firm model as embedded with conflicts of interest.” “By their very nature, proxy advisory firms are adversarial; without recommendations against management’s proposals, the need for these services become unnecessary. The lack of direct pecuniary interest in the issuers and lack of accountability for results of voting recommendations creates the opportunity for bias against management.”

NIRI acknowledges that it worked with the Society of Corporate Secretaries & Governance Professionals in the development of their positions and supports them.

In a comment letter dated October 25, 2010, the **Center on Executive Compensation** of the HR Policy Association (HR executives of 325 of the largest U.S. corporations) cited academic studies concluding that proxy advisory firm recommendations swing shareholder votes by 6% to 20%. It reported that a their survey of human resources officers showed that 54% had modified their compensation plans in some way in the last three years to satisfy a proxy advisory firm requirement [appears to presume that this is a problem]. They feel that this is a problem because the proxy advisory firms have conflicts related to (1) services provided to issuers [!], (2) proxy proposals submitted by clients of the advisory firm, (3) ownership or directorships with

public firms, and (4) ownership by firms that have other financial interests or services. They say:

“For example, Graef Crystal, the former executive compensation consultant and critic, was quoted in the New York Times in 1994 as follows regarding ISS, ‘They’ve got a severe conflict when they work both sides of the street. It’s like the Middle Ages when the Pope was selling indulgences. ISS is selling advice to corporations on how to avoid getting on their list of bad companies. There’s a veiled sense of intimidation.’ More recently, several major institutions have cited ISS’s corporate consulting conflicts as a reason for switching proxy service providers.”

The Center calls for proxy advisors to be prohibited from providing corporate governance services to issuers and for disclosure of all other types of conflicts.

The Center also states that its surveys and information indicate that proxy advisory firms frequently make errors in their evaluation of compensation programs, especially in selecting inappropriate peer groups for comparison. It calls for (1) mandatory input from issuers, (2) publication of error and correction rates, (3) permitting issuers to insert “dissenting statements,” and (4) regulatory oversight of inaccuracies.

The Center calls the market for proxy advisory services a near-monopoly and cites predatory pricing moves by ISS as preventing a competitive market for proxy advisory services. Furthermore, this market dominance makes the ISS conflict possible. No particular solution to this problem is suggested, but the Center calls for registration of most proxy firms as Investment Advisers and review of their reports for accuracy.

In a subsequent comment letter dated March 9, 2011, the Center on Executive Compensation of the HR Policy Association told the SEC that they had “sent letters to the CEOs of the 100 largest institutional investors reminding them of their fiduciary duties with respect to proxy voting. The Center urged the institutional investors to fulfill these duties by more closely monitoring the proxy advisory firms they retain.” They enclosed a 94 page White Paper entitled “A Call for Action in the Proxy Advisory Industry Status Quo” and a copy of the letter dated January 24, 2011. The letter asserts that “the SEC has indicated that institutional investors may rely on the advice of an independent third party, such as a proxy advisory firm, provided that the investors monitor the third party’s activities and verify that it is free from influence or incentive to recommend that the proxies should be voted in anyone’s interest other than the advisor’s clients.” The letter requested that institutional investors:

“substantiate that the voting policies on which the analyses are based have been demonstrated to reinforce a close link between executive compensation and company performance”

“Require that any proxy advisory firm you retain to address conflicts of interest, especially the practice of providing consulting services to issuers while making “independent” voting recommendations on those issuers’ proxies to institutional investor clients”

“Require proxy advisory firms to provide more transparency regarding their analysis of pay and governance policies, issue draft reports to issuers and give issuers adequate time to review and comment”

“Require proxy advisory firms to include the responses from issuers disputing a characterization of a pay or governance matter so that investors have an opportunity to understand the different points of view and engage the management of the issuer directly on the matter”

“Support greater SEC oversight of proxy advisory firms”

The White Paper makes the following arguments:

Corporate voting power has become much more concentrated in institutional investors instead of retail investors.

State pension funds ownership has increased, they are “more progressive in their activism,” and rely more heavily on proxy advisors.

Broadening of shareholder proposals and increased indexing has expanded the number of proxy votes.

1988 DOL and 2003 SEC regulatory changes impose fiduciary duties for pension funds, mutual funds and investment advisors to vote in beneficiaries’ interests.

2003 SEC action gave investment advisors a “safe Harbor” if they followed pre-determined policy and recommendations of a third party.

“Academic research shows proxy advisors wield exceptional clout.” Citing Belinfanti, they say that ISS has 61% market share and that Glass Lewis has 37%.

“Influence of proxy advisors will increase with the adoption of say on pay and other policy changes.” Elimination of broker discretionary voting, proxy access for nomination of directors and majority voting for directors are cited as increasing advisors’ power.

They charge that the basis for most investors' custom voting policies on pay issues is the proxy advisor's recommendations.

"Conflicts of interest at the largest advisory firms cast a shadow on the integrity of research and voting recommendations." ISS provides governance consulting to issuers and is owned by RiskMetrics, who could pressure ISS to help get business. Glass, Lewis is owned by Ontario Teachers who invest in the same issuers. Proxy Governance was owned by a brokerage firm and Egan-Jones is owned by a credit rating agency.

"Inaccuracies in proxy advisory service reports and lack of transparent methodologies add to skepticism over analytical rigor." The three most commonly reported problems all related to compensation: improper use of peer group data, erroneous analysis of long-term incentive plans, and "inaccurate discussion of provisions no longer in effect." It attributes the significant level of errors to seasonality, cost-cutting, short notice, lack of resources and quality control. They argue that "the implications of these inaccuracies is alarming" and should justify mandatory issuer review, issuer opportunity to include a statement, investor monitoring and SEC reviews.

"The extent of government regulation over the proxy advisory industry is inadequate given its influence over the proxy voting process." They argue that institutional investors have little incentive to monitor and change proxy advisory firm services because they have outsourced their duties at minimal costs.

"Proposals for increased oversight of the proxy advisory system take a step in the right direction." They call for greater transparency of methodologies and SEC filing of voting recommendations. They point out that "the Department of Labor went one step further in October 2010, by proposing regulations that would arguably impose ERISA fiduciary status on SEC-registered proxy advisory firms and possibly all proxy advisory firms."

"Fostering greater competition in the proxy advisory industry may address fundamental problems."

Draws a parallel to the concerns about conflicts in the credit rating industry and suggests that proxy advisors should be regulated in the same way.

In a comment letter dated December 27, 2010, the **Society of Corporate Secretaries & Governance Professionals** asserts that proxy advisory firms

“not only have significant influence on proxy voting, but for many matters they have become the de-facto arbiters of ‘good governance.’ They influence not only the vote, but corporate behavior in ways that do not necessarily benefit shareholders or increase shareholder value. Moreover, they exert such influence without having any economic interest in the shares of the companies they vote and without being subject to any fiduciary duties to the beneficial owners of the shares for whom they are voting.”

“The influence of proxy advisory firms is reflected by the large number of clients that follow precisely the voting recommendations of these firms. Evidence of this fact is that votes come in immediately the day after a proxy advisory firm releases its vote recommendations, as evidenced by the increase in the votes cast.”

The Society argues that proxy advisory firm influence undermines the integrity of the voting system because of certain conflicts (primarily ISS), all advisory firms make mistakes, and all advisory firms lack an economic interest in their votes and “therefore have no responsibility to insure their recommendations achieve the best economic outcome for shareholders of a particular company.”

The conflicts cited include providing services to both investors and issuers, making recommendations on shareholder proposals submitted by their investor clients, and their “interest in recommending proposals and adopting policies that sustain and expand demand for their services” (e.g., annual say-on-pay votes instead of every three years).

A survey of members shows that 65% of all **respondents** experienced at least one error. [No time period or severity specified] They attribute errors to (1) insufficient time to review and comment, (2) no possibility for review at all, (3) no correction of factual errors by the proxy advisory firm, (4) comparison to irrelevant or misleading peer groups, and (5) a one-size-fits-all approach.

While acknowledging the difficulty of reviewing all proxies, the Society criticizes the application of standard voting policies as “one-size-fits-all” analysis. In particular, the Society cites instances where ISS insisted on particular language in change-in-control agreements or particular “burn rates” in utilization of equity compensation programs. They also frame the lack of economic interest as resulting in recommendations which do not improve performance of the company. [As opposed to protecting shareholders’ interests]

The Society asks the SEC to manage conflicts of interest, require disclosure of all “methodologies, guidelines, assumptions or rationales used in making their recommendations,” disclose the entire fact-gathering and analytical process, force all reports to be submitted to issuers 5 days before release, disclose their issuer appeal process, include any response from the

issuer, report the number of issuer appeals and revisions, and disclose their compensation models and standards. They call for mandatory registration as investment advisors, oversight by investors, and the imposition of a fiduciary standard that investors must demonstrate that their votes maximize the economic value of the shares.

Institutional Investors

In a comment letter dated October 18, 2010, the State Treasurer of Connecticut, as the principal fiduciary of the **Connecticut Retirement Plans and Trust Funds** (“CRPTF,” a \$23 billion public pension fund) said that

“As a client of a proxy advisory firm (ISS), I believe that concerns raised by issuers about the influence of these firms are grossly overstated . . .

much of the discussion in the section of the Concept Release addressing the role and regulation of proxy advisory services rests on two inaccurate assumptions. First, the Concept Release refers several times to proxy advisors ‘controlling or significantly influencing’ shareholder voting. Indeed, the discussion of proxy advisors is part of a larger section of the Concept Release on the decoupling of control rights from economic exposure, implying that proxy advisors have complete dominion over shares held by their clients.

In my experience, proxy advisory firms are one of a number of inputs into shareholder voting decisions . . .

My interactions with other institutional investors indicate that they, like the CRPTF, consider proxy advisors’ recommendations, but the recommendations are not dispositive. The fact that some institutions are clients of more than one proxy advisor reinforces the notion that the institutions are not controlled by a single advisor . . .

A second erroneous assumption holds that a proxy advisor promulgates a single set of ostensibly “one-size-fits-all” voting guidelines and then issues recommendations accordingly. In fact, much of the work proxy advisors do involves applying a client’s own proxy voting guidelines (so-called ‘custom’ work) to recommend votes on ballot items . . .

Even the core voting guidelines of a proxy advisor like ISS are not a set of unilateral dictates. Rather, they reflect preferences of the clients of the proxy voting service, as well as best practices promoted by various constituencies in the course of each service’s policy updating process. There is a dynamic give-and-take, not a one-way domination of shareholder voting by proxy advisors. Commentators who point to particular ballot items that did not pass after ISS recommended that

clients vote against them as evidence of ISS's control ignore this fact and mistakenly assign causation to the ISS recommendation when the same votes could well have been cast in the absence of such a recommendation.”

CRPTF says that conflicts of interest are thoroughly reviewed by institutional investors and that there is no need to regulate proxy advisory firms like rating agencies because, unlike rating agencies, the investors pay for the services and can “exert more direct leverage.” Finally, CRPTF does not think that the SEC should regulate the substantive bases of proxy advisors’ decisions because institutional investors are well-prepared to evaluate the reasons and quality of voting recommendations. “In some cases . . . what issuers call factual inaccuracies may fairly be characterized as different conclusions drawn from the same facts.”

In a comment letter dated October 19, 2010, the **American Federation of State, County and Municipal Employees**, AFL-CIO (“AFSCME,” a labor union and sponsor of an \$850 million pension plan for its employees) says:

“Having conducted shareholder initiatives, we know that advisory firms’ recommendations are considered carefully by their clients, but are not always followed. Institutional investors with which we have communicated indicated that they review the reasoning provided for the recommendation, collect input internally and then make a voting decision.

Research we have conducted regarding mutual fund voting patterns on compensation issues supports the notion that proxy advisors do not control voting outcomes. For the past several years, AFSCME, The Corporate Library and Shareowners.org have analyzed reported votes of mutual funds on management and shareholder proposals on executive pay, as well as the election of selected directors at companies with controversial or excessive executive pay practices.

We found a great deal of difference in voting patterns, even among fund families we understand to be clients of the same proxy advisory firm. For example, Fidelity Funds supported 57% of management proposals on executive compensation, while Barclays [now BlackRock, Inc.] supported 96% of such proposals. On shareholder proposals, the disparity was even more dramatic: Legg Mason voted in favor of 97% of proposals in the categories selected for the study and Vanguard voted in favor of only 3%. Such a high degree of variance dispels any notion that clients follow proxy advisors’ recommendations in lockstep.”

In a comment letter dated October 20, 2010, the **Colorado Public Employees Retirement Association** (a \$36.8 billion public pension fund)

writes that “The fiduciary duty to vote proxies is a matter that COPERA and its Board of Trustees take very seriously.” A Board committee oversees the process; establishes policies; constantly monitors, evaluates and revises them; and manages the process of voting all proxies in-house.

“To effectively vote these proxies it is essential to utilize products provided by various proxy advisory firms. It would be impossible for staff to research every director nominee and evaluate the myriad of proposals that are presented for consideration. That said, it is important to note that analysis provided by a proxy advisory firm is but one piece of the puzzle when determining how to vote a proxy.”

“When utilizing analysis from a proxy advisory firm, COPERA has a high level of confidence that unbiased analysis is being provided. Throughout the years investors, such as COPERA, CalPERS and CalSTRS, have contributed to the development of governance policies that are used by proxy advisors. As such, it’s not uncommon to find in-house policies that are similar to the policies of proxy advisors.”

“Vote recommendations provided by proxy advisory firms should not be confused with or viewed as providing investment recommendations. While proxy advisory firms are not currently required to register but voluntarily do so, COPERA does not support the continued registration of proxy advisory firms. COPERA does not see any need for regulatory intervention concerning the methodologies used by proxy advisory firms at this time.”

In a comment letter dated October 29, 2010, **BlackRock**, Inc. (likely the largest asset management firm in the world, with \$3.45 trillion in assets under management) stated:

“We believe that the influence of proxy advisory firms in general, and ISS in particular, [has] been overstated. In our view, the assertion that the use of proxy research represents a disconnect between voting power and economic interest is an affront to investors who utilize proxy research to spot potential issues for review and to enhance the quality of their voting processes. For most U.S. voting decisions, BlackRock reviews analysis from three research providers. Like most large institutional investors, we reach an independent conclusion on the proxies that we review; we do not blindly follow any proxy advisory firm’s advice.”

With respect to the argument that proxy advisory firms have significant impact on the votes which follow the issuance of their recommendations, BlackRock says:

“Their research may sometimes encourage behaviors that would be otherwise acceptable to a wide range of investors. As a result, we believe a statistical analysis would likely show a correlation between advisory firms’ recommendations and institutional investors’ votes in some instances. We believe that it would be a mistake to conclude that such a correlation is the result of undue power on the part of proxy advisory firms.”

On the question of errors, BlackRock notes:

“This is also an issue on which investors regularly engage and provide feedback to the proxy advisory firms. We believe that substantial additional regulation of proxy firms would likely impose costs that will ultimately be borne by investors. We encourage the Commission to allow investors, and the market for proxy research, to impose discipline on providers. In our view, improvements in the quality of proxy research over the past several years suggest that the discipline of the market is working.”

In a comment letter date October 29, 2010, **Norges Bank Investment Management** (a subsidiary of Norway’s central bank which manages the government’s pension plan and has over \$100 billion invested in U.S. public equities) noted many positive developments in U.S. corporate governance, but observed:

“The dispersed ownership structure typical for U.S. companies means that strong corporate governance must play an important role in bridging the distance to shareholders and ensuring the accountability of management. This challenge can partially be remedied by an improvement of the proxy voting system.”

With respect to proxy advisory firms, they go on:

“We understand that vote recommendations by proxy research services firms may sometimes be a controversial focal point for issuers. In one way this is understandable because these recommendations generally express views commonly held by client institutions on some contentious issues. Our experience is that proxy research firms do put considerable effort into ensuring that their standard policies are well aligned with views shared by their clients.”

“Based on our procedures, and also on the information we have of the procedures of other institutions, we believe that concerns that any proxy research firms “are controlling or significantly influencing” vote outcomes are likely oversimplified and unfounded.”

“We are concerned that the suggested regulations of proxy research firms may drive up costs and barriers to entry.”

“Suggestions that the proxy research firms must publish their analysis and allow companies a right to review research and recommendations represent risks to the independence and efficiency of the services. In effect, we see a risk that the indicated regulatory measures will turn the proxy research firms into less effective agents for shareholders in their goal to promote better corporate governance standards. We believe that the sophistication of clients will contribute to a continuing gradual improvement of the services, as has been the case in history.”

Institutional Investor Organizations

In a comment letter dated October 14, 2010, the **Council of Institutional Investors** (“CII,” an organization of all types of institutional investors and a significant number of issuers) said:

“Some observers contend that proxy advisory firms’ recommendations have too much influence on the outcome of voting at U.S. public companies. The Council disputes this view . . .

Of 15,044 ISS baseline recommendations for nominees in 2010, 13 percent were “withhold” or “against.” Of the 1,879 nominees receiving “withhold” or “against” baseline recommendations with available voting results, less than 5 percent failed to receive majority support from shareowners. The average shareowner support for nominees with ‘withhold’ or ‘against’ baseline recommendations from ISS was 77 percent.

The notion that proxy advisory firms “control the institutional vote” wrongly assumes that institutions are a unified bloc of voters. In fact, many institutional investors are passive voters that defer routinely to the recommendations of management. We note that state and local pension funds, whose ranks include many of the most activist investors, hold just 6 percent of total outstanding equity . . .

The overlap between institutional investors’ guidelines and proxy advisers’ policies does not prove that advisers drive institutions’ positions on voting issues. Overlap may reflect advisers’ efforts to be in synch with their clients. Proxy advisory firms survey their clients’ views on voting issues regularly, and it is not unusual for advisers to adjust their guidelines on a particular issue to prevailing preferences.”

In a comment letter dated October 19, 2010, the **Social Investment Forum** (an organization of investors concerned about socially responsible and

sustainable investment that is active in making shareholder proposals) said that the Concept Release:

“ . . . mischaracterizes the role of proxy advisors, understates the diversity in voting patterns and ignores the market-based pressures on proxy advisory firms . . .

. . . we are not convinced that proxy advisory firms’ recommendations are frequently tainted by factual inaccuracies. The examples cited in the concept release point to differences over characterization, interpretations and conclusions rather than actual inaccuracies. Furthermore, as there are several proxy advisory firms in the U.S. market with comprehensive coverage, shareholders who are unhappy with their proxy advisory firms’ performance are able to change firms with little in the way of associated costs.”

The Social Investment Forum does agree, however, that further guidance on disclosure of conflicts of interest would be beneficial.

In a comment letter dated October 19, 2010, **The Corporate Library** (an independent corporate governance, compensation and risk consulting firm which has recently merged into Governance Metrics International) said:

“For too long, the [proxy voting] system has been designed for the benefit of issuers, and it is not so strong a statement to say that the devastation of the financial meltdown could have been mitigated or prevented if investors had been able to prevent the perpetuation of boards selected, compensated, informed (and misinformed) by insiders.

With regard to the list of items on which the SEC has invited comment, I would like to object in the strongest possible terms to the possible regulation of proxy advisory services . . .

The core founding principle of our democracy is freedom of expression . . . The core founding principle of our economy is to allow the market to determine the value of goods and services. Infringement of either free expression or the free market should only be done in the most extreme circumstances and no such justification is present here.

ISS developed the proxy advisory business because as [they] were trying to sell another product entirely institutional investors kept telling [them] that what they wanted was an independent assessment of management and shareholder proposals. At the time, many of them subscribed to the IRRC reports, which analyzed proposals but did not give recommendations. In those days of hostile takeovers and management entrenchment, they wanted advice that was as knowledgeable and as

objective as what they were receiving from securities analysts and other independent advisors.”

They note that the growth history of ISS shows the demand for its services from its customers. The entry of two other substantial competitors shows that barriers to entry are low. They point out that the firms frequently disagree, are transparent and highly competitive about their different approaches, and tend to be chosen by clients who agree with their policies. They go on:

“The issuers claim that these firms are too influential. Of course, they do not complain that they are too influential when they support management recommendations in the overwhelming majority of cases And it is absurd to suggest that the proxy advisory firms take a one size fits all approach. That is demonstrably not true. The SEC’s own rule-makings and the stunning conformity and lowest-common-denominator benchmarking approach of the issuer community is far more one size fits all than the proxy advisors, who provide detailed and highly specific analysis of matters like executive compensation that are tailored by sector, market-capitalization, and other factors

The arguments made by the other side show such a stunning statistical illiteracy that they are either disingenuous, ignorant or both. Issuers seem stung to discover that management may not believe management is acting in their best interests and believe that the answer is not to change their behavior or improve their communication, but to smother outside analysis of their proposals. If issuers object to the recommendations made by the proxy advisory firms, the answer is for them to respond directly and substantively in their communications with shareholders, not to cut off outside assessment.

An ABA assessment of ISS recommendations noted that they supported dissident candidates two-thirds of the time, suggesting that this reflected an anti-management bias. On the contrary. given that proxy contests only occur in a fraction of a percent of companies each year and by definition those are companies with the most severe performance issues, the fact that ISS supports management one-third of the time demonstrates that they take a very measured approach. Overwhelmingly, proxy advisory firms support management candidates. And overwhelmingly, their clients have shown that the firms pass the ultimate test of credibility and legitimacy by buying their products.”

Proxy Advisory Firms

In a comment letter submitted October 18, 2010, **Glass, Lewis & Co., LLC** (considered the second largest proxy advisory firm in the world and owned

by the Ontario Teachers' Pension Fund) responded to most of the topics in the SEC concept release, but included extensive comments on proxy advisory firms from the perspective of a firm which is not registered with the SEC as an investment adviser:

“ . . . we are neither an investment research firm nor do we have the authority to make voting decisions on our clients' behalf . . .

As a proxy research advisor, we do make proxy voting recommendations. However, since we are not beneficial owners, we do not have authority to make voting decisions. The power to instruct votes resides with our institutional investor clients . . . when clients adopt our policy on specific issues, generally because the client and Glass Lewis share the same philosophy on that issue (e.g., to disfavor anti-takeover provisions), they do so only following a close review of our policy guidelines by the client's proxy committee, board of trustees and/or other relevant internal oversight personnel. Of course, every client at all times retains the authority to change any vote we recommend for them . . . which they do routinely.

We believe the ultimate arbiter of the quality of any research is the end user, i.e. the institutional clients that engage the services of the research provider. Users are free to choose among the various proxy research providers.

. . . We conduct a detailed analysis of each issue at each company while eschewing a one-size-fits-all approach.

Glass Lewis' guidelines and compensation evaluation tools are designed for our paying subscribers, who bear the expense of our services through the subscription fees they pay to us. Both the benefits and costs of our services ultimately fall on our clients' beneficiaries (e.g., mutual fund shareholders and public pension plan participants). We do not believe these ultimate beneficiaries should subsidize the free public display of proprietary research for which they have paid . . . Giving away our research would limit the competitive advantage our research provides to our clients and requiring this of all providers may impede further entrants into the proxy research space.

. . . the cleanest and most effective way to manage conflicts is to not have them. Recognizing this, we were founded with the core policy of not providing any consulting services for corporate issuers . . . One example of an industry where the current solution was found ineffective is the credit ratings industry. Some credit ratings agencies, which, in effect, sell their ratings to the companies they rate, have been found to have altered ratings at the request of issuers . . . We believe that research

providers should be required to provide robust and specific disclosure about their potential conflicts . . . since our founding we have provided specific disclosure on the front page of our reports regarding potential conflicts.

Glass Lewis makes the case that registration as an investment adviser may not be the most effective means of regulating the industry and would inhibit new entrants. Rather, they suggest an exemption similar to publishers, with conditions preventing certain conflicts and disclosing others more specifically. As an alternative, they suggest subjecting proxy advisors to an Exchange Act rule which would require disclosure of any significant relationships with issuers.

Glass Lewis publishes its recommendations, on average, three weeks before the meeting date. If errors are brought to its attention or proxy filings are updated, they revise their reports accordingly and highlight the revision on the front page of the report.

In a comment letter submitted October 20, 2010, **Institutional Shareholder Services, Inc.** (“ISS,” the leading proxy advisory firm which is owned by MSCI) responded to the SEC concept release and some of the specific criticisms of them.

“At its core, ISS is a policy-based organization and ISS’ use of a series of published voting policies provides a very practical check and balance that ensures the integrity and independence of ISS’ analyses and vote recommendations . . . While ISS’ policies allow analysts to consider company-and market-specific factors in generating vote recommendations, the existence of a published analytical framework, along with the fact that vote recommendations are based on publicly-available information, allows ISS clients (and non-clients alike) to continually monitor and assess the integrity of ISS’ reports by making sure that ISS is faithfully and thoughtfully applying its policy guidelines.”

ISS further defends its services to issuers on the basis of a firewall between the functions advising issuers and investors. In their case, there are two separate business units, located separately and having separate staffs, who are not allowed to discuss clients. Clients of the issuer consulting business are informed in writing of the fact that they will obtain no favorable treatment in the proxy advisory process. ISS discloses to its proxy advisory clients that there is also an issuer advisory business and offers to provide those clients with specific data regarding services to particular issuers, including the amount of compensation involved.

ISS eliminates the potential conflict of being owned by a public company by not reporting on that company at all and arranging for independent proxy advice on its parent to be provided by its competitors.

ISS defends the policies underlying its voting recommendations on the basis that they “are formulated through an annual bottom-up process that collects information from a diverse range of market participants through multiple channels.” Their process begins with an annual Policy Survey of both institutional investors and corporate issuers, followed by a series of in-depth roundtables with industry groups and outside experts and a review of relevant literature and studies. ISS’ Global Policy Board considers all of this input in drafting each annual policy, which is then published for comment from investors, issuers and outside experts in a process they liken to SEC rule-making. All comments are published on their policy website.

ISS also says that it actively engages with issuers, usually after their proxy has been filed, and provides the opportunity for advance review for most S&P 500 companies. They also have extensive internal control and quality review processes, but note:

We acknowledge that corporate issuers do not always agree with our vote recommendations. This is understandable given that our vote recommendations are not always aligned with those of the company’s management and board. Simply put, the interests of the company’s owners can and do conflict with those of management and the board from time to time. ISS would not be serving its investor clients if it did not highlight these cases. We note, however, that when issuers dispute our analyses, the disputes generally relate to policy application (or the principles underlying the policies themselves), not the factual accuracy of the analysis.”

On the question of market power, ISS notes that there have been dramatic changes since 1985 when it essentially invented the field, and that competition has forced margin cuts, technological advances and substantial savings. They go on:

“While we do not formally track the extent to which our clients follow our voting recommendations, we believe that it is a misconception, albeit an often repeated one, that ISS’ clients blindly follow ISS’ recommendations. Part of this misconception stems from a mistaken view that ISS reflects a single point of view on each proxy issue. It is our experience that investors are not of a single mind with respect to corporate governance issues.”

“In addition to our benchmark policy guidelines (or ‘house’ view), ISS offers ‘specialty’ guidelines such as our ‘Socially Responsible Investment’

and Catholic ‘faith based’ policies. More significantly, ISS also manages and applies more than 400 custom policies on behalf of its clients . . . We estimate that the majority of shares that are voted by ISS clients fall under ISS’ custom or specialty recommendations.”

ISS points out that there is no factual basis for the assertions that ISS “controls” any portion of the vote and that the study by Professor Jill Fisch, et. al., finding that ISS shifts 6-10% of the vote acknowledges that it may be largely from ISS’ role as an information agent.

In a comment letter submitted October 20, 2010, **Pension Investment Research Consultants** (“PIRC,” who describe themselves as the “Third largest proxy advisor in the world”) said:

“Due to some submissions being of a particularly combative nature with regards to advisory firms we would like to offer an extended reference to how we do not perceive ourselves to act without our clients’ input, and how we have been adapting to the market place without regulation to date in many of our core markets.”

PIRC says that, although they prepare a standard set of recommendations, a large proportion of their clients have their own policies, often more stringent than the standard ones, and most clients consider other firms’ recommendations as well. All clients retain the ability to change their voting policies and individual votes at any time, which they do especially on mergers. The standard recommendations are derived from clients’ views and are frequently revised to reflect their current thinking.

“It should be recognized that the U.S. proxy advisor market is a construct of the economics of the market place and not purely under the influence of oligopoly. The costs associated with a more European method of engagement dialogue will add value to all participants, but costs time and money.”

PIRC has a policy of not working for issuers and is committed to disclosure of conflicts of interest. PIRC is also concerned that “engaging with companies and their reviewing our draft voting recommendations, should not lead us into an additional conflict of interest. For us, this might arise as we substantiate and evidence our position, and how we believe it is in shareholder interests, whilst at the same time not becoming consultants to the company (albeit, unpaid ones).”