

THE RISE OF CORPORATE GUIDELINES IN THE UNITED STATES, 2005-2021: THEORY AND EVIDENCE

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Institutional investors are legally obliged to be faithful stewards of their portfolio companies. Yet, the conventional wisdom among commentators is that institutional investors have failed to perform this obligation as they are not incentivized to make adequate investments in corporate governance. This Article contends that this criticism is based on an incomplete analysis that misses a critical aspect of the operation of institutional investors. The critics focus exclusively on institutional investors' efforts in actively engaging with the managements of their portfolio companies. They ignore, however, an important passive governance tool that institutional investors routinely use: corporate guidelines. Corporate guidelines are published by institutional investors to articulate their stance on governance issues and justify their voting decisions in annual meetings. Corporate guidelines have become increasingly popular not only among investors, but also among other market actors who interact with investors in shaping corporations' governance regimes, such as the corporations' managements and other shareholders, proxy advisory firms, and law firms.

This Article demonstrates how corporate guidelines exert a profound effect on corporate governance. For institutional investors, corporate guidelines constitute an ideal tool for balancing the investors' governance-related duties and the need for cost minimization. The promulgation and use of guidelines is less costly than active engagements, and unlike outsourcing voting decisions to proxy advisory firms, it is regarded as a valid way to fulfill the investors' duties as corporate stewards. For the managements, aligning governance policies with corporate guidelines signals their commitment to sound governance practices, helping them fend off challenges by activist shareholders. Activist shareholders, for their part, routinely cite corporate guidelines to support their proposals. The Article empirically substantiates these claims by

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analyzing the ways in which the guidelines were used by corporations and activist shareholders in proxy statements published by S&P 500 corporations. Initially, I focused on the years 2019–2021. Consecutive to my initial findings, I expanded the scope to the years 2005 and 2010. Finally, in order to get a more comprehensive outlook, I expanded the scope of my research, continuing with a focus on the S&P 500 top 100 corporations during the years 2005–2021. This expansion examined the number of explicit references made by corporations, and resulted in a significant spike in such references between 2015–2021. Furthermore, although the amount of explicit references made by activist shareholders was not consistent along these years, still such references were made frequently. Importantly, my analysis notes that in certain years under assessment, when the corporate proxy statements of the 100 largest companies are examined, almost 40% of such statements included explicit references to corporate guidelines. This fact can not be dismissed when examining institutional investors stewardship.

*Overall, I collected **data from 3,313 proxy statements published by S&P 500 corporations in 2005-2021**. The Article therefore offers the first comprehensive theoretical and empirical examination of corporate guidelines and their effect on corporate impact.*

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INTRODUCTION

In recent years, corporate scholars and policymakers have devoted a great deal of attention to large institutional investors. In particular, there exists a heated debate in the corporate world about the capabilities and incentives of institutional investors to invest in corporate stewardship—defined as monitoring, voting, and engagement¹—in their portfolio companies. The main focus is on mutual funds, which hold most of the assets of institutional investors.²

According to common wisdom, which finds support in theoretical and empirical studies, institutional investors refrain from active stewardship for three principal reasons. First, managers of mutual funds have poor incentives to invest in active stewardship since their compensation is not affected by the success of their portfolio companies. Furthermore, the business model of mutual funds is predicated on offering the lowest possible fees to clients and therefore does not align with active stewardship. The stewardship budgets and personnel of mutual funds, including the “Big Three”—BlackRock, Vanguard, and State Street—are far too small to allow them to invest in informed voting and engagements in the thousands of corporations that comprise their portfolios.³ Second, since mutual funds and other types of institutional investors, such as pension funds, have business ties with the corporations in which they invest, active intervention in those corporations may lead to confrontations that jeopardize those ties. Third, and relatedly, managers of corporations wield political power, and confrontations with them may cause a political backlash against institutional investors.

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

² Lucian A. Bebchuk, Alma Cohen, & Scott Hirst, *The Agency Problems of Institutional Investors*, J. ECON. PERSP. 89, 94 (2017) (arguing that investment funds, including open-end mutual funds, closed-end mutual funds, exchange-traded funds, and other similar funds, “are the most important category of institutional investors and represent most of the assets held by institutional investors”). Also, Assaf Hamdani et al. explored the structure of fees paid to managements of private pension funds. They concluded that in order to align incentives of pension funds managers with those of funds’ clients, and to motivate funds to enhance clients’ interests, regulators should consider to revise current regulatory regime and to allow pension funds to charge performance-based fees to enhance better investment management. See Assaf Hamdani, Eugene Kandel, Yevgeny Mugerma, & Yishay Yafeh, *Incentive Fees and Competition in Pension Funds: Evidence from a Regulatory Experiment*, 2 J. L. FIN. & ACC. (2017).

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

Over the years, scholars have advanced various proposals to enhance the involvement and activism of institutional investors in their portfolio companies. For example, Lucian Bebchuk, Alma Cohen, and Scott Hirst have argued that policymakers should reassess and reform the regulation of mutual funds' fees to induce them to be more active. An alternative way to enhance mutual funds' activism has been proposed by Lawrence A. Cunningham, who proffered a new model, called "quality shareholder voting." This proposal aims to "increase the voting power of long-term committed shareholders" by granting an increasing voting power for shares "held for a given number of years."⁴ A different mechanism has been suggested by Adi Libson and Gideon Parchomovsky who have called for the use of tax incentives to encourage mutual funds to become more active.⁵

Other scholars have suggested using voting mechanisms to alter the behavior of passive institutional investors. Dorothy Shapiro Lund has suggested that passive index funds should be barred from voting their shares since they lack adequate incentives to inform themselves before voting.⁶ A less extreme proposal was made by Caleb N. Griffin, who advocated a "pass-through" mechanism that would empower beneficial investors in index funds to decide how the votes associated with the funds' shares would be cast.⁷

In this Article, I show that the participants in the debate about the role played by institutional investors in improving corporate governance and reducing agency costs have largely overlooked an important, and surprisingly effective, mechanism employed by institutional investors: "corporate guidelines." This term covers proxy voting guidelines that are drafted and published by mutual funds on an annual basis, as well as letters drafted by them that provide insights into their priorities, views, and philosophy. It also reflects principles, standards, and general statements published by organizations and groups of institutional investors, such as the Council of Institutional Investors (CII) and the Institutional Stewardship Group (ISG).

The corporate guidelines contain "model principles" that pertain to all aspects of corporate governance. The guidelines allow institutional investors to communicate their expectations regarding sound corporate governance to their portfolio companies. While there is no *de jure* sanction for violating the norms promulgated in the guidelines, they exert enormous influence on companies and their managements. Managers and directors who disregard guidelines risk retaliation from institutional investors and may even lose their job. Critically, the guidelines

⁴ Lawrence A. Cunningham, *Quality Shareholder Voting*, The CLS Blue Sky Blog (Nov. 21, 2019).

⁵ Adi Libson & Gideon Parchomovsky, *Reversing the Fortunes of Active Funds* 99 TEX. L. REV. 581 (2021).

⁶ Dorothy Shapiro Lund, *The Case against Passive Shareholder Voting*, 43 J. CORP. L. 493, 497 (2018).

⁷ Caleb N. Griffin, *We Three Kings: Disintermediating Voting at the Index Fund Giants*, 79 MAR. L. REV. 954, 994–996 (2020).

enable a new form of activism that is consistent with the profit model of mutual funds. I term this form “guidelines-based stewardship.”

The growing use of corporate guidelines can be ascribed to three main reasons. First and foremost, the use of guidelines allows institutional investors to strike a balance between their strict fiduciary duties, on the one hand, and their need to be cost-effective, on the other. It is important to understand that institutional investors are legally obligated to vote in thousands of shareholder meetings. This is a colossal burden. Relatedly, given their enormous power, institutional investors are expected to act as responsible “corporate citizens.”⁸ The guidelines provide institutional investors with an effective way to influence their portfolio companies without collapsing under the weight of full-fledged activism.

The second reason for the growing use of corporate guidelines is that guidelines constitute a “softer” and less adversarial device, relative to classic interventions. Corporate guidelines do not mandate specific governance structures. Consequently, they reduce the potential for confrontation between institutional investors and the managements of their portfolio companies. Maintaining solid ties with portfolio companies is not only an independently important goal, but also helps stave off political pressures to enhance the regulation of institutional investors.

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

This Article is the first to engage in an in-depth examination of corporate guidelines and demonstrate their efficacy as a corporate governance tool. The Article aims to make two novel contributions to corporate law scholarship: one theoretical and one empirical. Theoretically, the Article adds a hitherto unnoticed dimension to the burgeoning literature on the role of institutional investors in financial markets. Specifically, it highlights the use of guidelines as a principal aspect of corporate stewardship and examines their strengths and weaknesses. My analysis also suggests that the use of guidelines will only increase and multiply in the future.

Empirically, I examined the scope and pervasiveness of the use of guidelines in the corporate realm. To this end, I collected and analyzed 3,313 proxy statements published by the S&P 500 corporations in advance of their annual shareholder meetings in the years 2005, 2010, and 2019–2021, and by the S&P 500 top 100

⁸ Subection III.A.1.

corporations in the years 2005–2021.⁹ For each corporation in my sample, I collected information on whether the corporation’s proxy statement includes *explicit references* to investors’ corporate guidelines, broken down by references made by *corporations* and their *shareholders*.

Corporations make references to the guidelines to communicate with their shareholders and other constituencies and to express their commitment to sound corporate governance. As importantly, the guidelines are also a centerpiece of the strategy of *activist shareholders*. Activist shareholders frequently rely on corporate guidelines when submitting proposals for corporate reforms and then use the guidelines to convince managements to agree to reforms and to persuade large institutional investors to support their campaigns.

With respect to explicit references to guidelines *made by corporations*, my analysis reveals that in the years 2005, 2010, 2019, 2020, and 2021, respectively, 1, 3, 32, 28, and 24 proxy statements included *such explicit references* to investors’ corporate guidelines, which constitute 0.25, 0.69, 6.48, 5.68, and 5.76 percent of the sample, respectively. Importantly, most of the explicit references were made by the *largest corporations*. Thus, in the years 2019, 2020, and 2021, respectively 13.13, 12.24, and 13.10 percent of the proxy statements of the 100 largest corporations of the S&P 500 contained such a reference. This finding supports the hypothesis that larger corporations, which establish a precedent for the rest of the market, are more responsive to corporate guidelines. To complete the picture, my analysis reveals that from 2005 until 2018, only a very small percentage of the proxy statements of the 100 largest corporations of the S&P 500 contained explicit references to corporate guidelines made by corporations. The growing numbers of references made by corporations can be explained by the growing burden imposed on institutional investors to act as active stewards and to actively engage with their portfolio companies. In turn, this pressure has pushed institutional investors to highlight their guidelines and expectations from their portfolio companies, by sending letters, making declarations, and forming the ISG. This dynamic forces portfolio companies to take corporate guidelines more seriously.

Moreover, corporate guidelines have a profound effect on corporate best practices. My analysis reveals that in 2019, 226 corporations (45.2 percent of the sample) declared their commitment to the best practices and acknowledged that their boards review the corporation’s policies, frameworks, and guidelines, striving to ensure compliance with them. By influencing industry best practices, corporate guidelines indirectly shape corporate governance.

⁹ Of the S&P 500 corporations examined in 2019–2021, 494 issued proxy statements in 2019, 493 in 2020, and 417 in 2021. The reason why not all 500 corporations published proxy statements is that some of them went private and in 2021 not all of them have published their statements yet.

It should be emphasized at this point that my statistical data on explicit references to guidelines do not capture their full effect. My empirical analysis focuses on *explicit* and direct use of the guidelines. But the guidelines are not always used explicitly. The guidelines are routinely invoked in interactions between institutional investors and corporations. Yet, this use of the guidelines evades empirical quantification. As I discuss in the Article, the guidelines also serve as a background for conversations between corporations and institutional investors, but this effect, too, cannot be empirically measured.

Furthermore, my analysis also examines explicit references to guidelines *made by activist shareholders*, and reveals that in the years 2005, 2010, 2019, 2020, and 2021, respectively, 30, 33, 28, 17, and 14 proxy statements included *such explicit references* to investors' corporate guidelines, which constitute 7.50, 7.59, 5.67, 3.45, and 3.36 percent of the sample, respectively. Importantly, most of the explicit references were made by activist shareholders that targeted the *largest corporations*. Thus, in the years 2019, 2020, and 2021, respectively, 14.14, 10.20, and 11.90 percent of the proxy statements of the 100 largest corporations of the S&P 500 contained such a reference made by activist shareholders.

Taken together – the explicit references to corporate guidelines made by both corporations and activist shareholders – my analysis reveals that in the years 2005, 2010, 2019, 2020, and 2021, respectively, 31, 35, 53, 43, and 38 proxy statements included *explicit references* to investors' corporate guidelines, which constitute 7.75, 8.05, 10.73, 8.72, and 9.11 percent of the sample, respectively. Importantly, most of the explicit references were made in the proxy statements of *largest corporations*. Thus, in the years 2005, 2010, 2019, 2020, and 2021, respectively 11.90, 15.91, 24.24, 21.43, and 25.00 percent of the proxy statements of the 100 largest corporations of the S&P 500 contained such a reference. Interestingly, in the years 2008, 2009, 2016, and 2017, respectively, 28.24, 39.08, 32.63, and 32.98 percent of the proxy statements of the 100 largest corporations of the S&P 500 contained such a reference. These findings cannot be dismissed when speaking of institutional investors' stewardship and more specifically of the potential power of corporate guidelines formulated and published by institutional investors.

Finally, not just corporations and activist shareholders refer to investors' corporate guidelines. Leading law firms that advise corporations refer to institutional investors' corporate guidelines and urge corporations to review and pay close attention to the guidelines.¹⁰ In addition, proxy advisory firms, which have become a major force in the corporate world in the past two decades, rely on institutional investors' guidelines when advising market actors how to vote.

Structurally, the Article is organized as follows. In Part I, I will discuss the scholarship on the role of institutional investors in improving corporate governance.

¹⁰ Part IV.

A main theme in the literature concerns the passivity of institutional investors and their reluctance to serve as corporate stewards. I will show that the existing literature has paid scant attention to the potential power of corporate guidelines. In Part II, I will introduce the major characteristics of corporate guidelines, and the dynamic created between investors and their portfolio corporations by the guidelines. In Part III, I analyze the reasons behind the rise in the popularity of the guidelines. In Part IV, I provide detailed evidence on the use of corporate guidelines by corporations, shareholders, law firms, and proxy advisors. A short conclusion follows.

I. THE FOCUS ON INSTITUTIONAL INVESTORS' (LACK OF) PARTICIPATION IN ACTIVE STEWARDSHIP

A. *Institutional Investors' (Lack of) Activism*

One of the most prominent phenomena of the past three or four decades in corporate law is the emergence of institutional investors. Today, institutional investors own between seventy and eighty percent of public corporations' shares traded in the U.S. equity markets, and the largest institutional investors each hold approximately five to ten percent of a typical large public corporation.¹¹ As a report published by Sullivan & Cromwell LLP in 2019 reveals, “[A]s of December 2018, one of BlackRock, Vanguard or State Street was the largest shareholder in 438 of the S&P 500 companies, roughly eighty-eight percent, and collectively the three firms owned 18.7% of all shares in the S&P 500.”¹²

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

According to the first model, institutional investors, especially mutual funds, are passive because of inadequate incentives and conflicts of interest.¹³ In short, corporate governance activism is very costly. Activism means targeting companies in which investors assume that intervention would potentially improve the

¹¹ Assaf Hamdani & Sharon Hannes, *The Future of Shareholder Activism*, 99 B.U. L. REV. 971, 973 (2019).

¹² Sullivan & Cromwell LLP, *Review and Analysis of 2018 U.S. Shareholder Activism*, 23 (March 14, 2019), <https://www.sullcrom.com/files/upload/SC-Publication-SandC-MnA-2018-US-Shareholder-Activism-Analysis.pdf>.

¹³ Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1057–62 (2007).

company's share value, and taking several actions to press the company to adopt the investors' strategy. The actions may include proposing precatory or binding shareholder proposals, running "vote no" campaigns against incumbent directors, calling special meetings, and more. In certain cases, an activist shareholder may also initiate a lawsuit against the company, in order to obtain information from the company, or change its decisions.¹⁴

To get a sense of how costly activism is, Nickolay M. Gantchev found that a single activist campaign, ending in a proxy fight, and usually led by an activist hedge fund, has an average cost of \$10.71 million.¹⁵ Although this estimation refers to a costly campaign that ends with a contested vote,¹⁶ other forms of activism are costly as well. High cost itself should not be an insurmountable barrier because, theoretically, institutional investors can pass on the cost to their clients by charging higher fees, but the problem here is that given regulatory barriers, mutual funds cannot charge performance-based fees, but only fees based on a fixed percentage of the assets under management of the fund. Such an incentive structure therefore discourages managers of mutual funds to be active.¹⁷ I will elaborate this point further in Section III.A below, where I discuss the need of institutional investors to stay cost-efficient.

Moreover, managers of some types of institutional investors, such as pension funds and mutual funds, have business ties with public companies that distort their incentives to monitor these companies. As Bebchuk and Hirst explain, managers of large institutional funds believe that if they defer to the decisions of their portfolio companies' managements, they would have better chances to obtain business from those companies, such as 401(k) employer-sponsored retirement plans.¹⁸ Such ties

¹⁴ The underlying objective of activist campaigns is mainly to obtain seats on the board of the company. Also, as a recent report reveals, in past years, other "common underlying objectives of proxy contests related to business strategies, balance-sheet actions (such as returning cash to shareholders through dividends or share repurchases, which are often related to capital allocation strategies) and divestitures or other M&A actions (such as encouraging a sale of the company or opposing a merger)." Sullivan & Cromwell LLP, *supra* note 12, at 27.

¹⁵ Nickolay Gantchev, *The Costs of Shareholder Activism: Evidence from a Sequential Decision Model*, 107 J. FIN. ECON. 610 (2013). See also Kahan & Rock, *Hedge Funds*, *supra* note 13, at 1050 ("All of this consumes significant resources, both in-house and from hiring outside advisors").

¹⁶ Activist campaigns may also end with a settlement between activists and the target company. See Lucian A. Bebchuk, Alon Brav, Wei Jiang, & Thomas Keusch, *Dancing with Activists*, 137 J. FIN. ECON 1 (2020) (indicate that the incidence of such settlements has grown over the years).

¹⁷ Kahan & Rock, *Hedge Funds*, *supra* note 13, at 1051.

¹⁸ Bebchuk, Cohen, & Hirst, *supra* note 2, at 101–103. Some of the company employee savings and retirement plans and other affiliates have retained institutional investors (such as BlackRock, State Street, etc.) to provide investment management, trustee, custodial, administrative, and ancillary investment services.

push institutional investors' managers to favor corporate officers and vote for the officers' proposals rather than shareholders' proposals.¹⁹

Lastly, managers of institutional investors may fear that a backlash would result from activism, and therefore choose to be significantly deferential to corporate officers. This means they are less willing to intervene in corporate officers' decision-making processes and to confront the officers. The reason is that going against the officers may trigger opposition from the officers and "from parts of the public that are resistant to concentrations of financial power"²⁰ in the hands of large institutional investors. Given the fact that corporate officers' "control [of] the massive resources of Main Street companies [provides them with a] formidable foe in the political arena,"²¹ opposition from corporate officers may lead to a political and regulatory backlash and a reduction of institutional investors' power. Therefore, institutional investors are not likely to choose an intervention strategy, even when it may enhance the value of their portfolio companies.²²

According to the second model developed by Ronald J. Gilson and Jeffrey N. Gordon, although institutional investors are not proactive, they are not passive in the common sense. Rather, they are "rationally reticent," meaning they are "will[ing] to respond to proposals but are unlikely to [propose] them."²³ Put differently, institutional investors such as mutual funds are inactive in the sense that they are unlikely to intervene, except when other players, such as activist hedge funds, are involved in shareholder activism.

Both models can explain why institutional investors grossly underinvest in corporate stewardship. As Lucian Bebchuk and Scott Hirst document, the big three have very small stewardship departments and their stewardship budgets are insignificant.²⁴ Specifically, BlackRock, Vanguard, and State Street have stewardship teams composed of forty-five, twenty-one, and twelve members, respectively. At the same time, their portfolios (worldwide) include 11,246, 13,225, and 12,191 companies, respectively. Given this data, the Big Three can only spend "very limited resources on stewardship."²⁵ Although it seems that the Big Three

¹⁹ Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2060–2064. For empirical research that supports this argument, see Dragana Cvijanović, Amil Dasgupta, & Konstantinos E. Zachariadis, *Ties that Bind: How Business Connections Affect Mutual Fund Activism*, 71 J. FIN. 2933, 2933 (2016); Gerald F. Davis & E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds*, 85 J. FIN. ECON. 552, 569 (2007).

²⁰ Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2070.

²¹ *Id.* at 2069.

²² Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2066–2070.

²³ Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 887 (2013).

²⁴ Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2075–2080.

²⁵ *Id.* at 2079.

intend to increase their stewardship personnel,²⁶ the trend does not seem to be significant enough to change the picture.

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

B. Investors' Private Engagements

Before proceeding to analyze the passive dimension of stewardship, we should also pay attention to a special type of active stewardship: private engagements of large institutional investors with their portfolio companies. These “behind-the-scenes” engagements are considered to be a collaborative approach, which differs from the one-sided approach where institutional investors demand corporations to adopt certain changes. Instead, these engagements reflect an approach in which investors and their portfolio companies cooperate and understand each other.²⁷ In other words, such engagements are a more communicative and “non-confrontational”²⁸ means that allow investors to maintain a more “dynamic relationship” with companies’ managements.²⁹ As a recent brochure of BlackRock states, “[E]ngagement is an important mechanism to provide feedback or signal concerns about factors affecting long-term performance, not to tell companies what to do.”³⁰

In their recent article, Matthew J. Mallow and Jasmin Sethi, both senior directors at BlackRock, describe many interrelated forms of engagement including “holding direct conversations with companies, regulators, and issue experts; conducting educational outreach with the market; collaborating with other investors, companies, and advocates; convening summits to identify tipping points; soliciting shareholder proposals; and sponsoring academic and other intellectual analysis on the issues to increase market participant awareness.”³¹

²⁶ *Id.* at 2075. See also Michelle Edkins, *BlackRock Investment Stewardship Engagement Priorities for 2019*, HARVARD L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Jan. 31, 2019), <https://corpgov.law.harvard.edu/2019/01/31/blackrock-investment-stewardship-engagement-priorities-for-2019/> (reporting that today BlackRock has an investment stewardship team comprised of approximately forty professionals operating across all regions).

²⁷ Matthew J. Mallow & Jasmin Sethi, *Engagement: The Missing Middle Approach in the Bebchuck–Strine Debate*, 12 N.Y.U. J.L. & BUS. 385, 390 (2016).

²⁸ *Id.* at 392.

²⁹ *Id.* at 390.

³⁰ *BlackRock Investment Stewardship: Protecting Our Clients' Assets for the Long-Term*, BLACKROCK 6 (2019), <https://www.blackrock.com/corporate/literature/publication/blk-profile-of-blackrock-investment-stewardship-team-work.pdf> [hereinafter: BlackRock Investment Stewardship].

³¹ Mallow & Sethi, *supra* note 27, at 393. See also Lisa M. Fairfax, *Mandating Board-Shareholder Engagement?*, 3 U. ILL. L. REV. 821, 848 (2013).

To complete the picture, commentators have also raised doubts regarding the effectiveness of private engagements as a form of corporate stewardship. As Bebchuk and Hirst point out, private, “behind-the-scenes” engagements are not a substitute for classic activism, because, first, data provided in the public reports of the largest institutional investors reveals that investors engage privately with only a small number of their portfolio companies. Specifically, “[F]rom 2017 through 2019, the average proportion of portfolio companies with no engagement were 88.9% for BlackRock, 94.2% for Vanguard, and 94.5% for SSGA.”³² Second, since private engagements are non-confrontational, it is unlikely that institutional investors will force their portfolio companies to make changes involuntarily, which reduces the effectiveness of private engagements because companies can ignore the investors’ expectations without being punished.³³

C. Corporate Guidelines are Overlooked

Oddly, little research, if any, has been devoted to exploring the uses and potential power of corporate guidelines. Some prominent scholars have briefly discussed the potential role played by guidelines. For example, in their article, Lucian Bebchuk and Scott Hirst acknowledge that investors can use general principles to monitor their portfolio companies, but argue that monitoring “cannot be effectively carried out using general principles.”³⁴ As they emphasize, monitoring requires a company-specific analysis regarding each and every company,³⁵ and this seem to be the consensus among scholars.³⁶ Moreover, as John Coates explains, the current analysis of index providers’ incentives regarding stewardship fails to “capture the real implications of indexing for U.S. corporate governance” because the analysis should but does not take into account the way index funds form and publish “policies” regarding various governance issues, and how these policies may influence corporate governance systems in their portfolio companies.³⁷ Lastly, in

³² Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2086.

³³ *Id.* at 2088.

³⁴ *Id.* at 2083.

³⁵ *Id.* at 2084.

³⁶ See, e.g., Kahan & Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders*, 100 B.U.L. REV. 1771, 1778 (2020) (explain how engagements by institutional investors that involve the oversight of individual companies on governance and performance, require them to have company-specific information). See also Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 772 (2017) (“The firm-specific nature of the tradeoff between principal costs and agent costs is the reason that firms adopt a wide variety of governance structures”).

³⁷ John Coates, *The Future of Corporate Governance Part I: The Problem of Twelve 15* (Harv. Pub. Law, Working Paper No. 19-07, 2018).

their recent article, Edward Rock and Marcel Kahan explain how market-wide governance issues can be decided with reference to the voting guidelines.³⁸

In a similar vein, scholars have recognized that large institutional investors are likely to enjoy the economies of scale derived from the fact that they invest in hundreds of companies, and are therefore incentivized to study corporate governance issues to take advantage of the insights common to all relevant companies.³⁹ However, beyond general recognition of the potential of corporate guidelines, a deeper study of their nature and cost-effectiveness is needed. This article aims to fill this void.

II. THE ESSENCE OF CORPORATE GUIDELINES

A. *Corporate Guidelines: General Features*

Traditionally guidelines on corporate governance are set by regulators, such as the Securities and Exchange Commission, and quasi-regulators including stock exchanges, such as the NYSE and NASDAQ. These guidelines are a set of principles and practices that aim to support and promote sound corporate governance and, accordingly, enhance corporate value.

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

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

³⁸ Kahan & Rock, *Let Shareholders Be Shareholders*, *supra* note 36, at 1778.

³⁹ *Id.*, at 1800-1801. See also Jill E. Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17, 35 (2020) (“[T]he Big Three enjoy substantial economies of scale with respect to corporate governance and market-wide initiatives”).

Today, large institutional investors like BlackRock, Vanguard, Fidelity, and State Street⁴⁰ publish their own governance guidelines on an annual basis. In fact, mutual funds have been subject to a duty to publish their guidelines since 2003, when the SEC adopted the Advisors Act Rule 206(4)-6 that requires mutual funds to disclose the policies and procedures they use to vote proxies relating to portfolio securities, and to disclose their voting decisions in order to allow clients to see whether their practices are aligned with the guidelines.⁴¹

The guidelines are used to instruct the investors how to vote and communicate with their portfolio companies. As BlackRock recently stated, “voting guidelines are the benchmark against which [they] assess a company’s approach to corporate governance.”⁴² Relatedly, guidelines constitute a tool whereby investors give their perspective on various corporate governance practices that can promote long-term financial performance, and thus show their vision and preferences to the corporations in which they invest. Institutional investors do not differ significantly in their guidelines. Differences mainly exist in the form of how closely the investors will follow their guidelines. Some investors allow for more flexibility within the guidelines, enabling them to diverge when necessary, while other investors leave less room for discretion.

When voting on certain issues, institutional investors may diverge from their own guidelines. Such a divergence is not automatically perceived as a breach of good corporate governance. However, at least some of the investors have an “align or explain” mechanism, meaning that when their voting behaviors in certain portfolio companies do not align with their own guidelines, they must explain the reason for the divergence. For example, T. Rowe Price has a Proxy Committee that develops its guidelines and distributes the guidelines to portfolio managers. Ultimately, the portfolio managers decide how to vote on the proxy proposals of companies in their portfolios, but as T. Rowe Price’s guidelines stress, “when portfolio managers cast votes that are counter to the Proxy Committee’s guidelines, they are required to document their reasons in writing to the Proxy Committee.”⁴³

⁴⁰ *Examining the Market Power and Impact of Proxy Advisory Firms: Hearing Before the S. Comm. on Capital Mkts. & Gov’t Sponsored Enters. of the H. Comm. on Fin. Servs.*, 113th Cong. 17 (2013) [hereinafter Hearing before the House] (testimony of Lynn Turner, Managing Director, LitiNomics, Inc.: “If you look at the Web sites of the largest public pension funds and the 15 largest money managers . . . you will find they all have their own custom-designed proxy voting guidelines”).

⁴¹ See 17 C.F.R. § 275.206(4)-6 (2003). See also Hearing Before the House, *Id.* at 28 (providing explanation by the former Chairman of the SEC about the rule).

⁴² *Protecting and Enhancing Our Clients’ Assets for the Long Term*, BLACKROCK, <https://www.blackrock.com/corporate/about-us/investment-stewardship#engagement-priorities> (last visited Dec. 24, 2019).

⁴³ See *Proxy Voting Guidelines*, T. ROWEPRICE (2019), <https://www.troweprice.com/content/dam/trowecorp/Pdfs/Proxy%20Voting%20Guidelines%20-%202019.pdf>, at 1.

Lastly, guidelines designed by institutional investors typically reserve some degree of flexibility for the portfolio companies, by allowing them to take into account their individual characteristics when complying with the guidelines, as long as they show the holistic attitude stipulated by the guidelines. Put differently, institutional investors' guidelines do not seek to dictate specific governance structures, but rather defer to the structures chosen by corporations' boards of directors, as long as they align with the investors' philosophy.

An illustrative example is the guideline that requires the separation of the chairman of the board and the CEO. BlackRock's guideline allows its portfolio companies to choose between an independent chairman and a lead director that serves together with the chairman when the roles of the chairman and the CEO are combined.⁴⁴ During the roundtable held by the SEC in 2018 on proxy process, Mrs. Rakhi Kumar, Senior Managing Director and Head of ESG Investment and Asset Stewardship at State Street, explained how some of the corporate governance issues are "gray" and require attention to specific details. As she stressed, "We realize it's not just as easy as flipping the role of a chair and CEO. We realize it has much more to it, such as the individual in place, the time commitment, the job description."⁴⁵

The above example reflects the typical attitude of institutional investors to their own guidelines. Thus, although at first glance corporate guidelines designed by institutional investors may be seen as a rigid set of one-size-fits-all rules, they are actually relatively flexible principles that leave discretion for both the investors and managements of corporations.⁴⁶

⁴⁴ *Proxy Voting Guidelines for U.S. Securities*, BLACKROCK (Jan. 2019), <https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf>, at 6 ("We believe that independent leadership is important in the boardroom. In the U.S. there are two commonly accepted structures for independent board leadership: 1) an independent chairman; or 2) a lead independent director when the roles of chairman and CEO are combined. In the absence of a significant governance concern, we defer to boards to designate the most appropriate leadership structure to ensure adequate balance and independence. In the event that the board chooses a combined chair / CEO model, we generally support the designation of a lead independent director if they have the power to: 1) provide formal input into board meeting agendas; 2) call meetings of the independent directors; and 3) preside at meetings of independent directors. Furthermore, while we anticipate that most directors will be elected annually, we believe an element of continuity is important for this role for an extended period of time to provide appropriate leadership balance to the chair / CEO").

⁴⁵ *See Round Table on the Proxy Process*, SEC 183 (July 30, 2018), <https://www.sec.gov/files/proxy-round-table-transcript-111518.pdf> [hereinafter SEC Roundtable-2018].

⁴⁶ *See, e.g., Vanguard, Vanguard-Advised Funds Proxy Voting Policy*, SEC (Oct. 1, 2019), https://www.sec.gov/Archives/edgar/data/932471/000093247119007334/sai069_102019.htm ("In evaluating proxy proposals . . . we will give substantial weight to the recommendations of the company's board, absent guidelines or other specific facts that would support a vote against management"); BlackRock Guidelines, *supra* note 44, at 3 ("These Guidelines are not intended to

For these reasons, institutional investors' corporate guidelines are likely to meet little opposition from corporations, and thereby alleviate the concerns raised by Bebchuk and Hirst about the disincentives of investors to confront corporations' managers.⁴⁷ This means that unlike active stewardship, institutional investors are not likely to underinvest in designing corporate guidelines because the guidelines won't harm the business ties between the managers of the investors and the portfolio companies or lead to other types of backlash.

B. Corporate Guidelines: The Potential Influence

In this part, I explain how corporate guidelines have omnipresent power and influence. As I have discussed in Section I.A, the research conducted so far by scholarship shows that institutional investors have a limited pecuniary interest and lack the budgets and personnel needed to influence governance regimes in their portfolio companies.⁴⁸ It therefore concludes that institutional investors' influence on corporate governance in their portfolio companies is limited.⁴⁹ In this section, I will argue that this view underestimates the influence of institutional investors on corporate governance because it fails to capture the potential power of corporate guidelines.

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

1. The Omnipresent Power of Corporate Guidelines

Skepticism regarding institutional investors' involvement in stewardship typically originates from statistics and numbers. For example, as mentioned before, Bebchuk and Hirst argue that the limited personnel and budgets of the Big Three cannot allow them to be good stewards in the huge number of corporations they invest in. Bebchuk and Hirst support their argument by citing that the number of companies with which the Big Three engage, according to their annual stewardship

limit the analysis of individual issues at specific companies and are not intended to provide a guide to how BlackRock will vote in every instance. . . . They are applied with discretion, taking into consideration the range of issues and facts specific to the company and the individual ballot item"); *Proxy Voting Guidelines*, FIDELITY 1 (Jan. 2020) ("Fidelity maintains the flexibility to vote individual proxies based on our assessment of each situation").

⁴⁷ See *infra* Section I.A.

⁴⁸ *Id.*

⁴⁹ *Id.*

reports, constitute only 5.5%–11% of their portfolio companies, and only 0.6%–2.3% of these companies experienced multiple engagements by the Big Three.⁵⁰ Bebchuk and Hirst also provide evidence on the frequency of the Big Three’s voting against say-on-pay proposals, showing that they rarely vote against the proposals initiated by managements. They argue that these findings indicate a near absolute deference of the Big Three to the managements of their portfolio companies.⁵¹ Pro-management voting by index funds was documented also by other empirical studies.⁵² While these findings are convincing, they do not capture the full story.

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

The analysis of the real power of the largest institutional investors will not focus only on the dynamic between the investors and their portfolio companies in the

⁵⁰ Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2084–2088.

⁵¹ *Id.* at 2091–2095.

⁵² Ryan Bubb & Emiliano Catan, *The Party Structure of Mutual Funds* (Mar. 10, 2019) (unpublished manuscript) (on file with SSRN); Patrick Bolton, Tao Li, Enrichetta Ravina, & Howard Rosenthal, *Investor Ideology* (European Corp. Governance Inst., Finance Working Paper No. 557/2018, 2019), <https://ssrn.com/abstract=3119935>. Interestingly, institutional investors themselves admit that they prefer engaging with their portfolio companies to supporting shareholder proposals submitted to these companies. For example, Mr. Ray A. Cameron, Head of the Investment Stewardship Team for the Americas Region at BlackRock, stated that “[w]e prefer engagement, as we see shareholder proposals as a tool often of last resort, an avenue for accelerated change when needed. During our direct engagements with companies, we address the issues covered by many shareholder proposals that we believe to be material to the long-term value of the company. Where management demonstrates a willingness to address the material issues raised, and where we believe progress is being made, we will generally support the company and vote against the shareholder proposal.” SEC Roundtable-2018, *supra* note 45, at 116. *See also Id.* at 118 (“BlackRock takes an engagement-first approach. And we find that even when we do not support shareholder proposals or some proposals, the conversations that we have with companies on related topics often lead to positive change without the use of what some might consider to be a blunt instrument”); Tim McLaughlin & Ross Kerber, *Index Funds Invest Trillions But Rarely Challenge Management*, REUTERS (Oct. 8, 2019) (citing a statement of Michelle Edkins, head of corporate governance at BlackRock: “‘A vote against management is a sign of a failed engagement,’ Michelle Edkins, who oversees BlackRock’s proxy voting, said in an interview”).

formal voting process because changes in governance are also made by corporations in the period between annual meetings. Corporations may modify their governance guidelines during the year based not on shareholder proposals, but on analysis of corporate guidelines.

As some corporations' proxy statements reveal, corporations' governance guidelines are designed in advance of the shareholder meeting, based on the board of director's review of "governance guidelines published by institutional investors and proxy advisors," "stockholder expectations," "proxy voting guidelines of [the company's] major stockholders," "Investor Stewardship Group's (ISG) Corporate Governance," "investor concerns," whether a certain standard has been "recognized by the Council of Institutional Investors as a market standard," "evolving governance best practices," "emerging best practices in corporate governance," and "prevailing practices among other U.S. companies."⁵³

The above statements mean corporations do not ignore corporate guidelines of the largest institutional investors and proxy advisory firms, as well as the industry's best practices. As the Investor Stewardship Group (ISG), an initiative formed by the largest institutional investors, emphasizes on its website: "Listed companies should recognize that some of their largest investors now stand together behind these principles."⁵⁴ The ISG's position reflects a threat that if corporations choose not to follow the principles perceived by investors to be good corporate governance, they should have good reasons; otherwise, they are exposed to sanctions from the investors in the form of, for example, the investors' decision to oppose reelection of directors; or the decision to support shareholder proposals. Such a threat is credible despite the fact that institutional investors tend to vote with management and are perceived as pro-management.

As Mr. Brandon Rees, Deputy Director of Corporations and Capital Markets for the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO), stated during the Roundtable held by the SEC in 2018: "Large institutional investors—the BlackRocks and State Streets and Vanguard of the world—do not need the shareholder proposal rule process to get attention of management or board of directors. There's not a corporate secretary or investor relations department in the country that would not return their call within 24 hours."⁵⁵

Besides this general statement, Mr. Gary Retelny, President and CEO of the largest proxy advisory firm ISS, recently emphasized in the SEC's 2018 Roundtable that where institutional investors "have their own custom policies that they have designed and that they want to implement with regard to" their portfolio companies,

⁵³ See Appendix A.

⁵⁴ *About the Investor Stewardship Group and the Framework for U.S. Stewardship and Governance*, INV'R STEWARDSHIP GRP., <https://isgframework.org/> (last visited Feb. 2, 2020) [hereinafter ISG].

⁵⁵ SEC Roundtable-2018, *supra* note 45, at 150.

“[w]hat ISS does, essentially, is help them with the work flow . . . based on [investors’] own individual custom policies.”⁵⁶ Relatedly, according to the recent empirical research conducted by Bebchuk and Hirst, the Big Three “have been very active in supporting [shareholder] proposals advocating governance changes favored by their governance principles.”⁵⁷ Lastly, a report recently published by State Street, one of the prominent signatories of ISG, reveals that State Street’s initial screen in March 2018 identified sixty-six S&P 500 companies that did not comply with the ISG’s governance principles. Subsequently, many of these companies improved their practices before their annual shareholder meetings or were able provide sufficient justification for their practices. State Street eventually voted against those who failed to do so.⁵⁸

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

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

Corporate guidelines, unlike active engagements, may allow corporations to avoid embarrassment and harm to their reputation. Simply put, at the moment that a shareholder proposal is submitted and requires that the board implement a governance change, if the board subsequently recommends to the company’s shareholder to vote “for” the shareholder proposal, it may be interpreted as if the board was unaware of and failed to make the fit and proper governance arrangement in advance. Such a dynamic may create an element of “shaming” the board. By contrast, if the board chooses to propose a governance change by itself and supports its proposal by referring to institutional investors’ guidelines, the board is likely to signal that it is its commitment to good corporate governance, not external forces, that is driving the proposed governance change. Such a proposal initiated by the board can even be made soon after the board has refused to accept a shareholder proposal on the same governance issue.

⁵⁶ *Id.* at 191–192. *See also Id.* at 192 (“87 percent of the shares that we execute votes for—vote as per their own custom policies”).

⁵⁷ Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2104.

⁵⁸ *See Stewardship Report 2018–19*, STATE STREET GLOBAL ADVISORS 59 (2019), <https://www.ssga.com/investment-topics/environmental-social-governance/2019/09/annual-asset-stewardship-report-2018.pdf> [hereinafter SSGA 2018-19].

To illustrate this dynamic, let's take the giant pharmaceutical company Allergan as an example. In its 2018 proxy statement, shareholders requested Allergan's Board to adopt a policy that would require the chair of the board, whenever possible, to be an independent director. To support their proposal, shareholders wrote that "a number of institutional investors said that a strong, objective board leader can best provide the necessary oversight of management. Thus, the California Public Employees' Retirement System's Global Principles of Accountable Corporate Governance recommends that a company's board should be chaired by an independent director, as does the Council of Institutional Investors. An independent director serving as chairman can help ensure the functioning of an effective board."⁵⁹

Allergan's Board of Directors recommended that the shareholders should vote against this shareholder proposal,⁶⁰ and at the annual meeting held on May 1, 2019, the proposal was rejected.⁶¹ 101,019,176 shares voted "for" and 159,894,901 voted "against."⁶² Interestingly, at the time of the voting, the largest shareholders of Allergan were: Wellington Management Group with 24,934,153 (7.49%) of Allergan shares; BlackRock with 21,466,017 (6.45%) of Allergan shares; and Vanguard with 24,179,830 (7.27%) of Allergan shares.⁶³ Although their voting guidelines supported the separation of the Chairman and the CEO,⁶⁴ Wellington, BlackRock, and Vanguard voted against the proposal,⁶⁵ which determined the results of the voting on the proposal.

However, subsequently in its 2019 proxy statement, Allergan's Board adopted the governance change that would require the chair of the board to be an independent director but presented the change as its own initiative. It stated that "the Board has also heard from many of our shareholders that they would value a policy requiring an independent Chair that the Board could phase in with the next CEO transition. Accordingly, the Board has adopted changes to its corporate governance guidelines and the Nominating and Corporate Governance Committee charter so that, phased in within a reasonable period of time in connection with the next CEO transition

⁵⁹ Allergan PLC, Proxy Statement (Schedule 14A) (Mar. 23, 2018).

⁶⁰ *Id.*

⁶¹ Allergan PLC, Current Report (Form 8-K) (May 1, 2019).

⁶² *Id.*

⁶³ Allergan PLC, *Proxy Statement*, *supra* note 59.

⁶⁴ *Global Proxy Voting Guidelines*, WELLINGTON MANAGEMENT (Dec. 5, 2018), <https://www.wellington.com/en/wp-content/uploads/2017/08/global-proxy-voting-guidelines.pdf>; BlackRock Guidelines, *supra* note 44, at 6; Vanguard, *Proxy Voting*, *supra* note 46.

⁶⁵ Advanced Series Trust, Annual Report of Proxy Voting Record of Registered Management Investment Company (Form N-PX) (Aug. 28, 2019); Vanguard Index Funds, Annual Report of Proxy Voting Record of Registered Management Investment Company (Form N-PX) (Aug. 30, 2019).

following the March 2019 adoption of the Corporate Governance Guidelines, the Chair of the Board shall be, whenever possible, an independent director.”⁶⁶

Another example is related to Booking Holding Company (the former Priceline Group, Inc.). In its 2015 proxy statement, the board opposed a shareholder proposal concerning enhanced proxy access.⁶⁷ However, after the proposal was eventually approved at the annual meeting in 2015, the board tried to describe this governance change as a result of its own effort to improve governance.⁶⁸ As the proxy statement of 2019 stated, “Our management and the Board of Directors regularly evaluate ways to improve the Company’s corporate governance. The Board adopted the Proxy Access By-Laws in 2015. The Board’s adoption of Proxy Access By-Laws demonstrates the Company’s commitment to good corporate governance practices and responsiveness to stockholders. We adopted our current Proxy Access By-Laws after significant evaluation and deliberation by the Nominating and Corporate Governance Committee and the full Board of Directors and meaningful stockholder engagement. This thoughtful review included an analysis of best practices among other leading U.S. public companies and a review of the corporate governance policies of some of our largest stockholders.”⁶⁹

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

III. THE RISE OF CORPORATE GUIDELINES

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

⁶⁶ Allergan PLC, Proxy Statement (Schedule 14A) (Mar. 22, 2019).

⁶⁷ The Priceline Group, Inc., Proxy Statement (Schedule 14A) (Apr. 22, 2015).

⁶⁸ The Priceline Group, Inc., Current Report (Form 8-K) (Jun. 4, 2015).

⁶⁹ Booking Holdings, Inc., Proxy Statement (Schedule 14A) (Jun. 4, 2019).

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

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

First, institutional investors are obliged to vote in the best interests of their clients as part of their fiduciary duties. Relatedly, given their enormous power, these investors are expected to act as good stewards. *Second*, large investors are subject to a burden of voting in thousands of annual meetings every year. This enormous burden has pushed them to increasingly use the services of proxy advisory firms. Such reliance on advisory firms has drawn huge criticism that institutional investors outsource their duties owed to their clients instead of fulfilling them. Meanwhile, lots of mutual funds have moved toward the passive indexing strategy—a move that has portrayed them as passive stewards and attracted much attention and criticism from commentators and policymakers. Mutual funds have been forced to defend themselves, again, by emphasizing their willingness to devote more resources to corporate stewardship.⁷⁰ Unable to simply disregard the above criticism, institutional investors must show that they take control of their own duties. *Third*, institutional investors, mainly mutual funds, must remain cost-effective in order to achieve competitive advantages in a market that substantially limits their incentives to invest in active stewardship. The combination of these elements, discussed below, has led to institutional investors' increasing reliance on corporate guidelines.

1. Compliance with Fiduciary Duties and Good Citizenship

Institutional investors owe fiduciary duties to their clients. According to the law and relevant regulations, institutional investors are required to vote their proxies in the best interests of their clients. At first, after the passage of the Employee Retirement Income Securities Act of 1974 (ERISA), the U.S. Department of Labor (DOL) began ordering private pension funds to act solely in the interests of their plan participants and beneficiaries. Subsequently, in 1988, the DOL released a letter, commonly known as the “Avon Letter,” stating that “the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock.”⁷¹ In 2003, the SEC adopted a rule and

⁷⁰ Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2034.

⁷¹ See Letter from Allan Lebowitz, Deputy Assistant Secretary of the Pension Welfare Benefits Admin. at the U.S. Dep't. of Labor, to Helmuth Fandl, Chairman of the Ret. Bd., Avon Products, Inc. (Feb. 23, 1988).

amendments under the Investment Advisers Act of 1940 pertaining to mutual funds and investment advisers in order to encourage them to vote their proxies in the best interests of their shareholders.⁷²

The SEC and the U.S. Congress have continued to reinforce institutional investors' duties in the following years. Just recently, in November 2018, in the statement announcing a roundtable on proxy process, Chairman Jay Clayton stated that “[s]hareholder engagement is a hallmark of our public capital markets.”⁷³ In effect, it seems that pension funds, mutual funds, and policymakers have interpreted the Investment Advisers Act of 1940 as requiring funds to vote at every shareholder meeting, on every matter. As the SEC Commissioner Elad L. Roisman recently stated, “it appears to be the default position of many advisers that they vote every proxy, for every company, in every fund’s portfolio.”⁷⁴

Beyond legal duties, institutional investors are also subject to reputational concerns. Simply put, due to their enormous power in influencing corporate governance (e.g., they have plenty of resources to invest in corporate stewardship and also enjoy economies of scale in this aspect), large investors are expected to act as good stewards⁷⁵ and, more metaphorically, as good corporate citizens.⁷⁶ These concerns incentivize the investors to act as responsible actors who promote better corporate governance since such a positive image is likely to improve the way they

⁷² See Proxy Voting, 17 C.F.R. § 275.206(4)-6 (2003).

⁷³ See SEC Roundtable-2018, *supra* note 45.

⁷⁴ Elad L. Roisman, Commissioner, Sec. & Exch. Comm., Keynote Remarks: ICI Mutual Funds and Investment Management Conference (Mar. 18, 2019), (transcript available at https://www.sec.gov/news/speech/speech-roisman-031819#_ftnref10); see Hearing before the House of Rep., *supra* note 40, at 2 (providing a written testimony of Jeffrey D. Morgan, President & CEO of National Investor Relations Institute: “[M]utual fund and pension fund managers are required to vote all their shares on every matter”). *But see* Letter from the Inst. Inv’r, Serv., to Brent J. Fields, Secretary, the Sec. & Exch. Comm. (Nov. 7, 2018) (on file at <https://www.issgovernance.com/file/publications/iss-roundtable-comment-letter.pdf>) (explaining that the regulation “does not . . . require investment advisers to vote every proxy, regardless of facts and circumstances”).

⁷⁵ Bubb & Catan, *supra* note 52, at 28 (“Our main hypothesis for passive managers is that larger passive managers will invest more resources into voting due to economies of scale and because they face greater reputational risks. Put simply, the BlackRocks, Vanguards, and State Streets of the world face more pressure to act as good stewards and can spread the costs of doing so across a wider asset base, than smaller passive managers”).

⁷⁶ See, e.g., Proxy Advisory Firms Roundtable, SEC 74 (Dec. 5, 2013), <https://www.sec.gov/spotlight/proxy-advisory-services/proxy-advisory-services-transcript.txt> [hereinafter: SEC Roundtable-2013], in which Mr. Eric Komitee, General Counsel at Viking Global Investors, LP, remarked, “I think investment advisers generally speaking have a duty of good corporate citizenship in the United States the same way ordinary citizens have a civic duty to vote in elections, you know, where the outcome is potentially important to corporate America and the companies in which they invest.”

are perceived by policymakers, the media, etc.⁷⁷ This is especially important for large investors like BlackRock, Vanguard, and State Street, given the fact that in recent years they have been the subject of widespread criticism due to their market power, which has reduced competition and accordingly harmed consumers.⁷⁸ As Edward Rock and Marcel Kahan explain, “The best way to avoid regulation is to be viewed by relevant audiences as responsible steward.”⁷⁹ Moreover, reputation is critical to maintaining clientele, as former Senator Phil Gramm stated during the Roundtable held by the SEC in 2018: “You’re going to be relatively unaffected by the profitability of the company where you’re casting those proxies. But you may very well be affected by the public perception of your actions, and therefore the marketability of your index.”⁸⁰ Therefore, it should come as no surprise that the leaders of the largest institutional investors consistently emphasize their strong commitment to corporate stewardship.⁸¹

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

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

Institutional investors are subject to a very burdensome governance task. During the past two decades, corporate law and regulations have significantly expanded the types of issues that require a shareholder vote. For example, as the 2019 BlackRock Investment Stewardship report reflects, its investment stewardship team votes “at over 17,000 meetings a year.”⁸² As the 2019 Vanguard Investment Stewardship

⁷⁷ See Kahan & Rock, *Let Shareholders Be Shareholders*, *supra* note 36, at 1799.

⁷⁸ See Eric A. Posner, Fiona M. Scott Morton, & E. Glen Weyl, *A Proposal to Limit the Anti-Competitive Power of Institutional Investors*, 81 ANTITRUST L. J. 669 (arguing that ownership concentration by the largest passive investors will undermine product market competition and calling to limit their power); Fiona Scott Morton & Herbert Hovenkamp, *Horizontal Shareholding and Antitrust Policy*, 127 YALE L.J. 1742 (2018) (holding the same position as the previous article); Asaf Eckstein, *The Virtue of Common Ownership in an Era of Corporate Compliance*, 105 IOWA L. REV. 507 (2020) (describing criticism against common ownership structure and the concentrated power of the largest institutional investors).

⁷⁹ See Kahan & Rock, *Let Shareholders Be Shareholders*, *supra* note 36, at 1798.

⁸⁰ SEC Roundtable-2018, *supra* note 45, at 189.

⁸¹ Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2084.

⁸² BlackRock Investment Stewardship, *supra* note 30, at 13.

report reveals, “[i]n the 2019 proxy year, the Vanguard funds voted on 169,746 proposals at 18,961 company meetings across every major financial market.”⁸³

The growing burden has pushed more and more investors to outsource their voting task to proxy advisory firms, in order to fulfill their fiduciary duties.⁸⁴ This trend has attracted much criticism and calls for legislative and regulatory intervention.⁸⁵ Large institutional investors have been accused of violating their fiduciary duties by blindly following the recommendations of proxy advisory firms, which operate without transparency and with conflicts of interest. Public companies have also urged policymakers to take a stronger position on the proxy advisory industry. In response, the SEC as well as the U.S. Congress have investigated and debated the merits of proxy advisory regulation.

In 2010, the SEC issued a Concept Release that focused on the U.S. proxy system in general and on proxy advisors in particular.⁸⁶ The House of Representatives held a hearing on the matter in June 2013,⁸⁷ and the SEC followed up on this hearing with a roundtable discussion in December 2013.⁸⁸ At the same time, Commissioner Daniel M. Gallagher expressed “grave concerns” as to “whether investment advisers are indeed truly fulfilling their fiduciary duties when they rely on and follow recommendations from proxy advisory firms.”⁸⁹ No rulemaking initiatives resulted from these discussions until June 30, 2014, when the Investment Management and Corporate Finance Divisions of the SEC issued a joint Legal Bulletin No. 20 (SLB-20) outlining the responsibilities of proxy advisors and institutional investors when casting proxy votes.⁹⁰ During these hearings and

⁸³ Investment Stewardship: 2019 Annual Report, VANGUARD 8 (August 2019) https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019_investment_stewardship_annual_report.pdf.

⁸⁴ Another reason for reliance on proxy advisors is the SEC interpretation that institutional investors could cleanse any conflict of interest they may have with their portfolio companies by relying on voting policies developed by an independent, third-party agency—such as a proxy advisory firm. See Asaf Eckstein, *Great Expectations: The Peril of an Expectations Gap in Proxy Advisory Firm Regulation*, 40 DEL. J. CORP. L. 77 (2015).

⁸⁵ *Id.* See also Asaf Eckstein & Sharon Hannes, *A Long/Short Incentive Scheme for Proxy Advisory Firms*, 53 WAKE FOREST L. REV. 787 (2018).

⁸⁶ Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42,982, 43,011-12 (proposed Jul. 14, 2010).

⁸⁷ Hearing before the House, *supra* note 40, at 2.

⁸⁸ SEC Roundtable-2013, *supra* note 76, at 41–42.

⁸⁹ Michael J. Segal, Trevor S. Norwitz, & Sabastian V. Niles, *Wachtell Lipton discusses Commissioner Gallagher’s Critiques of Proxy Advisory Firms*, THE CLS BLUE SKY BLOG (Jul. 17, 2013), <https://clsbluesky.law.columbia.edu/2013/07/17/wachtell-lipton-discusses-commissioner-gallaghers-critiques-of-proxy-advisory-firms/>.

⁹⁰ *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms*, SEC (Jun. 30, 2014), <https://www.sec.gov/interps/legal/cfslb20.htm> [<http://perma.cc/L7KN-MD8R>] (providing a set of

discussions, participants complained that institutional investors “sidestep their fiduciary obligations instead of actually fulfilling them themselves,”⁹¹ that the SEC “effectively decoupled the voting decision from the fiduciary duty” by allowing institutional investors to exclusively rely on proxy advisors,⁹² and that today, “investment managers vote automatically in line with a proxy advisory firm’s recommendation, so-called robo-voting.”⁹³ This debate shows no sign of fading. Just in 2018 the SEC initiated, again, a series of discussions on how to curb the power of proxy advisory firms. In November 2019, the SEC voted to propose amendments to its rules governing proxy advice.⁹⁴

The outrage is directed not only at proxy advisory firms, but also at large institutional investors, and the way they fulfill their fiduciary duties has been under close scrutiny.⁹⁵ In response to the criticism, investors emphasize their commitment to enhance good governance in their portfolio companies. For example, BlackRock CEO Larry Fink declared that BlackRock reaches its voting decisions independently.⁹⁶ This declaration was accepted with satisfaction. For example, following this declaration, Martin Lipton of Wachtell, Lipton, Rosen & Katz wrote to the firm’s clients that “it is a helpful sign that a major institutional investor is willing to take a direct and pragmatic role in governance issues rather than outsourcing this responsibility to a proxy advisory firm or agitating for short-term results.”⁹⁷

So far, I have described how the largest institutional investors have attracted much attention for the way they fulfill their duties. It would not be an exaggeration to say that the attention has skyrocketed with the growing use of index fund services provided by the Big Three. Index funds have become a major force in the investing

questions and answers summarizing investment advisers’ responsibilities in voting client proxies and retaining proxy advisory firms, as well as the availability and requirements of two exemptions to the federal proxy rules that are often relied upon by proxy advisory firms) [hereinafter SLB 20].

⁹¹ Hearing before the House, *supra* note 40, at 19.

⁹² *Id.* at 29.

⁹³ SEC Roundtable-2018, *supra* note 45, at 191.

⁹⁴ SEC Proposes Rule Amendment to Improve Accuracy and Transparency of Proxy Voting Advice, SEC (Nov. 5, 2019), <https://www.sec.gov/news/press-release/2019-231>.

⁹⁵ In that regard, see Reena Aggarwal, Isil Erel, & Laura Starks, *Influence of Public Opinion on Investor Voting and Proxy Advisors* (Fisher College of Business, Working Paper No. WP 2014-03-12, 2015), <https://ssrn.com/abstract=2447012> (analyzing how institutional investors’ behaviors and voting are influenced by “the economic and social climate of public opinion”).

⁹⁶ Martin Lipton, *Disintermediating the Proxy Advisory Firms*, HARVARD L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Jan. 21, 2012), <https://corpgov.law.harvard.edu/2012/01/21/disintermediating-the-proxy-advisory-firms/>.

⁹⁷ Susanne Craig, *The Giant of Shareholders, Quietly Stirring*, THE N.Y. TIMES (May 18, 2013), <https://www.nytimes.com/2013/05/19/business/blackrock-a-shareholding-giant-is-quietly-stirring.html>.

arena and accordingly they have attracted huge attention. More and more scholars have started to explore these funds' incentives to be good stewards, and many of them criticize the funds for not having sufficient incentives.⁹⁸ Some scholars have taken a step forward and called on lawmakers to consider restricting the rights of index funds to vote at annual meetings of companies in which they invest.⁹⁹ The media has also warned against “[t]he [h]idden [d]angers of the [g]reat [i]ndex [f]und [t]akeover.”¹⁰⁰ In response, leaders of index funds have emphasized that they are not passive with regard to engagements with their portfolio corporations.¹⁰¹ Relatedly, they have stressed that they are committed to expanding their stewardship teams' capabilities,¹⁰² and intensifying their stewardship efforts.¹⁰³ As an example of their increasing commitment, mutual funds in recent years have expressed their dissatisfaction with the short-term vision of activist hedge funds,¹⁰⁴ and mutual fund leaders in letters they sent to the CEOs of their portfolio companies have criticized the process of quick and private settlements between companies and activists, which has deprived the funds of their voice.¹⁰⁵

⁹⁸ Kahan & Rock, *Let Shareholders Be Shareholders*, *supra* note 36; Bebchuk & Hirst, *Index Funds*, *supra* note 1; Davidson Heath, Daniele Macciocchi, Roni Michaeli, & Matthew C. Ringgenberg, *Do Index Funds Monitor?* (European Corp. Governance Inst., Finance Working Paper No. 638/2019, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3259433.

⁹⁹ Lund, *supra* note 6.

¹⁰⁰ David McLaughlin & Annie Massa, *The Hidden Dangers of the Great Index Fund Takeover*, BLOOMBERG (Jan. 9, 2020), <https://www.bloomberg.com/news/features/2020-01-09/the-hidden-dangers-of-the-great-index-fund-takeover>.

¹⁰¹ See, e.g., Jennifer Thompson, *Index Tracking ETFs Deny Any “Abdication” of Stewardship Role*, FINANCIAL TIMES (Feb. 5, 2018), <https://www.ft.com/content/9c9743e0-e40c-11e7-a685-5634466a6915>. See also *Viewpoint: The Investment Stewardship Ecosystem*, BLACKROCK 12 (July 2018), <https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-investment-stewardship-ecosystem-july-2018.pdf>.

¹⁰² See, e.g., *BlackRock Investment Stewardship 2018 Annual Report*, 2018 BLACKROCK 2 (declaring that BlackRock is “committed to doubling team size by 2020”).

¹⁰³ See, e.g., Madison Marriage, *BlackRock, Vanguard and State Street Bulk Up Governance Staff*, FIN. TIMES (Jan. 28, 2017), <https://www.ft.com/content/657b243c-e492-11e6-9645-c9357a75844a>; Press Release, BlackRock, *BlackRock Releases 2020 Stewardship Priorities for Engaging with Public Companies* (Mar. 18, 2020) (on file at <https://www.blackrock.com/corporate/newsroom/press-releases/article/corporate-one/press-releases/stewardship-priorities>); *Delivering on Our Commitment to Sustainability and Stewardship*, BLACKROCK, <https://www.blackrock.com/corporate/about-us/investment-stewardship/our-commitment-to-stewardship> (last visited May 16, 2020).

¹⁰⁴ For a discussion of long-term activism versus hedge fund activism, see Sharon Hannes, *Super Hedge Fund*, 40 DEL. J. CORP. L. 163, 189–199 (2015).

¹⁰⁵ John C. Coffee et al., *Activists Directors and Agency Costs: What Happens When an Activist Director Goes on the Board?*, 104 CORNELL L. REV. 381, 386 & n. 5, 436–7 & n. 95–97 (2019) (describing how BlackRock, State Street, and Vanguard objected the procedure of such settlements).

The upshot here is that in the past two decades institutional investors have been subject to an increasing burden because of their growing governance tasks, and they cannot relieve the burden by simply outsourcing these tasks or abandoning their duties. Therefore, subject to the huge costs coupled with the governance tasks, institutional investors are seeking a legitimate and cost-effective way to show their commitment to stewardship.

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

Corporate stewardship, defined as monitoring, voting, and engagement,¹⁰⁶ is very costly, and is likely to raise investors' expenses without bringing much benefit, and thus harm their profitability. However, while institutional investors must stay cost-effective in comparison to their peers, it is hard for them to cut the costs incurred by corporate stewardship because, as I explained above, they cannot ignore their fiduciary duties and cannot outsource fulfillment of the duties to proxy advisory companies without repercussions. Thus, institutional investors must find a mode of stewardship that has minimal cost but at the same time is perceived as legitimate by the public and regulators. Corporate guidelines emerge as a solution to the above dilemma.

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

For active investors, especially mutual funds, their clients seek to get the highest profit possible. The profit equals the annual return achieved by the fund, minus the expenses incurred by the fund. Expenses include administrative costs and investment management fees paid to portfolio managers who perform research analysis to determine which securities the fund will pick. The investment management fees are often the biggest part of the fund's expenses.¹⁰⁷ The total cost of the fund, divided by the fund's total assets, is the Total Expense Ratio (TER). Investors, when considering whether to invest in a fund, give special attention to the TER.¹⁰⁸ This is because expenses are deducted from the total assets of the mutual funds before the clients get their share. The lower the expense ratio is, the

¹⁰⁶ Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2045.

¹⁰⁷ Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961, 1988 (2010).

¹⁰⁸ In that regard, it is very obvious how Vanguard highlights the fact that its expense ratio is the lowest in the industry. See *Why Ownership Matters*, VANGUARD, <https://about.vanguard.com/whats-sets-vanguard-apart/why-ownership-matters/> (last visited Jan. 22, 2020) ("No wonder Vanguard's average asset-weighted fund expense ratio in 2018 was 0.10%, less than one-fifth that of the 0.58% industry average (excluding Vanguard)").

higher the return to the clients is. To illustrate, if the fund has an expense ratio of one percent, and the gross annual return is fifteen, then the net return to the clients is fourteen percent.¹⁰⁹ The upshot here is that active mutual funds must be cost-effective to be able to compete with their peers. Given that active corporate stewardship is very costly, managers of mutual funds are likely to prefer using low-cost alternatives, such as corporate guidelines.

The preceding analysis is not merely theoretical. During hearings and discussions held over the years, investors have stressed that they are likely to allocate their time and resources to choosing investments, rather than to active engagement. In some sense, allocating resources to corporate stewardship is perceived by investors as an obstacle to fulfilling their other responsibilities. This is illustrated by statements made by some institutional investors.¹¹⁰

As Eric Komitee, General Counsel at Viking Global Investors, LP, stressed during the Roundtable held by the SEC in 2013, “There are only so many hours in the year, and every hour spent evaluating proxies is potentially an hour spent not evaluating alternative investments that could go into the portfolio. It’s an hour not spent evaluating counterparty risks and custodial issues and all the other aspects of an investment adviser’s fiduciary duty that compete for, you know, the most scarce resource that everybody has, which is time.”¹¹¹ Similarly, at the Roundtable held by the SEC in November 2018, Scott Draeger, President and General Counsel of R.M. Davis Private Wealth Management, stated that “[o]ver time, [voting] grew to be a huge responsibility. And the analysts really found that they were spending so much time focused on proxies that it left them with resources lacking to do their day-to-day, typical investment work in the portfolio investments themselves.”¹¹²

When speaking about passive investors, cost-effectiveness is even more crucial. The emergence of passively managed funds—index mutual funds and exchange-traded funds (ETF)—is one of the most heated topics in corporate scholarship today. Unlike active funds that pick stocks, passive funds replicate the return of a selected index. The rationale behind a passive fund is, as the late Jack Bogle, the index fund pioneer who founded Vanguard, put it, “Don’t look for the needle in the haystack. Just buy the haystack.” As such, passive funds provide a return to investors with lower costs of intermediation. Passive funds, dominated by the Big

¹⁰⁹ See MARK MOBIUS, *MUTUAL FUNDS: AN INTRODUCTION TO THE CORE CONCEPTS* (2007). See also David John Marotta, *Know Your Fund Expense Ratios*, FORBES (Apr. 23, 2019) (“Low fund expense ratios are one of the best predictors of superior future returns. Lower fees and expenses leaves more money for investors”).

¹¹⁰ Although those statements were not made by the largest investors, probably because they did not want to be perceived as not fully committed to stewardship, it seems that those statements tell the real story.

¹¹¹ SEC Roundtable-2013, *supra* note 76, at 74.

¹¹² SEC Roundtable-2018, *supra* note 45, at 185.

Three,¹¹³ compete with active funds. Generally speaking, passive mutual funds charge ultra-low fees, and cost clients about 1/4–1/8 as much as comparable active mutual funds. This explains the “mass migration” from active to passive funds.¹¹⁴ Passive funds also compete amongst themselves for the lowest tracking error performance, and for the lowest cost. In a definite way, Vanguard won “[t]he [f]ee [w]ar [that] [r]ages [o]n,” with the lowest average fees and the largest market share.¹¹⁵ The fee war has been so fierce that it continues to push the fee charged by both active and passive funds downward. As the Morningstar’s Annual Fee Study reveals, the fee has declined significantly over the years, with a drop of 6% in 2018 alone.¹¹⁶ So the bottom line here is that passive investors must be more effective when it comes to costs than their active peers, which increases their disincentives to invest in active engagements.

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

For both active and passive funds, an incentive problem discourages investment managers from investing in active engagement. Even if investment managers have improved the value of their portfolio by investing in stewardship, they typically would capture only a tiny fraction of the increase in value. Specifically, active investors capture around 0.79 percent of the improvement in the value of the position whereas passive investors capture only 0.12 percent.¹¹⁷ Such a fraction “would

¹¹³ Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U.L. REV. 721, 723 (2019).

¹¹⁴ According to the 2018 Morningstar Report, index funds have an average expense ratio of 0.15%, while actively managed funds charge 0.67% on average. Morningstar, Inc., *Morningstar’s Annual Fee Study Finds That in 2018 Investors Paid Less to Own Funds Than Ever Before*, PR Newswire (Apr. 30, 2019), <https://www.prnewswire.com/news-releases/morningstars-annual-fee-study-finds-that-in-2018-investors-paid-less-to-own-funds-than-ever-before-300840661.html>.

¹¹⁵ Christine Idzelis, *Fee War Saved Investors Billions Last Year*, INSTITUTIONAL INVESTOR (Apr. 30, 2019), <https://www.institutionalinvestor.com/article/b1f6gyxqq4v43/Fee-War-Saved-Investors-Billions-Last-Year>.

¹¹⁶ Morningstar, *supra* note 114.

¹¹⁷ *Id.* at 97.

generally be insufficient to induce the level of stewardship investment that would best serve the interests of beneficial investors.”¹¹⁸

Moreover, under the current regulatory regime, investment managers are not allowed to include the expenses of stewardship as part of the fees paid by their investors, and so they bear the full costs of stewardship.¹¹⁹ One may further argue that investment managers may have indirect incentives to invest in stewardship in order to enhance funds’ performance and thereby attract flows of new assets to the fund, which will increase their fees. However, as empirical studies have shown, the effect of funds’ performance on flows is complex and not linear,¹²⁰ which means performance may not be perceived as being of much instrumental value in boosting flows.

To complete the picture, in contrast to Bebchuk, Edward Rock and Marcel Kahan stress that the most important incentive for index funds’ advisers to invest in stewardship is the size of their holdings. Although the rate charged by equity index funds is very low (the average in 2017 was 0.09%), given that passive index funds have the largest positions in companies, the incentive of passive funds’ managers to invest in stewardship is likely to be high.¹²¹

Lastly, Bebchuk and Hirst also point out a free-rider problem that discourages index funds’ managers from investing in stewardship. The investment of a certain fund in stewardship would not improve the fund’s performance relative to other funds. This is because if a fund succeeded in enhancing the value of a portfolio

¹¹⁸ *Id.*; Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2056.

¹¹⁹ Bebchuk, Cohen, & Hirst, *supra* note 2, at 96.

¹²⁰ Compare Erik R. Sirri & Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 J. FIN. 1589, 1598 (1998) (providing empirical evidence showing that asset flows respond strongly to prior superior performance, but are much less sensitive to past poor performance: “For top performers . . . performance is associated with economically and statistically significant inflows. For other funds, performance is positively associated with flows, but this relationship is statistically weak. . . . [For] the poorest performers . . . there is virtually no relationship between historical performance and flows”), Judith Chevalier & Glenn Ellison, *Risk Taking by Mutual Funds as a Response to Incentives*, 105 J. POL. ECON. 1167, 1169 (1997) (finding that there are “significant nonlinearities in the relationship, with the overall sensitivity of the relationship and its shape being dependent on the age of the fund in question”), and Jill E. Fisch, *supra* note 107, at 1994 (“Investors fail to respond to chronic poor performance by withdrawing their funds, allowing some of the worst performing mutual funds to survive”), with Jonathan Lewellen & Katharina Lewellen, *Institutional Investors and Corporate Governance: The Incentive to be Engaged* (Tuck Sch. of Bus., Working Paper No. 3265761, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3265761 (providing empirical evidence of how institutional investors gain an extra sum of money in annual management fees from both changes in the AUM (direct incentives) and future flow of assets (indirect incentives) and finding that flow of assets is typically sensitive to performance when speaking about the largest institutional investors, and thereby concluding that the investors do have incentives to invest in stewardship).

¹²¹ Kahan & Rock, *Let Shareholders Be Shareholders*, *supra* note 36, at 1777-1793.

company through investment in stewardship, the increase in value would be captured by all other investors of that company and rival index funds that track the same index.¹²² Bebchuk and Hirst thereby conclude that active involvement in their portfolio companies “would not result in a superior performance that could enable the manager to attract funds currently invested with rival investment managers.”¹²³ Therefore, index funds may have even less of an incentive to invest in stewardship than active funds, and this is supported by empirical evidence.¹²⁴

To sum up, maintaining cost-effectiveness is critical to institutional investors, especially passive index investors, which translates to their need to take a more modest approach toward stewardship by relying upon corporate guidelines.¹²⁵

B. Soft Device that Reduces Risk of Confrontation

The second explanation of why institutional investors are likely to heavily rely on corporate guidelines is that these investors have additional considerations beyond those of good stewardship. Recall that institutional investors prefer not to directly confront managements of corporations, both because managements have strong political power and thus confrontation with managements may trigger a regulatory backlash, and because institutional investors have business ties with the corporations they invest in.¹²⁶

As I explained in Subsection II.B.2 above, unlike active engagement, corporate guidelines are considered as a “soft” device that allows institutional investors to enforce their governance principles in a non-confrontational and flexible way. Since guidelines do not aim to force corporations to accept a specific arrangement, they are less likely to create a clash between institutional investors and managements. Relatedly, corporate guidelines designed by institutional investors may give managements an elegant way to adopt governance changes without embarrassment. By referring to the guidelines when proposing their own initiatives to improve governance, corporations’ boards can signal that they have kept their

¹²² Bebchuk & Hirst, *Index Funds*, *supra* note 1, at 2047. *See also* Bebchuk, Cohen, & Hirst, *supra* note 2, at 96–97. Note that even if a rival index fund does not invest in this particular portfolio company, it can still benefit from the increase in the company’s value as long as it tracks the same index, because such an increase would raise the value of the index.

¹²³ Bebchuk, Cohen, & Hirst, *supra* note 2, at 98.

¹²⁴ *See* Heath et al., *supra* note 98 (supporting Bebchuk and Hirst’s thesis and finding that index funds vote with management more frequently than active funds and are more likely to defer to management).

¹²⁵ Interestingly, mutual funds may also maintain cost-effectiveness by other methods. For example, their ownership of corporations operating within similar geographies and industries enables them to monitor common threats faced by those companies at lower costs, by applying more formulaic models. *See* Eckstein, *The Virtue of Common Ownership*, *supra* note 78.

¹²⁶ *See* Section I.A.

shareholders' interests in mind and are actively seeking governance changes that are fit and appropriate. This would allow corporations to align with best practices demanded by institutional investors through the back door and prevent a direct confrontation between the corporations and the investors in the front door.

C. *Standardization in Corporate Law: A Global Phenomenon*

In this subsection I suggest another explanation of the rise of corporate guidelines. In his recent article, John Coates analyzes how three mega-trends have reshaped corporate governance. One of these trends is globalization.¹²⁷ The growing power of institutional investors' guidelines should be seen as an integral part of a global push for standardization. This subsection, while not offering an exhaustive discussion, points to some of the major phases of this trend.

To begin with, in May 1999, members of the Organization for Economic Cooperation and Development (OECD) voted unanimously to endorse the OECD Principles of Corporate Governance. Since their endorsement, the Principles have been recognized as the basic governance standards for companies and investors around the world. Some EU jurisdictions, such as the UK and Germany, have also adopted corporate governance codes, in the form of "comply or explain," which means that the codes are not legally binding, but once a corporation decides not to comply with them, it should explain the reasons for noncompliance.¹²⁸ Similar codes were adopted by other countries, such as Japan (which adopted a stewardship code in 2014) and Hong Kong (which adopted principles of responsible ownership in 2016).¹²⁹

In 2003, the International Corporate Governance Network (ICGN), led by investors that are today responsible for assets under management in excess of thirty-four trillion dollars, published its first set of governance principles in order "to promote effective standards of corporate governance and investor stewardship."¹³⁰ ICGN's governance principles were updated in 2013 and in 2017, and they deal with various aspects in corporate governance such as the board's leadership and independence (including the need for an independent chair and the role of the lead

¹²⁷ Coates, *supra* note 37.

¹²⁸ John Armour, Luca Enriques, Henry Hansmann, & Reinier Kraakman, *The Basic Governance Structure: The Interests of Shareholders as a Class*, in *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* 63 (3rd ed., 2017).

¹²⁹ Glenn Booraem, *What We Do. How We Do It. Why It Matters: Vanguard's Investment Stewardship Commentary*, HARV. L. SCH. FORUM. CORP. GOV. (May 1, 2019), <https://corpgov.law.harvard.edu/2019/05/01/what-we-do-how-we-do-it-why-it-matters-vanguards-investment-stewardship-commentary/>.

¹³⁰ *About*, INT'L CORP. GOVERNANCE GRP., <https://www.icgn.org/about> (last visited Jan. 12, 2020).

independent director) and the board's composition (including diversity and director tenure).¹³¹

In 2006, the United Nations Principles for Responsible Investment (PRI) was first launched. Sixty-three investment companies with 6.5 trillion dollars in assets under management (AUM) signed a commitment to incorporate Environmental, Social and Governance (ESG) principles into their investment decisions. By 2018, the number of signatories had increased to 1,715 and represented 81.7 trillion dollars in AUM.¹³² PRI's principles put special emphasis on ESG issues, seeking to promote better ESG in companies in which the signatories invest and appropriate disclosure on ESG issues in those companies.¹³³

The push for standardized corporate governance on the global level received another boost after the 2008 financial crisis occurred, leading to a growing number of stewardship codes, principles, and guidelines being adopted by many countries around the world.¹³⁴

Recently, sixty of the largest institutional investors in the U.S. and their international counterparts gathered and formed the Investor Stewardship Group (ISG). Together, these investors have combined assets in excess of 31 trillion dollars in the U.S. equity markets.¹³⁵ The ISG developed six principles that went into effect on January 1, 2018.¹³⁶ These principles are perceived by the ISG as “fundamental to good corporate governance at U.S. listed companies,”¹³⁷ and as “minimum standards in the market,” i.e., their “minimum” expectations of corporate governance from corporations they invest in.¹³⁸ Although these principles are not mandatory, companies have difficulty ignoring them because they are usually backed by the investors' credible threat to detect and punish non-compliance.¹³⁹ For

¹³¹ *Global Governance Principles*, INT'L CORP. GOVERNANCE GRP. (2017), http://icgn.flpbks.com/icgn_global_governance_principles/ICGN_Global_Governance_Principles.pdf.

¹³² Robert G. Eccles & Svetlana Klimenko, *The Investor Revolution*, HARV. BUS. REV. (May 2019), <https://hbr.org/2019/05/the-investor-revolution>.

¹³³ PRINCIPLES FOR RESPONSIBLE INVESTMENT, <https://www.unpri.org/> (last visited Jan. 14, 2019).

¹³⁴ *Q&A on Stewardship Codes*, ERNST & YOUNG (August 2017), [https://www.ey.com/Publication/vwLUAssets/ey-stewardship-codes-august-2017/\\$FILE/ey-stewardship-codes-august-2017.pdf](https://www.ey.com/Publication/vwLUAssets/ey-stewardship-codes-august-2017/$FILE/ey-stewardship-codes-august-2017.pdf).

¹³⁵ ISG, *supra* note 54

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ Andrew Letts, *Engaging with Rakhi Kumar of State Street Global Advisor*, PJT CAMBERVIEW (May 9, 2018), <https://pjtpartners.com/pjtcamberview/engaging-with-rakhi-kumar-of-state-street-global-advisors>.

¹³⁹ Rick Lacaille & Rakhi Kumar, *2019 Proxy Voting and Engagement Guidelines: North America*, HARV. L. SCH. FORUM. CORP. GOV. (Mar. 27, 2019), <https://corpgov.law.harvard.edu/2019/03/27/2019-proxy-voting-and-engagement-guidelines-north->

example, recall that after State Street, one of the most prominent signatories of the ISG, reported that it had identified sixty-six S&P 500 companies that failed to comply with the ISG's governance principles, many of these companies eventually modified their practices based on the ISG's principles before their annual shareholder meetings, or provided sufficient explanations for their non-compliance. Those who did neither suffered the opposition of State Street in the voting process.

To summarize, all of the global developments described in this section can be seen as an accelerating force that has been pushing institutional investors toward standardization and, more specifically, toward relying upon proxy voting guidelines.¹⁴⁰

IV. INSTITUTIONAL INVESTORS' GUIDELINES: EVIDENCE

In the previous part, I analyzed the importance of corporate guidelines. While doing so, I focused on the nature of corporate guidelines and the potential supply-side explanations of the rise of guidelines, i.e., the explanations of why corporate guidelines have become a preferred instrument created by investors and groups of investors to participate in corporate governance. In this part, I will provide evidence of the potential power, i.e., the demand-side influence, of corporate guidelines. To do so, I will analyze the ways major players in the corporate governance arena—corporations, shareholders, legal advisors, and proxy advisors—use corporate guidelines.

Specifically, I will show how corporations use corporate guidelines to reflect their commitment to their largest investors and to oppose shareholder proposals, how shareholders base their proposals on corporate guidelines to support their positions, and how legal advisors refer to the guidelines to warn their corporate clients. Next, I will demonstrate how corporations and shareholders make frequent use of what they term “best practices,” which may be created and maintained by corporate guidelines. Finally, I will discuss proxy advisors' use of corporate guidelines and how investors are involved in the formulation of proxy advisors' own guidelines. Before turning to discuss how the different players interact with corporate guidelines, I will first explain the methodology for the empirical study of the uses of corporate guidelines and summarize the findings.

america/ (“as a founding member of the Investor Stewardship Group (‘ISG’), we proactively monitor companies’ adherence to the Corporate Governance Principles for US listed companies”).

¹⁴⁰ In a post published in 2019, Glenn Booraem, a Principal and an Investment Stewardship Officer at Vanguard, acknowledged that the events described above (the adoption of the UK Governance Code, the United Nations Principles for Responsible Investment, the Japan Stewardship Code, the Hong Kong Principles for Responsible Ownership; and the establishment of the ISG), “reinforced the need for stronger governance practices and continue to influence the evolution of corporate governance.” Booraem, *supra* note 129.

A. *Empirical Research: Sample and Methodology*

In order to analyze how corporate guidelines are used by major players in corporate governance, I analyzed the proxy statements published by corporations in the form of DEF 14A (Schedule 14A). Initially, my dataset contained proxy statements published in 2019–2021 by the 500 corporations that constituted the S&P 500 list as of December 10, 2019. In order to expand the scope of this research, a further inspection of data was performed in five-year intervals, for the years 2010 and 2005. Ultimately, to obtain a broader perspective, the dataset’s timeframe was expanded for the S&P 500 top 100 corporations to the years 2005–2021, which included a total of 3,313 proxy statements, to this end. For each corporation in my sample, I collected information about whether the corporation’s proxy statement includes explicit references—made by both the corporation and its shareholders—to guidelines of institutional investors and organizations representing these investors, such as CII or the ISG.

1. The Big Picture

In this subsection, data is presented on the total number of proxy statements of S&P 500 corporations that included an explicit reference to the guidelines in the years 2005, 2010, and 2019–2021, in order to provide a fuller scope of assessment. The references are then parceled into two subgroups: references made by corporations and references made by shareholders. The analysis reveals that in 2005, proxy statements of 31 corporations, comprising 7.75 percent of the sample, contained references to corporate guidelines. Of the top 100 corporations, the proxy statements of 10 corporations, representing 11.90 percent of the category, included an explicit reference by the corporation, its shareholders, or both.

Thereafter, in 2010, the analysis reveals that proxy statements of 35 corporations, comprising 8.05 percent of the sample, contained references to corporate guidelines. Of the top 100 corporations, the proxy statements of 14 corporations, representing 15.91 percent of the category, included an explicit reference by the corporation, its shareholders, or both.

In 2019, the proxy statements of 53 corporations, comprising 10.73 percent of the sample, incorporated references to corporate guidelines. Of the top 100 corporations, meaning corporations included in the first tier of the S&P 500 and having the largest market capitalization, the proxy statements of 24 corporations, i.e., 24.24 percent, included an explicit reference by the corporation, its shareholders, or both.

As for 2020, my analysis shows that the proxy statements of 43 corporations, comprising 8.72 percent of the sample, included references to corporate guidelines. Of the top 100 corporations, the proxy statements of 21 corporations, representing

21.43 percent of the group, included an explicit reference by the corporation, its shareholders, or both.

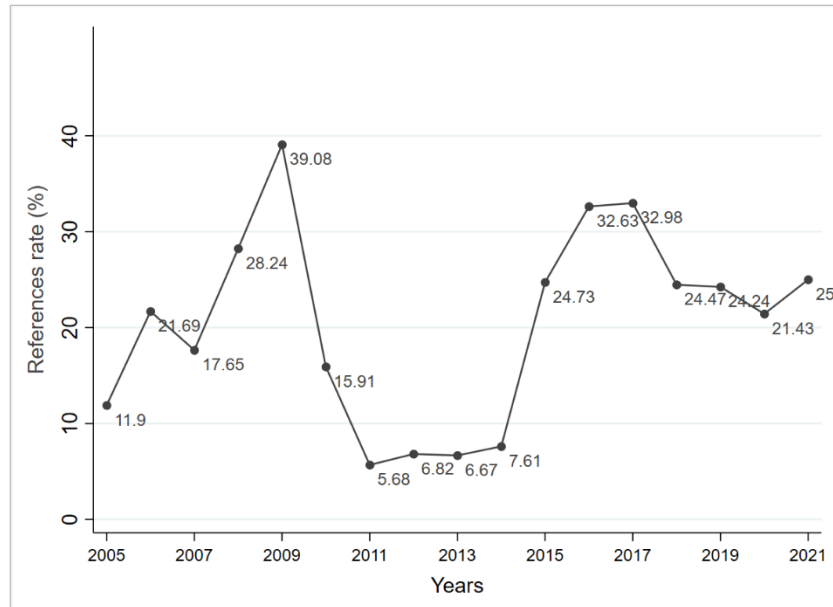
Finally, in 2021, the analysis shows that the proxy statements of 38 corporations, comprising 9.11 percent of the sample, contained references to corporate guidelines. Of the top 100 corporations, the proxy statements of 21 corporations, representing 25.00 percent of the category, included an explicit reference by the corporation, its shareholders, or both. Table 1 presents summary statistics on the information in the above categories.

TABLE 1. PROXY STATEMENTS OF S&P 500 CORPORATIONS THAT INCLUDED EXPLICIT REFERENCES TO GUIDELINES IN 2005, 2010, 2019–2021

Year	<i>References included in Proxy Statements of Top 100 Corporations</i>			<i>References included in Proxy Statements</i>		
	References	Sample Size	Percentage	References	Sample Size	Percentage
2005	10	84	11.90%	31	400	7.75%
2010	14	88	15.91%	35	435	8.05%
2019	24	99	24.24%	53	494	10.73%
2020	21	98	21.43%	43	493	8.74%
2021	21	84	25.00%	38	417	9.13%
Average	18	90.60	19.70%	40	447.8	8.88%

When focusing on the largest 100 corporations in the S&P 500, the analysis reveals that in 2005 – 2021 a significant percentage of proxy statements encompass explicit references to corporate guidelines made by corporations or activist shareholders, as Graph 1 reflects.

GRAPH 1. PROXY STATEMENTS OF S&P 500 TOP 100 CORPORATIONS THAT INCLUDED EXPLICIT REFERENCES TO GUIDELINES IN 2005–2021



Finally, explicit references by corporations and shareholders to the guidelines cover a wide range of corporate governance topics. Some of the proxy statements include references – made by corporations or shareholders – to more than a single topic. Table 2 summarizes the references by topic.

TABLE 2. NUMBER OF EXPLICIT REFERENCES TO GUIDELINES (MADE BY CORPORATIONS AND SHAREHOLDERS) IN 2005, 2010, 2019–2021, BY TOPICS

Subject	2005		2010		2019		2020		2021	
	Corp.	Sh.	Corp.	Sh.	Corp.	Sh.	Corp.	Sh.	Corp.	Sh.
General Statement	1	-	3	-	26	-	27	-	23	-
Enhance Proxy Access	-	-	-	-	2	7	-	1	-	1
Right To Act By Written Consent	-	-	-	-	-	-	-	8	-	2
Elimination of Supermajority Voting Requirement for By-Law Amendment	-	9	-	3	1	2	-	2	-	-
Commulative / Majority Voting for Director Elections	-	1	-	3	-	4	-	1	-	-
Workforce Involvement in Corporate Governance	-	-	-	-	-	-	-	-	1	-
Equal Shareholder Voting (Multi-Class Voting Structure)	-	-	-	-	-	1	-	1	-	1
Separation of CEO/Chairman Roles (Independent Chairman)	-	3	-	5	-	9	1	-	-	3
Right of Shareholders to Call a Special Meeting	-	-	-	12	-	4	-	1	-	3
Repeal of Classified Board	-	9	-	2	-	1	-	-	-	1
Rights Plan (Poison Pill)	-	3	-	1	-	-	-	-	-	-
Disclosure of Political Spending	-	-	-	-	-	1	-	1	-	-
Independent Directors	-	2	-	-	-	-	-	-	-	-
Tax Aspects	-	-	-	-	-	1	-	1	-	-
Executive Compensation	-	5	-	11	-	-	-	-	-	-
ESG	-	-	-	-	16	3	21	6	23	3

2. Corporations' References to Guidelines

Thus far, my analysis has focused on the aggregate number of explicit references to the guidelines made by both corporations and shareholders. Next, I am going to break down the aggregate data into two categories: references made by corporations and references made by shareholders. This breakdown gives us better resolution of the use of the guidelines by each group. The main finding is that both corporations and shareholders use the guidelines. This indicates that the guidelines have become a critical benchmark for both groups. In this subsection, I will present data on references made by corporations. In the next subsection, I will provide data on references made by shareholders.

The empirical analysis reveals that in the years 2019 through 2021, 32, 28, and 24 corporations, representing 6.48, 5.68, and 5.76 percent of the sample, issued explicit references to corporate guidelines. Most of the references were issued by the top 100 corporations, of which 13.13, 12.24, and 13.10 percent made such references.

In order to obtain a more accurate sense of corporate guidelines, proxy statements by the S&P 500 corporations in 2005 and 2010 were also examined.¹⁴¹ This examination reveals that 1 and 3 corporations, constituting 0.25 and 0.69 percent of the corporations in the sample, issued explicit reference to corporate guidelines.

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

Table 3 presents summary statistics on explicit references made by corporations in 2005, 2010, and 2019 through 2021.

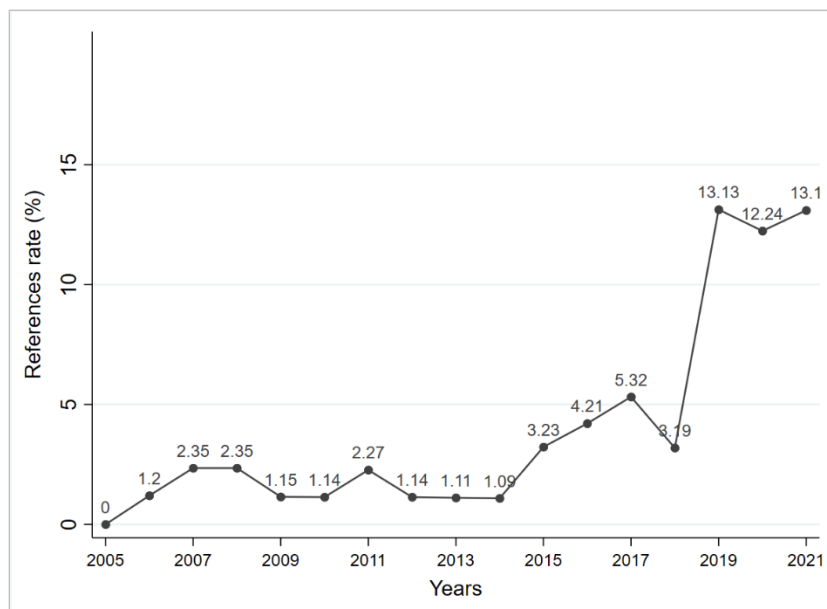
¹⁴¹ For consistency's sake, I examined only corporations that are also included in the 2019-2021 analysis, meaning corporations included in the S&P 500 list as of December 10, 2019.

TABLE 3. EXPLICIT REFERENCES MADE BY S&P 500 CORPORATIONS TO GUIDELINES IN 2005, 2010, 2019–2021

Year	Top 100 Corporations that Made a Reference to the Guidelines			Corporations that Made a Reference to the Guidelines		
	References	Sample Size	Percentage	References	Sample Size	Percentage
2005	0	84	0.00%	1	400	0.25%
2010	1	88	1.14%	3	435	0.69%
2019	13	99	13.13%	32	494	6.48%
2020	12	98	12.24%	28	493	5.68%
2021	11	84	13.10%	24	417	5.76%
Average	7.40	90.60	7.92%	17.60	447.80	3.77%

A widening of the time frame examined of the S&P 500 top 100 corporations, from 2005 through 2021, reveals a rise in explicit references made by corporations starting in 2015. In the years 2019 to 2021 a material spike in explicit references is shown. Graph 2 presents a statistical summary on the percent of explicit references made by corporations.

GRAPH 2. PERCENTAGE OF EXPLICIT REFERENCES TO GUIDELINES MADE BY THE S&P 500 TOP 100 CORPORATIONS IN 2005–2021



Note that references made by corporations to corporate guidelines on executive compensation issues are excluded from the dataset as every proxy statement contains such references. Also, the statistics do not include the statements that corporations have revised their policies in response to their investors' views or sentiments. This is because it is not clear from the proxy statements whether the corporations learned about the investors' views or sentiments through active dialogue, by studying corporate guidelines, or both.

Explicit reference statistics, however, do not reflect the full effect of corporate guidelines. There is an important connection between the guidelines and industry *best practices*. The content of the guidelines may inspire, inform, or augment an industry best practice. Thus, when corporations make references to best practices, they indirectly make references to the guidelines. To capture this effect, I analyzed the data from 2019 to identify references to best practices. My empirical analysis shows that in addition to explicit references to corporate guidelines made in 2019, 226 corporations, comprising 45.2 percent of the sample, declared that their boards reviewed the corporation's policies, frameworks, and guidelines according to current and evolving best practices, or emphasized that their governance guidelines were aligned with best practices or that they were committed to best practices. The guidelines' influence on best practices may create a derivative effect. Corporations and shareholders referred to *statistics* on certain governance arrangements adopted by corporations included in S&P 500, S&P 1500, or Fortune 100. Shareholders referred to statistics on best practices to support their proposals in 42 proxy statements, representing 8.4 percent of the sample, 17 of which were statements of the 100 largest companies. Corporations referred to statistics on best practices in 30 proxy statements, 28 of which were made in response to a shareholder proposal.

3. Shareholders' References to Guidelines

Not just corporations make explicit references to corporate guidelines. Shareholders that submit proposals to their corporations also refer to corporate guidelines in order to support their proposals and convince corporations to make changes and adopt certain governance arrangements. As the analysis highlights, in 2005, 30 corporations (7.50 percent of the sample) received shareholder proposals that referred to corporate guidelines.

With respect to 2010, 33 corporations (7.59 percent of the sample) received shareholder proposals that referred to corporate guidelines.

Thereafter, in 2019, 28 corporations (5.67 percent of the sample) received shareholder proposals that referred to corporate guidelines. Most of the references

were included in the proposals submitted to the largest corporations, including 14.14 percent of the top 100 corporations.

In 2020, 17 corporations (3.45 percent of the sample) received shareholder proposals that referred to corporate guidelines. Most of the references were included in the proposals submitted to the largest corporations, including 10.201 percent of the top 100 corporations. Finally, in 2021, 14 corporations (3.36 percent of the sample) received shareholder proposals that referred to the corporate guidelines. Most of the references were included in the proposals submitted to the largest corporations, including 11.90 percent of the top 100 corporations.

The fact that explicit references to corporate guidelines—by both corporations and shareholders that targeted these corporations—appear in the proxy statements of the largest corporations comports with my hypothesis about the centrality of the guidelines to corporate governance. The largest corporations attract much more attention from the media, practitioners, academia, policymakers, shareholders, and other corporations, than smaller ones.

Table 4 presents summary statistics on references made by shareholders who targeted S&P 500 corporations.

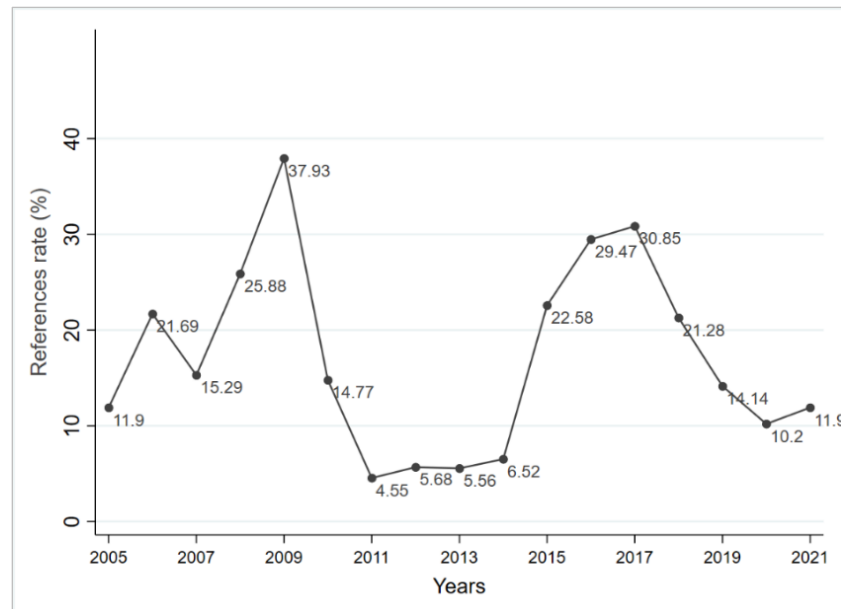
TABLE 4. EXPLICIT REFERENCES TO GUIDELINES MADE BY ACTIVIST SHAREHOLDERS WHO TARGETED S&P 500 CORPORATIONS IN 2005, 2010, 2019–2021

Year	<i>Proxy Statements of Top 100 Corporations that Include References made by Shareholders</i>			<i>Proxy Statements of Corporations that Include References made by Shareholders</i>		
	References	Sample Size	Percentage	References	Sample Size	Percentage
2005	10	84	11.90%	30	400	7.50%
2010	13	88	14.77%	33	435	7.59%
2019	14	99	14.14%	28	494	5.67%
2020	10	99	10.20%	17	493	3.45%
2021	10	84	11.90%	14	417	3.36%
Average	11.40	90.60	12.59%	24.40	447.80	5.51%

The collected data of the S&P 500 top 100 corporations in the years 2005 through 2021 show changes in shareholders' activity during this period. A spike in shareholders' activity is noted in years 2008 and 2009 and can be linked to the financial crisis. The two

primary foci of shareholders' proposals in these years are executive compensation and shareholder's right to call for a special meeting. These topics align with shareholder's interests with regard to the influences of the financial crisis. Graph 3 presents the summary statistics of guideline references by shareholders in the proxy statements of S&P 500 top 100 corporations from 2005 through 2021.

GRAPH 3. PERCENTAGE OF EXPLICIT REFERENCES MADE BY ACTIVIST SHAREHOLDERS THAT TARGETED S&P 500 TOP 100 CORPORATIONS IN 2005–2021



B. Guidelines as a Device Used by Corporations: A Descriptive Analysis

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

The purpose of these communications is clear: to satisfy investors, especially large institutional investors, by signaling corporations' commitment to existing and potential investors. Some corporations invest special efforts to impress investors. For example, Delta Air Lines stated in its 2019 Annual Meeting Proxy Statement that "[i]n 2018, Delta was named as a 'Most Honored Company' by the financial journal Institutional Investor, which ranked Delta's investor relations effort number

1 in the airline category.”¹⁴² Similarly, Honeywell International, Inc., described in detail all of the recent awards it received from institutional investors (most honored company, leadership award, best investor relations, etc.).¹⁴³ Similar statements appear in proxy statements of other leading companies.¹⁴⁴

Another means to express corporations’ commitment to large institutional investors is to explain how corporations’ guidelines and the guidelines established by institutional investors are aligned. Among the leading corporations to declare how they conform to the guidelines and standards of institutional investors are Bank of America¹⁴⁵ and Salesforce.com.¹⁴⁶ Corporations also refer to the governance guidelines designed by the ISG and the CII, including the largest players such as BlackRock, State Street, T. Rowe Price, Vanguard, etc.¹⁴⁷ For example, UnitedHealth Group made such references when responding to a shareholder proposal to amend its proxy access bylaw provisions.¹⁴⁸ My research also reveals that corporations are making growing use of the ISG’s guidelines as a reference

¹⁴² Delta Air Lines, Inc., Proxy Statement (Schedule 14A) (May 10, 2019).

¹⁴³ Honeywell Int’l, Inc., Proxy Statement (Schedule 14A) (Mar. 14, 2019).

¹⁴⁴ *See, e.g.*, Merck & Co. (Schedule 14A) (April 8, 2019), at 27.

¹⁴⁵ Bank of America Corp., Proxy Statement (Schedule 14A) (Mar. 13, 2019) (“Through our Corporate Governance Committee, the Board regularly reviews and closely monitors stockholders’ views on the appropriate number of public company boards on which directors may serve. The Committee considers: the proxy voting guidelines of our major stockholders”).

¹⁴⁶ Salesforce.com, Inc., Proxy Statement (Schedule 14A) (Apr. 25, 2019) (“[T]he Board of Directors also recognizes that many investors and others now view supermajority voting provisions as unduly limiting the Board of Directors’ accountability to stockholders or stockholder participation in the corporate governance of the Company”).

¹⁴⁷ *Associate Members*, COUNCIL OF INST. INV’R, https://www.cii.org/associate_members (last visited Jan. 19, 2020).

¹⁴⁸ UnitedHealth Group, Inc., Proxy Statement (Schedule 14A) (Apr. 19, 2019) (“The 20 shareholder aggregation limit we adopted has been adopted by almost all U.S. listed companies implementing proxy access (approximately 93% as of December 31, 2018), and has been recognized by the Council of Institutional Investors as a market standard”).

point. Among the leading corporations to do so are Procter & Gamble,¹⁴⁹ Intel,¹⁵⁰ IBM,¹⁵¹ Target,¹⁵² and Gilead Sciences.¹⁵³

It may come as no surprise that today corporations disclose the level of their commitment to institutional investors' guidelines. In fact, institutional investors encourage companies to proactively disclose their compliance with their principles.¹⁵⁴ As State Street revealed in its Stewardship Report in 2019, "In instances of non-compliance when companies cannot explain the nuances of their governance structure effectively, either publicly or through engagement, we may vote against the independent board leader."¹⁵⁵ In this regard, it is worth noting that State Street has a structured, built-in process to monitor departures from its guidelines based on their portfolio companies' disclosures. As State Street reveals,

¹⁴⁹ The Procter & Gamble Co., Proxy Statement (Schedule 14A) (Aug. 23, 2019), <https://www.sec.gov/Archives/edgar/data/80424/000119312519227275/d738651ddef14a.htm> ("We have evaluated the Company's governance practices against the Corporate Governance Principles published by the Investor Stewardship Group ('ISG'), a collective of some of the largest U.S.-based institutional investors and global asset managers, and found they were highly consistent. P&G's strong corporate governance policies and practices are disclosed throughout this proxy statement, but the following table highlights some of the key ways that P&G's governance practices are consistent with ISG's Corporate Governance Principles"). The Proxy Statement also lists "Policies consistent with the Investor Stewardship Group's Corporate Governance Principles" and "Signatory to Commonsense Corporate Governance Principles 2.0" as "Corporate Governance Principles." *Id.*

¹⁵⁰ Intel Corp., Proxy Statement (Schedule 14A) (2019) ("These guidelines, which investors may find on our website at www.intel.com/governance, along with our other corporate governance practices, compare favorably under the Investor Stewardship Group's (ISG) Corporate Governance Framework for U.S. Listed Companies, as shown in the table below").

¹⁵¹ International Business Machines Corp., Proxy Statement (Schedule 14A) (Mar. 11, 2019) ("And this year, IBM became a signatory of the Commonsense Principles 2.0 and endorsed the Investor Stewardship Group's corporate governance principles"). The Proxy Statement further states that "[m]ost recently, the Company has been on the forefront of strong governance practices as a signatory to the Commonsense Principles 2.0, bringing the company and investor viewpoints on critical governance matters together. The Company also endorses the Investor Stewardship Group's principles on corporate governance to promote strong governance practices." *Id.*

¹⁵² Target Corp., Proxy Statement (Schedule 14A) (Apr. 29, 2019) ("For your convenience, we organized the corporate governance highlights listed above so you can see how our corporate governance practices compare favorably with the corporate governance principles developed by the Investor Stewardship Group (ISG), which includes some of the largest institutional investors and global asset managers and advocates for best practices in corporate governance").

¹⁵³ Gilead Sciences, Inc., Proxy Statement (Schedule 14A) (Mar. 25, 2019) ("We believe our strong corporate governance structures align with these ISG principles").

¹⁵⁴ Rick Lacaille & Rakhi Kumar, *2019 Proxy Voting and Engagement Guidelines: North America*, HARV. L. SCH. FORUM. CORP. GOV. (Mar. 27, 2019), <https://corpgov.law.harvard.edu/2019/03/27/2019-proxy-voting-and-engagement-guidelines-north-america/>.

¹⁵⁵ *Id.*

its stewardship activities are directly monitored by the State Street Global Advisors Investment Committee (IC), which is composed of several subcommittees. One of them, the Proxy Review Committee, “provides day-to-day oversight of the Stewardship Team, including approving departures from proxy voting guidelines.”¹⁵⁶ Like State Street, other large institutional investors may also diverge from their guidelines and best practices.¹⁵⁷

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

Furthermore, corporations sometimes refer to investors’ guidelines in response to shareholder proposals.¹⁵⁸ In doing so, corporations are aware of the fact that since the large institutional investors hold shares in the corporation, quite often ranging between 7%–10%, shareholders are likely to support their proposal with a statement regarding large investors’ guidelines in order to force the corporation to agree to adjust its policy.

When facing a shareholder proposal that uses institutional investors’ guidelines to convince the corporation to adopt certain policies, the board of this corporation has two options: to recommend the shareholders to vote “for” or “against” the proposal. When choosing to recommend against the proposal, as in fact happens most of the time, the board cannot just provide its bottom line, but rather it has to support its recommendation. This dynamic frequently forces corporations to open a dialogue with those institutional investors who choose to diverge from their own guidelines.

Lastly, as I will explain in Section IV.E below, in many cases, corporations refer to industry best practices, especially when responding to a shareholder proposal. In

¹⁵⁶ SSGA 2018-19, *supra* note 58, at 22. See also Edward B. Rock, *Institutional Investors in Corporate Governance*, in THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 363 (Jeffrey N. Gordon & Wolf-Georg Ringe, eds., 2015).

¹⁵⁷ Guido Ferrarini & Maria Cristina Ungureanu, *Executive Remuneration*, in THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 334, 354 (Jeffrey N. Gordon & Wolf-Georg Ringe, eds., 2015) (“In anticipation of the 2014 proxy season, Vanguard sent letters to approximately US 350 companies to proactively engage with them on governance issues. The letters are tailored to the individual companies and identify governance practices at the companies that Vanguard believes are not in line with what the asset manager views as best practices”).

¹⁵⁸ See, e.g., Booking Holdings, Inc., Proxy Statement, *supra* note 69 (declaring, in response to a shareholder proposal to enhance proxy access, “We adopted our current Proxy Access By-Laws after significant evaluation and deliberation by the Nominating and Corporate Governance Committee and the full Board of Directors and meaningful stockholder engagement. This thoughtful review included . . . a review of the corporate governance policies of some of our largest stockholders.”)

this regard, it is important to understand that when corporations refer to best practices, they are essentially indirectly referring to corporate guidelines because the best practices are strongly influenced by the guidelines.

C. Guidelines as a Device Used to Support Shareholder Proposals: A Descriptive Analysis

Some shareholders increasingly use institutional investors' guidelines as part of their proposals submitted to the corporation to be voted on at shareholder meetings. These shareholders are often activist hedge funds, which have significant incentives to invest in activism (in comparison to mutual funds),¹⁵⁹ or corporate gadflies, which are becoming dominant players in recent years.¹⁶⁰ Guidelines are being used by these players as a tool to convince corporations to follow certain practices. Usually, shareholders also include information regarding the way large institutional investors voted on the matter in their proposals.¹⁶¹

My dataset provides many examples of direct and specific references made by shareholder proposals to large institutional investors' guidelines. For example, shareholders referred to the guidelines when they called on Apple to improve proxy access;¹⁶² when they asked Amazon to reduce the ownership threshold for calling special shareholder meetings;¹⁶³ when they asked Alphabet (Google) to elect

¹⁵⁹ Zohar Goshen & Sharon Hanes, *The Death of Corporate Law*, 94 N.Y. U. L. REV. 263, 283–5 (describing the role played by hedge funds during the past years). See also Hamdani & Hanes, *supra* note 11; Kahan & Rock, *Hedge Funds*, *supra* note 13.

¹⁶⁰ Kobi Kastiel & Yaron Nili, *The Giant Shadow of Corporate Gadflies*, 94 S. CAL. L. REV. (forthcoming 2021) (discussing the growing importance of corporate gadflies). See also James R. Copland, *Frequent Fliers: Shareholder Activism by Corporate Gadflies*, PROXYMONITOR (2014), <https://www.proxymonitor.org/Forms/2014Finding5.aspx> (providing evidence regarding gadflies dominance); Steven Davidoff Solomon, *Grappling with the Cost of Corporate Gadflies*, N.Y. TIMES (Aug. 19, 2014), <https://dealbook.nytimes.com/2014/08/19/grappling-with-the-cost-of-corporate-gadflies/?mtrref=www.google.com&gwh=A39F4B83C27A2E8E2D06901656D5DC2A&gwt=pay&assetType=REGIWALL> (providing similar evidence).

¹⁶¹ See, e.g., Facebook, Inc., Proxy Statement (Schedule 14A) (Apr. 12, 2019) (including shareholder proposal to use majority voting for director elections, which states that “[a]mong our Company’s largest shareholders: T. Rowe Price Associates and BlackRock both voted FOR 88.9% of shareholder proposals on this topic. SSGA Funds Management voted FOR 100% of such proposals”).

¹⁶² Apple, Inc., Proxy Statement (Schedule 14A) (Jan. 8, 2019) (“BlackRock’s 2018 Proxy Voting Guidelines included the following: ‘In general, we support market-standardized proxy access proposals, which allow a shareholder (or group of up to 20 shareholders) holding three percent of a company’s outstanding shares for at least three years the right to nominate the greater of up to two directors or 20% of the board’”).

¹⁶³ Amazon.com, Inc., Proxy Statement (Schedule 14A) (Apr. 11, 2019) (“Large funds such as Vanguard, TIAA-CREF, BlackRock and SSGA Funds Management, Inc. (State Street) support the right of shareholders to call special meetings”).

directors by a majority vote;¹⁶⁴ and when they required ExxonMobil to separate the roles of the Chairman and the CEO.¹⁶⁵ Frequently, it is the same group of shareholders—known as “corporate gadflies”—who include references to institutional investors’ guidelines in their proposals.¹⁶⁶

These findings may shed light on a recent study conducted by Ian R. Appel, Todd A. Gormley, and Donald B. Klein, in which they found that passive investors affect the corporate governance of the companies in which they invest.¹⁶⁷ They discuss possible mechanisms by which passive investors may influence governance, such as “facilitating activism by other, non-passive investors.”¹⁶⁸ They assume that a “threat” of activism by others may be enough to enhance governance, and that such a threat is likely to increase when the “concentration of passive institutions’ ownership stakes” increases.¹⁶⁹

Furthermore, as my research reveals, shareholders also refer to the guidelines issued by the Council for Institutional Investors (CII). Such references were made, for example, by shareholders who submitted proposals to the Board of Amazon to modify the vote-counting practice;¹⁷⁰ by shareholders who submitted proposals to the Board of Facebook to give each share an equal vote¹⁷¹ and to separate the roles

¹⁶⁴ Alphabet, Inc., Proxy Statement (Schedule 14A) (Apr. 30, 2019) (“BlackRock’s proxy voting guidelines include the following: ‘Majority voting standards assist in ensuring that directors who are not broadly supported by shareholders are not elected to serve as their representatives.’ Among our Company’s largest shareholders: T. Rowe Price Associates and BlackRock both voted FOR 88.9% of shareholder proposals on this topic. SSgA Funds Management voted FOR 100% of such proposals”).

¹⁶⁵ Exxon Mobil Corp., Proxy Statement (Schedule 14A) (Apr. 11, 2019) (“Numerous institutional investors recommend separation of these two roles. For example, California’s Public Employee Retirement System’s Principles & Guidelines encourage separation, even with a lead director in place”).

¹⁶⁶ This group includes Mr. John Chevedden, Mr. James McRitchie, and Mr. Kenneth Steiner.

¹⁶⁷ Ian R. Appel, Todd A. Gormley, & Donald B. Klein, *Passive Investors, Not Passive Owners*, 121 J. FIN. ECON. 111 (2016) (finding that increased ownership by passive funds in companies is associated with an increased percentage of independent directors, a removal of takeover defenses, and a lower percentage of dual class share structures).

¹⁶⁸ *Id.* at 128.

¹⁶⁹ *Id.*

¹⁷⁰ Amazon.com, Inc., Proxy Statement, *supra* note 163 (“Policy 3.7 of the Council of Institutional Investors (CII, ‘The Voice of Corporate Governance’) declares that ‘abstentions should be counted only for purposes of a quorum’”).

¹⁷¹ Facebook, Inc., Proxy Statement, *supra* note 161 (“The Council for Institutional Investors (CII) recommends a seven year phase-out of dual class share offerings. The International Corporate Governance Network supports CII’s recommendation ‘to require to a time-based sunset clause for dual class shares to revert to a traditional one-share/one-vote structure no more than seven years after a company’s IPO date’”).

of the Chairman and the CEO;¹⁷² by a shareholder who asked the board of JPMorgan to adopt cumulative voting;¹⁷³ and by shareholders who submitted proposals to the Board of AT&T to modify proxy access requirements.¹⁷⁴

Lastly, shareholders may also rely on governance guidelines provided by institutional investors through other channels. For example, shareholders have referred to the annual letter sent by BlackRock Chairman and CEO Larry Fink to corporations in which BlackRock invests and their senior managements. Boeing's shareholders did so when they urged the Compensation Committee of the Board of Directors to adjust financial performance metrics to exclude the impact of share repurchases when determining the amount or vesting of any senior executive incentive compensation grant or award.¹⁷⁵ Similarly, Gilead Sciences' shareholders requested that the Board issue a report describing how Gilead plans to allocate tax savings as a result of the Tax Cuts and Jobs Act.¹⁷⁶ Institutional investors other than BlackRock use annual letters to communicate with the managements of their portfolio companies as well. In fact, "[i]t has become customary, over the last few years, for companies and other stakeholders to await annual letters from large institutional investors that provide insight into investor views."¹⁷⁷

¹⁷² *Id.* ("The Council of Institutional Investors argues: Having an independent chair helps the board carry out its primary duty—to monitor the management of the company on behalf of its shareowners. A CEO who also serves as chair can exert excessive influence on the board and its agenda, weakening the board's oversight of management. Separating the chair and CEO positions reduces this conflict, and an independent chair provides the clearest separation of power between the CEO and the rest of the board").

¹⁷³ JPMorgan Chase & Co., DEF 14A, <https://www.sec.gov/Archives/edgar/data/19617/000119312519098338/d695908ddef14a.htm>, at 90.

¹⁷⁴ AT&T, Inc., Proxy Statement (Schedule 14A) (Mar. 12, 2018) ("*Proxy Access: Best Practices 2017* (http://www.cii.org/files/publications/misc/Proxy_Access_2017_FINAL.pdf) by the Council of Institutional Investors (CII), notes that 'while proxy access has gained broad acceptance, some adopting companies have included, or are considering including, provisions that could significantly impair shareholders' ability to use it.' The report 'highlights the best practices CII recommends for implementing proxy access'").

¹⁷⁵ The Boeing Co., Proxy Statement (Schedule 14A) (Mar. 15, 2019) ("Large stock buybacks send 'a discouraging message about a company's ability to use its resources wisely and develop a coherent plan to create value over the long term,' Laurence Fink, chairman and CEO of BlackRock, wrote in an April 14, 2015 letter to S&P 500 Index companies.").

¹⁷⁶ Gilead Sciences, Inc., Proxy Statement, *supra* note 153 ("Larry Fink, CEO of BlackRock recently stated: 'Companies have not been explicit enough about their long-term strategies. In the United States, for example, companies should explain to investors how the significant changes to tax law fit into their long-term strategy. What will you do with increased after-tax cash flow, and how will you use it to create long-term value? This is a particularly critical moment for companies to explain their long-term plans to investors'").

¹⁷⁷ Pamela L. Marcogliese et al., *Synthesizing the Messages from BlackRock, State Street, and T. Rowe Price*, HARVARD L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Feb. 28, 2019),

Before moving forward, and just to complete the picture, it is worth noting that shareholders, besides referring to corporate guidelines, may also support their proposals by citing guidelines drafted by other individuals and entities such as index providers,¹⁷⁸ professional and academic opinion leaders,¹⁷⁹ and policymakers.¹⁸⁰

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

To better understand the push for corporate guidelines, and to have a more complete picture of the dynamic they create, it is worth examining the way law firms treat them when they advise their corporate clients. Today, the best U.S. law firms study institutional investors' philosophy, expectations, and vision through the analysis of their proxy voting guidelines, letters, and public statements.

Law firms are well aware of the fact that it is necessary for their corporate clients to have the support of large institutional investors when asking shareholders to vote for proposals initiated by the management, and when asking them to vote against

<https://corpgov.law.harvard.edu/2019/02/28/synthesizing-the-messages-from-blackrock-state-street-and-t-rowe-price/>; Cyrus Taraporevala, *CEO's Letter on SSGA 2022 Proxy Voting Agenda*, HARVARD L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Jan. 18, 2022), <https://corpgov.law.harvard.edu/2022/01/18/ceos-letter-on-ssga-2022-proxy-voting-agenda/>

¹⁷⁸ For example, when John Chevedden submitted to UPS a proposal for equal voting rights for each shareholder, he emphasized that “[l]ast year, S&P Dow Jones Indices said that companies with multiple classes of shares would be barred from entering its flagship S&P 500 index.” United Parcel Service, Inc., Proxy Statement (Schedule 14A) (Mar. 15, 2019). More generally, in this context it is useful to refer to Scott Hirst & Kobi Kastiel, *Corporate Governance by Index Exclusion*, 99 B.U. L. REV. 1229 (2019) (describing how index providers constitute another source of corporate governance rules).

¹⁷⁹ For example, a proposal submitted to the Board of Netflix, Inc., by activist shareholder John Chevedden, which recommended removing the requirement of supermajority vote, referred to Professor Lucian Bebchuk and his colleagues' position against supermajority vote. Netflix, Inc., Proxy Statement (Schedule 14A) (Apr. 23, 2019). Also, references to this article were made by Chevedden when he targeted Norfolk Southern Corp.; FirstEnergy Corp.; Twitter, Inc.; Skyworks Solutions, Inc.; Leidos Holdings, Inc. Similar references were made by James McRitchie when he targeted BlackRock, Inc.; and by other shareholders when they targeted Discovery, Inc.

¹⁸⁰ For example, a proposal submitted by Chevedden to Anthem, Inc., to eliminate the classified board structure, emphasized that “Arthur Levitt, former Chairman of the Securities and Exchange Commission said, ‘In my view it’s best for the investor if the entire board is elected once a year. Without annual election of each director shareholders have far less control over who represents them.’” Anthem, Inc., Proxy Statement (Schedule 14A) (Mar. 29, 2019). Similarly, a shareholder proposal submitted to the Board of Walt Disney Company requested the company to report on cyber security and data privacy, emphasized that “[i]n September 2017, the Co-Director of the SEC's Enforcement Division announced creation of a ‘Cyber Unit’ stating, ‘Cyber-related threats and misconduct are among the greatest risks facing investors and the securities industry.’” It also added that “[p]rior to becoming Chairman of the SEC, Jay Clayton wrote, ‘cyber-threats are among the most urgent risk to America's economic and national security and the personal safety of its citizens.’” The Walt Disney Co., Proxy Statement (Schedule 14A) (Jan. 11, 2019).

shareholder proposals adverse to management recommendations. As explained earlier, each large institutional investor typically holds between five to ten percent of the shares of a public corporation. Together, they frequently constitute a solid block of shares that can tip the scale in any voting process. As I explained in Section IV.B, complying with institutional investors' guidelines is a necessary condition to win the investors' support. Therefore, law firms frequently advise their clients to pay attention to and follow the guidelines.

One illustrative example is a memorandum sent by Davis Polk to a client, stressing that “[o]ne thing to note—as influential as these proxy advisory firms' voting guidelines are, it is just as, if not more, important to review the voting guidelines of the company's actual institutional shareholders.”¹⁸¹ Another example is the following statement made by Martin Lipton, the founding partner of Wachtell, Lipton, Rosen & Katz:

“Major institutional investors, including BlackRock, Fidelity, State Street and Vanguard have established significant proxy departments that make decisions independent of ISS and warrant careful attention. It is important for a company to know the voting policies and guidelines of its major investors, who the key decision-makers and point-persons are and how best to reach them. It is possible to mount a strong defense against an activist attack supported by ISS and gain the support of the major institutional shareholders.”¹⁸²

Other leading law firms also closely follow large institutional investors' evolving perspectives and views.¹⁸³

¹⁸¹ *Client Memorandum, A Say-on-Pay Update – Plus Strategies for Responding to a Negative Recommendation by a Proxy Advisory Firm*, DAVIS POLK (Nov. 29, 2018), https://www.davispolk.com/files/2018-11-29-a_say-on-pay_update_plus_strategies.pdf.

¹⁸² Martin Lipton, *Dealing with Activists Hedge Funds and Other Activist Investors*, HARV. L. SCH. FORUM. CORP. GOV. (Jan. 25, 2019), <https://corpgov.law.harvard.edu/2020/01/20/dealing-with-activist-hedge-funds-and-other-activist-investors-3/>.

¹⁸³ *See, e.g., Purpose, Culture and Long-Term Value—Not Just a Headline*, KIRKLAND & ELLIS (Feb. 11, 2019), https://www.kirkland.com/-/media/publications/governance-update/2019/02/kirkland-governance-update--feb-2019_final.pdf (stating that letters sent by “two of the world's largest long-term ‘passive’ investors [(BlackRock and State Street)] offer a powerful counterpoint to the seemingly never-ending short-term oriented agitation from activist hedge funds”); *BlackRock Publishes Updated Proxy Voting Guidelines*, WHITE & CASE (Feb. 21, 2018), <https://www.whitecase.com/publications/alert/blackrock-publishes-updated-proxy-voting-guidelines>; *Proxy Access—Now a Mainstream Governance Practice*, SIDLEY AUSTIN 6–8 (Feb. 1, 2018), <https://www.sidley.com/-/media/update-pdfs/2018/02/20180201-corporate-governance-report.pdf> (describing in detail institutional investors' policy to support proxy access [including policies of BlackRock, CalPERS, Fidelity, State Street T. Rowe Price, and Vanguard]); Richard J. Grossman & Demetrius A. Warrick, *Shareholder Activism Trends in the 2019 Proxy Season*, SKADDEN (Apr. 23, 2019), <https://www.skadden.com/insights/publications/2019/04/quarterly->

Other professionals in the corporate field use institutional investors' corporate guidelines as a reference point. For example, in October 2014, the Business Roundtable, an association of the CEOs of leading U.S. corporations, released a proposed voting policy on "Independent Chair Shareholder Proposals (U.S.)."¹⁸⁴ This policy referred to the perspectives of BlackRock and State Street on the matter.¹⁸⁵ Similarly, in its annual corporate directors survey published in 2019, PwC described new developments in the policies of State Street and BlackRock regarding gender diversity.¹⁸⁶

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

E. Best Practices

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

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

Such references are used as a tool to convince corporations to adopt certain governance arrangements. For example, a shareholder of Facebook who submitted a proposal that called the Board to elect directors by a majority vote supported his proposal by stating that "[m]ore than 89% of the companies in the S&P 500 have

insights/shareholder-activism-trends-in-the-2019-proxy; Marc S. Gerber, *US Corporate Governance Turning Up the Heat*. SKADDEN (Jan. 17, 2019), <https://www.skadden.com/insights/publications/2019/01/2019-insights/us-corporate-governance-turning-up-the-heat> (describing BlackRock's perspective regarding ESG issues).

¹⁸⁴ Business Roundtable, *2015 Proposed Voting Policy on "Independent Chair Shareholder Proposals (U.S.)"*, INSTITUTIONAL S'HOLDERS. SERVS. (Oct. 29, 2014), https://www.issgovernance.com/file/policy/Business_Roundtable.pdf.

¹⁸⁵ *Id.*, at 2–3.

¹⁸⁶ *The Collegiality Conundrum: Finding Balance in the Boardroom*, PwC 14 (2019), <https://www.pwc.com/us/en/services/governance-insights-center/assets/pwc-2019-annual-corporate-directors-survey-full-report-v2.pdf> [hereinafter *The Collegiality Conundrum*].

adopted majority voting for uncontested elections, as have 67% of the S&P 1500.”¹⁸⁷ A shareholder of Alphabet (Google) supported his proposal by exactly the same statement.¹⁸⁸ Similar use of best practices was made by shareholders with regard to other governance issues as well. For example, a shareholder of Pfizer supported his proposal to separate the role of the Chairman and the CEO, by stating that “[as of March 2017] 58% of S&P 1,500 firms separate these two positions and the number of companies separating these roles is growing.”¹⁸⁹ Similar proposals and statements have been made by shareholders of other companies as well.¹⁹⁰

In response to shareholder proposals that make such references, corporations also make similar references. For example, the Board of JPMorgan Chase & Co.’s response to a shareholder proposal on enhancing shareholder proxy access emphasized that “[t]he Firm’s proxy access by-law is aligned with current best practices and with prevailing practices among other U.S. companies.” The Board added that “[b]ased on a review of the Corporate Governance & Executive Compensation Survey 2018 by Shearman & Sterling, the terms of our proxy access by-law, including the re-nomination threshold, are consistent with the 67% of S&P 500 companies that have adopted proxy access.”¹⁹¹

F. Extension: Proxy Advisors’ Reliance on Corporate Guidelines and Investors Involvement in Designing Proxy Advisors’ Guidelines

Proxy advisors are considered as central players in corporate governance. During the past two decades, institutional investors have increasingly relied on proxy advisory firms, and many believe that institutional investors have outsourced their proxy voting and corporate governance decisions to proxy advisory firms. The leading proxy advisory firms—Institutional Shareholder Services (“ISS”) and Glass, Lewis & Co. (“Glass Lewis”), which together account for ninety-seven percent of the industry—have been called “de facto corporate governance regulators”¹⁹² and “de facto arbiters of U.S. corporate governance.”¹⁹³ In some cases, proxy advisors

¹⁸⁷ Facebook, Inc., Proxy Statement, *supra* note 161.

¹⁸⁸ Alphabet, Inc., Proxy Statement, *supra* note 164.

¹⁸⁹ Pfizer, Inc., Proxy Statement (Schedule 14A) (Mar. 14, 2019).

¹⁹⁰ *See, e.g.*, AbbVie, Inc., Proxy Statement (Schedule 14A) (Mar. 22, 2019) (“As of October 2018, 50% of the S&P 500 have separated the role of Chair and CEO. Furthermore, 31% of S&P 500 firms have an independent chair”). Although the above example includes accurate statistics, in some cases shareholder proposals mention the names only of leading corporations in which a requested governance arrangement was adopted.

¹⁹¹ JPMorgan Chase & Co., Proxy Statement, *supra* note 173.

¹⁹² Letter from Wachtell, Lipton, Rosen & Katz, to Elizabeth M. Murphy, Sec’y, SEC 6 (Oct. 19, 2010), <http://www.sec.gov/comments/s7-14-10/s71410-129.pdf>.

¹⁹³ Hearing before the House, *supra* note 40, at 2. For an overview of the evolution of the proxy advisory industry, see Eckstein & Hannes, *supra* note 85.

effectively controlled the vote of fifty percent of a corporation's total shares outstanding.¹⁹⁴

Similar to mutual funds, proxy advisory firms also lack capabilities and resources needed to research each company for which they provide voting advice or execute voting on behalf of their clients, i.e., institutional investors. For example, in June 2017, the ISS reported that its "Global Research team [located in the ISS's offices in Europe, North America, Asia, and Australia] consisted of approximately 460 analysts, including approximately 270 research analysts and 190 data analysts."¹⁹⁵ As Glass Lewis reports, it has around "380 employees worldwide, more than half of whom are dedicated to research."¹⁹⁶ These numbers are overshadowed by the enormous coverage proxy advisors are supposed to provide. As ISS currently reports, it "covers approximately 44,000 meetings in 115 countries yearly . . . working closely with clients to execute more than 10.2 million ballots representing 4.2 trillion shares."¹⁹⁷ Similarly, Glass Lewis reports that it covers "more than 20,000 meetings each year, across approximately 100 global markets."¹⁹⁸

In light of proxy advisors' lack of optimal capabilities to make an informed voting decision on each resolution submitted to a vote at every shareholder meeting, it is interesting to see that proxy advisors themselves rely on corporate guidelines to cope with their limited capacities. In the Roundtable on proxy process held by the SEC in November 2018, Mr. Gary Retelny, the President and the CEO of the ISS, explained that "what ISS does, essentially, is help [institutional investors] with the work flow . . . in actually executing those votes, based on [investors'] own individual custom policies."¹⁹⁹ Ms. Katherine Rabin, who served as the CEO of Glass Lewis, made a similar statement.²⁰⁰ Relatedly, proxy advisors' lack of capabilities may shed light on their reliance on their own guidelines, which has attracted much criticism. Critics have attacked proxy advisors for their "one size fits all" approach.²⁰¹

Interestingly, institutional investors not only design their own guidelines, but are also involved in the process in which proxy advisory firms develop their voting guidelines. A look at the development process of ISS guidelines can illustrate such

¹⁹⁴ Eckstein & Hannes, *supra* note 85, at 110.

¹⁹⁵ *Due Diligence Compliance Package*, INSTITUTIONAL S'HOLDER. SERVS. (Nov. 2017), <https://www.issgovernance.com/file/duediligence/Due-Diligence-Package-November-2017.pdf>.

¹⁹⁶ *About Us*, GLASS LEWIS, <https://www.glasslewis.com/company-overview/> (last visited May 18, 2020).

¹⁹⁷ *About ISS*, INSTITUTIONAL S'HOLDER. SERVS., <https://www.issgovernance.com/about/about-iss/> (last visited May 18, 2020).

¹⁹⁸ *About Us*, GLASS LEWIS, <https://www.glasslewis.com/company-overview/> (last visited May 18, 2020).

¹⁹⁹ SEC Roundtable 2018, *supra* note 45, at 192.

²⁰⁰ *Id.* at 193: "[A]t the end of the day, what we're doing is executing votes in accordance with the specific instructions of our clients. Whatever policy it is, it's their policy."

²⁰¹ Eckstein & Hannes, *supra* note 85, at 110.

involvement. This process includes four major phases: 1) survey: when ISS invites institutional investors, corporate issuers, and corporate governance organizations to respond to a survey regarding selected policy positions; 2) roundtable: ISS holds a roundtable to discuss with investors and issuers means to promote corporate guidelines; 3) comments: ISS publishes draft guidelines and gets feedback from investors and issuers; and 4) final guidelines: ISS publishes the final version of its guidelines for the subsequent proxy season.²⁰²

As reported by the ISS, it received inputs from 121 institutional investors and 382 corporate issuers for its 2017 Governance Principles Survey;²⁰³ 107 responses from institutional investors and 469 responses from corporations for its 2018 Survey;²⁰⁴ and 128 responses from investors and 227 responses from corporate executives for its 2019 Survey, which covered issues such as board gender diversity, director overboarding, combined CEO and chair, capital structure (including multi-class shares), etc.²⁰⁵ These data indicate that both institutional investors and corporations have a strong interest in proxy advisors' guidelines.²⁰⁶ Similarly, although Glass Lewis, the other leading proxy advisory firm, does not disclose the process for designing its guidelines, its process also includes inputs from institutional investors and corporations.²⁰⁷

²⁰² James R. Copland, David F. Larcker, & Brian Tayan, *The Big Thumb on the Scale: An Overview of the Proxy Advisory Industry* (Stanford Univ. Graduate Sch. of Bus., Research Paper No. 18-27, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3188174.

²⁰³ *2017–2018 Global Policy Survey: Summary of Results*, INSTITUTIONAL S'HOLDER. SERVS. (Sep. 25, 2017), <https://www.issgovernance.com/file/policy/2017-2018-iss-policy-survey-results-report.pdf>.

²⁰⁴ *2018 Governance Principles Survey: Summary of Results*, INSTITUTIONAL S'HOLDER. SERVS. (Sep. 18, 2018), <https://www.issgovernance.com/file/policy/2018-2019-iss-policy-survey-results-report.pdf>.

²⁰⁵ *2019 Global Policy Survey: Summary of Results*, INSTITUTIONAL S'HOLDER. SERVS. (Sep. 11, 2019), <https://www.issgovernance.com/file/policy/2019-2020-iss-policy-survey-results-report.pdf>.

²⁰⁶ See David F. Larcker, Allan L. McCall, & Brian Tayan, *The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions*, STANFORD GRADUATE SCH. BUS. (Mar. 2012) (“During the 2011 proxy season, 72.0 percent of companies reviewed the policies of a proxy advisory firm or engaged with a proxy advisory firm to receive feedback and guidance on their proposed executive compensation plan”).

²⁰⁷ Courteney Keatinge & Kern McPherson, *2020 Policy Guidelines—United States*, HARV. L. SCH. FORUM. CORP. GOV. (Nov. 13, 2019), <https://corpgov.law.harvard.edu/2019/11/13/2020-policy-guidelines-united-states/>.

CONCLUSION

Institutional investors, while often the largest shareholders in their portfolio companies, have little incentive to actively shape the companies' corporate governance regimes. There are two common explanations for this phenomenon: (1) active engagements are too costly because initiating an activist campaign is expensive and may disrupt the complex business relationships between investors and their portfolio companies; and (2) institutional investors are "rationally reticent" and thus only respond to others' shareholder proposals, instead of submitting their own. Institutional investors draw criticism for underinvesting in corporate governance. However, the critics ignore the power of a passive corporate governance instrument used by the investors: corporate guidelines. In this Article, I have explained the growing importance of corporate guidelines through the lenses of investors, corporations, shareholders, and other stakeholders.

Corporate guidelines, a set of sound principles and practices in corporate governance, are published by institutional investors to instruct their portfolio managers on voting decisions. Given institutional investors' holdings in their portfolio companies, their voting decisions have a significant impact on the governance policies in those companies. In short, studying corporate guidelines is not meaningless and it requires a broader scope than just focusing on the most observable voting patterns.

Investors have three main motivations to use corporate guidelines: First, the guidelines make it possible for institutional investors to fulfill their fiduciary duties, on the one hand, and stay cost-effective, on the other. Second, the guidelines allow institutional investors to avoid direct confrontations with the managements of their portfolio companies. Third, the development of corporate guidelines is part of the global push for the standardization of corporate law.

Corporations are not only passive targets that corporate guidelines are directed to influence, but also active users of those guidelines. The empirical part of this Article has shown that in the years 2005 through 2021 the top 100 S&P 500 corporations made over this period increasing explicit references to corporate guidelines in their proxy statements in order to signal their commitment to sound corporate governance principles and to support their governance policies or their responses to shareholder proposals. The Article further demonstrates that other market actors and institutions routinely rely on corporate guidelines. Activist shareholders cite the guidelines to make their proposals more convincing. Proxy advisory firms, which bear heavy burden to vote, also rely on pooling corporate guidelines and inputs from various investors to conceive and conclude on their voting decisions. It can therefore be stated that the corporate guidelines have become a principal mechanism that institutional investors use to shape corporate governance.