NOW IS THE TIME TO DESIGNATE PROXY ADVISORS AS FIDUCIARIES UNDER ERISA

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ABSTRACT

Now is the time to designate proxy advisors as investment advice fiduciaries under the Employee Retirement Income Security Act of 1974 (ERISA). Such a designation is not only necessary to correct long standing concerns, but also to make sure voting recommendations are in compliance with the sole objective required by ERISA, shareholder wealth maximization (SWM). Utilizing voting recommendations that do not have SWM as their objective, e.g., utilizing Environmental, Social, and Governance (ESG) objectives, would be in direct conflict with the fiduciary duties of an ERISA plan manager when managing the shareholder voting rights of a plan.

Being designated investment advice fiduciaries under ERISA would require proxy advisors, like plan managers, to not only be constantly guided by the fiduciary principles of *solely in the interest of the participants and beneficiaries*, *exclusive purpose of providing benefits to them* and the *prudent man* standard in the creation of its voting recommendations for ERISA plans, but also must have, without exception, SWM as their fiduciary objective when creating voting recommendations for ERISA plan managers. This means that ESG objectives cannot creep into these voting recommendations. To explain why this is so, a substantial portion of this Article is devoted to explaining how ESG interacts with the fiduciary duties of ERISA.

INTRODUCTION

In the United States, federal securities laws are primarily administered by the Securities and Exchange Commission (SEC). However, the Department of Labor (DOL), through its administration of the Employee Retirement Income Security Act of 1974 (ERISA), also has an important role to play

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as a securities regulator, especially in the area of investment management.[1] This importance is evidenced by the over $11 trillion worth of assets[2] held in ERISA "employee pension benefit plans."[3]

Under ERISA, those who manage plan assets or provide investment advice owe the strictest duties of loyalty and care to their beneficiaries[4] and participants.[5] These duties are comparable to what is found under the common law of trusts.[6] Moreover, since the famous Avon letter of 1988, it has been DOL policy that the fiduciary act of managing plan assets also includes managing the voting rights associated with a plan's equity holdings.[7]

Given that shareholder voting carries with it fiduciary duties, it is somewhat surprising to find that proxy advisors, the primary providers of shareholder voting recommendations,[8] have yet to be designated *investment advice fiduciaries* under Section 3(21)(A)(ii) of ERISA.[9] However, the time is now at hand. In the spring of 2019, the DOL announced that it was in the process of preparing a proposed rule ("forthcoming Proposed Rule 1") that targets proxy voting with the objectives of "(1) addressing practices that could present conflicts of interest associated with proxy advisory firm recommendations; (2) ensuring that proxy voting decisions are based on best information; and (3) ensuring that proxy voting decisions are solely in the interest of, and for the exclusive purpose of providing plan benefits to, participants and beneficiaries."[10]

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[1] Anita K. Krug, *The Other Securities Regulator: A Case Study in Regulatory Damage*, 92 TUL. L. REV. 339 341 (2017).

[2] Marlene Satter, *Retirement Assets Hit $29.2T: ICI Report*, THINKADVISOR, (Dec. 27, 2018) ($8.1 trillion in employer-sponsored Defined Contribution plans and $3.2 trillion in private-sector Defined Benefit plans), https://www.thinkadvisor.com/2018/12/27/retirement-assets-hit-29-2t-ici-report/.

[3] Under ERISA § 2(A), '"the terms "employee pension benefit plan" and "pension plan" mean any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund, or program − (i) provides retirement income to employees, or (ii) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond, …"'

[4] ERISA § 3(8) (The term "beneficiary" means a person designated by a participant, or by the terms of an employee benefit plan, who is or may become entitled to a benefit thereunder.").

[5] ERISA § 3(7) (The term "participant" means any employee or former employee of an employer, or any member or former member of an employee organization, who is or may become eligible to receive a benefit of any type from an employee benefit plan which covers employees of such employer or members of such organization, or whose beneficiaries may be eligible to receive any such benefit.").

[6] *See infra*, Part I.

[7] *Id.*

[8] Under ERISA § 2(A), '"the terms "employee pension benefit plan" and "pension plan" mean any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund, or program − (i) provides retirement income to employees, or (ii) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond, …"'

[9] ERISA § 3(21)(A)(ii).

[10] Department of Labor, *Proxy Voting Update*, RIN: 1210-AB91 (Spring 2019), https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201904&RIN=1210-AB91.

In addition, the DOL announced a related forthcoming proposed rule specifically targeting investment advice fiduciaries ("forthcoming Proposed Rule 2").[11] This forthcoming proposed rule will address the defects in the highly criticized and recently vacated 2016 fiduciary rule.[12] In that final rule, the DOL was found to have overreached in trying to designate almost all finance professionals who deal with ERISA plans as investment advice fiduciaries.[13] If the forthcoming Proposed Rule 2 is going to continue to pursue the idea of increasing the number and type of investment advice fiduciaries, but with a much more limited focus to make sure that statutory constraints are met, then a major focus should be on proxy advisors.

The DOL's forthcoming proposed rule making coincides with similar work going on at the Securities and Exchange Commission (SEC). At the SEC, Chairman Clayton has initiated a proxy process review that has as one of its major focuses the conflicts of interests and precision of voting recommendations of proxy advisors.[14] In response, I and others have written reports, law review articles and comment letters extensively detailing these concerns and what can be done to enhance the value of a proxy advisor's voting recommendations.[15]

Therefore, the time is now ripe to designate proxy advisors as investment advice fiduciaries. Such a designation is not only necessary to correct long standing concerns, but also to make sure voting recommendations are in compliance with the sole objective required by ERISA, shareholder wealth maximization (SWM). Utilizing voting recommendations that do not have SWM as their objective, e.g., utilizing Environmental, Social, and Governance (ESG) objectives, would be in direct conflict with the fiduciary duties of an ERISA plan manager (trustee who retains investment and

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[11] Department of Labor, *Fiduciary Rule and Prohibited Transaction Exemptions*, RIN: 1210-AB82 (Spring 2019), https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201904&RIN=1210-AB82.

[12] Chamber of Commerce of the USA v. United States Department of Labor, No. 17-10238 (5th Cir. 2018) at 31/38, https://www.ca5.uscourts.gov/opinions/pub/17/17-10238-CV0.pdf.

[13] *Id.* at 5/38 ("Consequently, it encompasses virtually all financial and insurance professionals who do business with ERISA plans and IRA holders.").

[14] Chairman Jay Clayton, U.S. Securities and Exchange Commission, *Statement Announcing SEC Staff Roundtable on the Proxy Process*, (July 30, 2018), https://www.sec.gov/news/public-statement/statement-announcing-sec-staff-roundtable-proxy-process.

[15] The following is a sampling of those writings: Bernard S. Sharfman, *Enhancing the Value of Shareholder Voting Recommendations*, TENN. L. REV. (forthcoming, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3305372; Letter from Bernard S. Sharfman to Mr. Brent J. Fields, Secretary, Securities and Exchange Commission (October 12, 2018) (the text of this letter was reprinted in THE HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION on November 2, 2018)), https://www.sec.gov/comments/4-725/4725-4513625-175932.pdf.; Bernard S. Sharfman, *Beware a Proxy Advisor's M&A and Proxy Contest Advice*, REALCLEARMARKETS (May 28, 2019), https://www.realclearmarkets.com/articles/2019/05/28/beware_a_proxy_advisors_ma_and_proxy_contest_advice_103753.html ("If proxy advisors such as ISS are to provide informed and precise voting recommendations on proxy contests and M&A, then they must invest vastly greater resources into generating their voting recommendations."); Bernard Sharfman, *From Across the Atlantic, Guidance for the SEC's Oversight of Proxy Advisors, Corporate Governance Blog*, THE CONFERENCE BOARD (June 24, 2019), https://www.conference-board.org/blog/postdetail.cfm?post=7076; Letter from Chris Netram, Vice President, Tax & Domestic Economic Policy to Mr. Brent J. Fields, Secretary, Securities and Exchange Commission, Re: File No. 4-725: SEC Staff Roundtable on the Proxy Process (March 5, 2019), https://www.sec.gov/comments/4-725/4725-5020171-182986.pdf; Frank M. Placenti, *Are Proxy Advisors Really a Problem?*, American Council for Capital Formation (October 2018), http://accfcorpgov.org/wp-content/uploads/2018/10/ACCF_ProxyProblemReport_FINAL.pdf.; Timothy M. Doyle, American Council for Capital Formation, *The Conflicted Role of Proxy Advisors* (May 2018), http://cdn.accf.org/wp-content/uploads/2018/05/ACCF-The-Conflicted-Role-of-Proxy-Advisor-FINAL.pdf.

voting authority or an investment manager who receives such authority through delegation by the trustee) when managing the voting rights of a plan.[16]

Being designated investment advice fiduciaries under ERISA would require proxy advisors, like plan managers, to not only be constantly guided by the fiduciary principles of *solely in the interest of the participants and beneficiaries*, *exclusive purpose of providing benefits to them* and the *prudent man* standard in the creation of its voting recommendations for ERISA plans, but also must have, without exception, SWM as their fiduciary objective when creating voting recommendations for ERISA plan managers. This means that ESG objectives cannot creep into these voting recommendations. To explain why this is so, a substantial portion of this Article is devoted to explaining how ESG interacts with the fiduciary duties of ERISA.

In addition, there are several supplemental recommendations that are necessary to support the primary recommendation of designating of proxy advisors as investment advice fiduciaries. These are discussed in much more detail in Part VII, but include:

- Proxy advisors must provide voting recommendations for ERISA plans that are exclusively focused on SWM. For ISS, this would require a new SWM specialty report for each ERISA plan client. Moreover, since Taft-Hartley plans come under the fiduciary duties of ERISA, the ISS Taft-Hartley specialty report, notable for its policy of being in compliance with AFL-CIO guidelines, would need to be withdrawn and replaced with the same SWM specialty report.

- While the focus of this Article has not been on the *stewardship teams* of large mutual fund families, they also need to be designated investment advice fiduciaries. Like proxy advisors, stewardship teams provide shareholder voting recommendations. Unlike proxy advisors, they have a much more restricted client base, the mutual fund families that they have created and/or manage. The designation of investment advice fiduciary would be required when an investment adviser with a stewardship team has been appointed the investment manager of an ERISA plan, the trustee has delegated shareholder voting authority to the investment adviser, the investment adviser's mutual funds are investment options for ERISA beneficiaries and participants, and the stewardship teams are providing voting recommendations to these mutual funds.

- Proxy advisors must abstain from providing ERISA plans with voting recommendations on environmental and social shareholder proposals unless they have a compelling reason to believe the board is uninformed. This will be a difficult standard to meet. In terms of evaluating how such proposals impacts shareholder wealth, the board and executive management have a large comparative advantage. Unlike the proxy advisor, they have access to inside information and the ability and resources to do a thorough financial analysis. Also, and perhaps most importantly, in terms of evaluating such proposals from the perspective of SWM, it can be assumed that the board is not conflicted.

[16] *See infra*, Part II.

- To help the DOL monitor a proxy advisor's compliance with their fiduciary duties, a proxy advisor should periodically provide the following information to the DOL:

  - Require a proxy advisor to provide a description of "the essential features of the methodologies and models applied."

  - Require a proxy advisor to provide information sources used in the creation of its voting recommendations.

  - Require a proxy advisor to describe the procedures in place to make sure that the voting recommendations provided ERISA plans meet the prudent man standard.

  - Require a proxy advisor to describe the procedures in place to make sure that the voting recommendations are exclusively tied to the objective of SWM.
  - Require a proxy advisor to describe the procedures in place to deal with a voting recommendation that is contested by a public company. These procedures must be consistent with the prudent man standard.

  - Require a proxy advisor to promptly identify and disclose to the DOL "any actual or potential conflict of interest or any business relationship that may influence" the creation of its voting recommendations.

  - Require a proxy advisor to disclose the procedures in place to determine when it will abstain from providing voting recommendations. As a resource constrained institution, there will be times when there are not enough resources available, e.g., expertise on a certain merger, proxy contest, or executive compensation in a certain industry or at a specific company, to make a voting recommendation that meets the prudent man standard.

Part I will discuss the two types of fiduciaries this writing is concerned with, plan managers and investment advice fiduciaries. Part II will discuss the fiduciary duties of plan managers required under ERISA. It will be shown that in the management of an ERISA plan's equity holdings, a plan manager must not only be constantly guided by the fiduciary principles of *sole interest*, *exclusive purpose* and the *prudent man* standard, but also must have, without exception, SWM as her fiduciary objective. Part III defines what is meant by ESG. This discussion is necessary before plunging into an analysis on how ESG, as either objectives or factors, impact the shareholder voting of plan managers. Part IV will discuss how ESG impacts the shareholder voting of plan managers. Part V discusses why plan managers need the help of proxy advisors. Part VI will discuss the issues involved with the voting recommendations of proxy advisors, both old and new, including ESG, and why they create a compelling case for the DOL to designate them as investment advice fiduciaries. Part VII will discuss not only the recommendation of designating proxy advisors as investment advice fiduciaries but also other supporting recommendations that are required for its implementation.

I. FIDUCIARIES UNDER ERISA

This writing requires an understanding of two types of fiduciaries and their duties under ERISA, plan managers and investment advice fiduciaries. The later being the type of fiduciary a proxy advisor can be designated under ERISA.

A. Plan Managers

Section 3(21)(A)(i) of ERISA provides that a "person is a *fiduciary with respect to a plan* to the extent (i) *he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets*.[17] Fiduciaries include trustees[18] who retain management control over the assets and investment managers[19] who are commonly delegated such authority by the trustees. Moreover, since 1988, when first presented in a formal Opinion Letter now commonly referred to as the "Avon letter,"[20] it has been DOL policy that the fiduciary act of managing plan assets also includes managing the voting rights associated with a plan's equity holdings.

In the Avon letter, the Pension and Welfare Benefits Administration, the DOL department that preceded the Employee Benefits Security Administration in the administration of ERISA,[21] stated that "In general, the *fiduciary* act of managing plan assets that are shares of corporate stock includes the management of voting rights *appurtenant* to those shares of stock."[22] This DOL policy has been affirmed by the DOL in 1990,[23] 1994,[24] 2008,[25] 2016,[26] and 2018.[27]

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[17] ERISA 3(21)(i).
[18] ERISA 405(c)(3).
[19] ERISA 402(c)(3).
[20] Letter from U.S. Dep't of Labor to Helmuth Fandl, Chairman of Retirement Board, Avon Products, Inc. (Feb. 23, 1988).
[21] Department of Labor, *History of EBSA and PWBA*, ("Until February 2003, EBSA was known as the Pension and Welfare Benefits Administration (PWBA)"), https://www.dol.gov/agencies/ebsa/about-ebsa/about-us/history-of-ebsa-and-erisa.
[22] *Id.*
[23] Letter from U.S. Dep't of Labor to Robert A.G. Monks, Institutional Shareholder Services, Inc. (Jan. 23, 1990) ("If either the plan or the investment management contract (in the absence of a specific plan provision) expressly precludes the investment manager from voting proxies, the responsibility for such proxy voting would be part of the trustees' exclusive responsibility to manage and control the assets of the plan.").
[24] *See* Department of Labor, *Interpretive bulletin relating to writing statements of investment policy, including proxy voting policy and guidelines*, 59 Fed. Reg. 38863 (July 29, 1994) ("… a statement of proxy voting policy would be an important part of any comprehensive statement of investment policy.").
[25] *See* Department of Labor, *Interpretive Bulletins Relating to the Employee Retirement Income Security Act of 1974*, 73 Fed. Reg. 61,732 (Oct. 17, 2008) ("The fiduciary act of managing plan assets that are shares of corporate stock includes the management of voting rights appurtenant to those shares of stock.")
[26] *See* Department of Labor, *Interpretive Bulletin Relating to the Exercise of Shareholder Rights and Written Statements of Investment Policy, Including Proxy Voting Policies or Guidelines*, 81 Fed. Reg. 95879 (Dec. 29, 2016) ("The Department's longstanding position is that the fiduciary act of managing plan assets which are shares of corporate stock includes decisions on the voting of proxies….").
[27] Department of Labor, Field Assistance Bulletin 2018-01 (April 23, 2018), https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-01.

B. Investment Advice Fiduciaries

Section 3(21)(A)(ii) of ERISA provides that a person is a fiduciary if (ii) he renders *investment advice* for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, ….”[28] However, ERISA does not define what is meant by “renders investment advice,”[29] leaving it to the DOL to designate what persons are deemed to be rendering investment advice and therefore fiduciaries under Section 3(21)(A)(ii).[30]

In 1975, one year after the enactment the of ERISA, the DOL created a five-part test to determine when a person is an “investment advice fiduciary” under Section 3(21)(A)(ii). The test can be summarized as follows:

> For advice to constitute “investment advice,” an adviser who does not have discretionary authority or control with respect to the purchase or sale of securities or other property for the plan must (1) Render advice as to the value of securities or other property, or make recommendations as to the advisability of investing in, purchasing or selling securities or other property (2) On a regular basis (3) Pursuant to a mutual agreement, arrangement or understanding, with the plan or a plan fiduciary, that (4) The advice will serve as a primary basis for investment decisions with respect to plan assets, and that (5) The advice will be individualized based on the particular needs of the plan.[31]

Given that the proxy advisory industry was not even in its infancy in 1975,[32] it should not be surprising that the test, when applied to proxy advisors, does not identify them as investment advice fiduciaries. Moreover, in 1975, shareholder voting was not yet understood to be a management function of an ERISA plan manager. Of course, this did not occur until the Avon letter was published in 1988.

In 2010, thirty five years later, the DOL revisited the issue of who is an investment advice fiduciary. It published a proposed rule that would have greatly expanded the number and types of persons that were to be considered fiduciaries.[33] By specifically including “advice and recommendations as to the exercise of rights appurtenant to shares of stock (e.g., voting proxies)” in

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[28] ERISA 3(21)(ii).

[29] Chamber of Commerce of the USA v. United States Department of Labor, No. 17-10238 (5th Cir. 2018) at 31/38, https://www.ca5.uscourts.gov/opinions/pub/17/17-10238-CV0.pdf.

[30] *Id.* citing 29 U.S.C. § 1135 (granting the DOL authority to adopt rules “to carry out the provisions” of ERISA, including to “define accounting, technical and trade terms used in such provisions”). For a good discussion of DOL discretion in this area of law, *see* Anita K. Krug, *supra* note 1.

[31] Department of Labor, Employee Benefits Security Administration, *Definition of the Term “Fiduciary,”* RIN 1210–AB32, 75 Fed. Reg. 65263, 65264 (proposed Friday, October 22, 2010) citing 40 FR 50842 (Oct. 31, 1975).

[32] United States Government Accountability Office, *Corporate Shareholder Meetings: Issues Relating to Firms That Advise Institutional Investors on Proxy Voting*, GAO-07-765 at 7-8 (June 2007) (Based on this report, it does not appear that proxy advisors even existed in 1975.), https://www.gao.gov/products/GAO-07-765.

[33] Department of Labor, *Definition of the Term “Fiduciary,”* 75 Fed. Reg. 65263 (proposed Friday, October 22, 2010), *supra* note 31.

the proposed rule," those additional persons would have included proxy advisors.[34] However, implementation of the rule failed as a result of strong public opposition to the general expansion.[35]

In 2016, the DOL once again tried to greatly expand the number and types of persons considered to be investment advice fiduciaries. This time it issued a final rule (the Fiduciary Rule of 2016) that did just that. [36] This rule also made proxy advisors investment advice fiduciaries under ERISA when making specific voting recommendations for a plan, but not when providing "guidelines or other information on voting policies for proxies that are provided to a broad class of investors without regard to a client's individual interests or investment policy, and which are not directed or presented as a recommended policy for the plan or IRA to adopt."[37] For example, when a proxy advisor posts its' voting guidelines on its website. The Fiduciary Rule of 2016 was heavily criticized for being an overreach of statutory authority[38] and was vacated by the 5th Circuit Court of Appeals in its 2018 decision, *Chamber of Commerce of the USA v. United States Department of Labor*.[39]

If the DOL tries in the future to designate proxy advisors as investment advice fiduciaries, then it would only need to make a few small wording changes to the five-part test to make it explicit that, consistent with the Avon letter, the providing of voting recommendations is a fiduciary duty under ERISA. That is, adding a reference to shareholder voting in parts 1 and 4 of the five-part test.

II. What are ERISA's Fiduciary Duties?

ERISA is a "comprehensive statute designed to promote the interests of employees and their beneficiaries in employee benefit plans."[40] Not surprisingly, Congress specified in ERISA that all fiduciaries, including plan managers and investment advice fiduciaries, must go about their work under the guidance of very strict fiduciary duties of *loyalty* and *care*.[41] These duties are very similar to what is found under the common law of trusts[42] and are succinctly described by the U.S. Supreme Court in *Central States, Southeast & Southwest Areas Pension Fund v. Central Transport, Inc.*:

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[34] *Id.* at 65266.

[35] For example, *see* Timothy J. Bartl, Senior Vice President and General Counsel, Center on Executive Compensation to Office of Regulations and Interpretations, Employee Benefits Security Administration, U.S. Department of Labor, *Comments on Definition of Proposed Fiduciary Rule* (Feb. 3, 2011) ("The Center is … concerned that the Proposed Regulation could potentially brand as fiduciaries numerous individuals and entities that provide basic services to plans that have not traditionally been considered fiduciary in nature."), http://www.execcomp.org/Docs/c11-21%20COEC%20Comments%20to%20DOL%20re%20Defn%20of%20Fiduciary.pdf.

[36] Department of Labor, *Definition of the Term "Fiduciary: Conflict of Interest Rule–Retirement Investment Advice*, RIN 1210–AB32, 81 Fed. Reg. 20946 (2016).

[37] *Id.* at 20967.

[38] *See* Anita K. Krug, *supra* note 1, at 347 (2017) ("[T]he DOL's adoption of it is an episode of failed rulemaking.").

[39] Chamber of Commerce of the USA v. United States Department of Labor, No. 17-10238 (5th Cir. 2018), https://www.ca5.uscourts.gov/opinions/pub/17/17-10238-CV0.pdf.

[40] *Id.* at 2/38 quoting *Shaw v. Delta Air Lines, Inc.,* 463 U.S. 85, 90, https://www.ca5.uscourts.gov/opinions/pub/17/17-10238-CV0.pdf.

[41] Central States, Southeast & Southwest Areas Pension Fund v. Central Transport, Inc., 472 U. S. 559, 570-71 (1985).

[42] *Id.*

> The manner in which trustee powers may be exercised, however, is further defined in the statute through the provision of strict standards of trustee conduct, also derived from the common law of trusts-most prominently, a standard of *loyalty* and a standard of *care*. Under the former, a plan fiduciary "shall discharge his duties with respect to a plan *solely in the interest of* the participants and beneficiaries and . . . for the *exclusive purpose* of providing *benefits* to participants and their beneficiaries; and . . . defraying reasonable expenses of administering the plan." 29 U. S. C. § 1104(a)(1)(A). See also § 1103(c)(1); cf. § 186(c)(5). Under the latter, a fiduciary "shall discharge his duties with respect to a plan . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a *prudent man* acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." § 1104(a)(1)(B).[43]

In sum, under ERISA, the guiding fiduciary principles of *solely in the interest* of the participants and beneficiaries, *exclusive purpose* of providing benefits to them, and the *prudent man* standard can never be waived.

A. Pursuit of Financial Benefits

Sole interest, exclusive purpose, and the prudent man standard are not the extent of fiduciary duties under ERISA. An ERISA plan manager must also be exclusively focused on the "pursuit of *financial* benefits for the plan beneficiaries:"[44]

> "providing benefits to participants and their beneficiaries" while "defraying reasonable expenses of administering the plan." Read in the context of ERISA as a whole, the term "benefits" in the provision just quoted must be understood to refer to the sort of financial benefits (such as retirement income) that trustees who manage investments typically seek to secure for the trust's beneficiaries.[45]

Therefore, ERISA fiduciary duties also incorporate a *mandatory* "common investor purpose,"[46] the "pursuit of *financial* benefits for the plan beneficiaries."[47] Even if the ERISA plan documents stated that other objectives could or must be pursued, such as helping to increase blue collar wages at public companies, this could not trump ERISA's fiduciary duties and would be void as a matter of public policy.[48] In sum, ERISA is explicitly constraining plan managers to solely focus on rates of return to help ensure that beneficiaries and participants ultimately receive what they are due, expect or hope for in terms of private pension benefits.

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[43] *Id.*

[44] Max M. Schanzenbach and Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, forthcoming, 72 STANFORD L. REV. at 15 (forthcoming 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3244665.

[45] Fifth Third Bancorp v. Dudenhoeffer, 134 S.Ct. 2459, 2468 (2014).

[46] This term is used in Sean Griffith's new article. *See* Sean J. Griffith, *Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority*, 98 TEX. L. REV. (forthcoming 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3404298.

[47] Schanzenbach and Sitkoff, *supra* note 44, at 15.

[48] Fifth Third Bancorp v. Dudenhoeffer at 2468 citing ERISA § 1110(a) ('"With irrelevant exceptions, "any provision in an agreement or instrument which purports to relieve a fiduciary from responsibility... for any ... duty under this part shall be void as against public policy"').

B. Shareholder Wealth Maximization as the Common Investor Purpose

The common investor purpose, the fiduciary "pursuit of *financial* benefits for the plan beneficiaries," in combination with the other fiduciaries duties required of a plan manager, can be achieved if the ERISA plan manager pursues the highest risk-adjusted return possible for the plan's beneficiaries and participants. From a practical perspective, it appears this to be the only way to approach the management of an ERISA plan without violating a plan manager's fiduciary duties. If the pursuit of this maximization does not occur, then other objectives such as third party interests or other motives, or negligence, must be in play.

For the management of equity holdings in an ERISA plan (common stock or any other type of security with company voting rights), the common investor purpose can only be achieved if it is interpreted to mean the pursuit of SWM. As so well put by Sean Griffith, "Shareholder wealth maximization is reducible, essentially, to return on equity, which in efficient markets, can be simplified even further to share price."[49] Utilizing the same logic as in the preceding paragraph, it appears that SWM is the only practical approach to the management of an ERISA plan's equity holdings without violating a plan manager's fiduciary duties. Therefore, in the management of an ERISA plan's equity holdings, a plan manager must not only be constantly guided by the fiduciary principles of *sole interest*, *exclusive purpose* and the *prudent man* standard, but also must have, without exception, SWM as her fiduciary objective. Moreover, going forward in this writing, SWM will be referred to as the common investor purpose that ERISA plan managers must aspire to in managing their equity holdings.

Of course, as so well stated by Ian Lee, "It cannot be ruled out, however, that, in some circumstances, an act, although not legally prohibited and not punished by markets, may be so obviously social welfare-reducing that despite managers' general lack of expertise at social welfare maximization it does not make sense to hold them to profit maximization."[50] For example, a company's use of slave labor in its overseas operations and a shareholder proposal that requires the company to stop using such labor. It would be hard to believe that an ERISA plan manager who supports such a proposal would be in breach of her fiduciary duties. However, the determination of fact patterns where, as a matter of public policy, an ERISA plan manager can veer from SWM in its investment management and shareholder voting rests on a very slippery slope. Therefore, if exceptions are to be made, it must be up to the courts and Congress to determine where the very limited exceptions to the general rule of SWM are to be found.

III. WHAT IS MEANT BY ESG

Being guided by ERISA's strict fiduciary principles will have major implications in the way a plan manager or investment advice fiduciary responds to the pressure of including ESG objectives and factors into their thinking and decision making, including shareholder voting. However, before such a discussion (found in Part IV) it is important to understand what is meant by ESG.

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[49] Griffith, *supra* note 46, at 22.

[50] Ian B. Lee, *Efficiency and Ethics in the Debate about Shareholder Primacy*, 31 DEL. J. CORP. L. 533, 578 (2006).

A. ESG as an Undefined Concept

ESG has as its roots the practice of avoiding investment in firms that make antisocial products.[51] This practice can be traced back to the 18th century.[52] However, this simple ethical approach to investing has morphed into what is now known as ESG, a concept that is so undefined as to be virtually all encompassing.[53] A good place to start is a description of ESG provided by SEC Commissioner Hester Peirce:

> E, S, and G tend to travel in a pack these days, which makes it hard to establish reliable metrics for affixing scarlet letters. *Governance* [G] at least offers some concrete markers, such as whether there are different share classes with different voting rights, the ease of proxy access, or whether the CEO and Chairman of the Board roles are held by two people. Even with these examples, however, people do not agree on which way they cut, and they may not cut the same way at every company. In comparison to governance, the environmental and social categories tend to be much more nebulous. The *environmental category* [E] can include, for example, water usage, carbon footprint, emissions, what industry the company is in, and the quantity of packing materials the company uses. The *social category* [S] can include how well a company treats its workers, what a company's diversity policy looks like, its customer privacy practices, whether there is community opposition to any of its operations, and whether the company sells guns or tobacco. Not only is it difficult to define what should be included in ESG, but, once you do, it is difficult to figure out how to measure success or failure.[54]

Moreover, "the ESG tent seems to house a shifting set of trendy issues of the day, many of which are not material to investors, even if they are the subject of popular discourse."[55]

B. ESG as a Stakeholder Model

Commissioner Peirce also stated that, '"ESG stands for "environmental, social, governance," but the "S" in ESG could just as well stand for "stakeholder."'[56] That is, ESG means that "greater attention should be paid to the interests of non-investor stakeholders and that by investing in initiatives and programs to promote the interests of these groups, the corporation will create long-term value that is larger, more sustainable, and more equitably shared among investors and society."[57] In sum, "[t]he corporation, the idea goes, should consider its impact on society as a whole."[58]

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[51] Schanzenbach and Sitkoff, *supra* note 44, at 6.
[52] *Id.* at 6-7.
[53] For a good discussion of this evolution, *see id*. at 6-11.
[54] Hester M. Peirce, SEC Commissioner, *Scarlet Letters: Remarks before the American Enterprise Institute* (June 18, 2019), https://www.sec.gov/news/speech/speech-peirce-061819.
[55] Hester M. Peirce, SEC Commissioner, *My Beef with Stakeholders: Remarks at the 17th Annual SEC Conference, Center for Corporate Reporting and Governance*, https://www.sec.gov/news/speech/speech-peirce-092118.
[56] *Id.*
[57] David F. Larcker, Brian Tayan, Vinay Trivedi, and Owen Wurzbacher, *Stakeholders and Shareholders: Are Executives Really "Penny Wise and Pound Foolish" About ESG?*, STANFORD CLOSER LOOK SERIES at 1 (July 2, 2019), https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-closer-look-78-esg-programs.pdf.
[58] Hester M. Peirce, SEC Commissioner, *My Beef with Stakeholders*, *supra* note 55.

In its broadest sense, these non-investor stakeholders include all those who transact with the company both internally and externally and all third parties who do not necessarily transact with company but are both positively and negatively impacted by its activities. For example, think about the non-investor stakeholders covered by ESG in the context of the E. That is, all those who are impacted by the environmental policies of a company may be stakeholders. Of course, this may mean most people in this world, if not everyone.

Arguably, this broader understanding of ESG being a stakeholder model is what Larry Fink was discussing in his 2018 Letter to CEOs:

> We also see many governments failing to prepare for the future, on issues ranging from retirement and infrastructure to automation and worker retraining. As a result, society increasingly is turning to the private sector and asking that companies respond to broader societal challenges. Indeed, the public expectations of your company have never been greater. Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.[59]

C. Governance and Shareholder Empowerment G

The *governance category* needs to be subdivided into at least two sub-categories. The first sub-category can be identified as "good corporate governance G." That is, the advocacy for a governance arrangement at a company that is based on the expectation that it will increase that company's shareholder value. For example, the call for the elimination of a classified board or a dual class structure at a particular company where it is expected that the value of the company stock will be increased from its elimination.

The second category can be identified as "shareholder empowerment G" and is the type of G that should be of concern to all those interested in being compliant with ERISA's fiduciary duties. This is where members of the shareholder empowerment movement, such as union-related funds that come under ERISA and public pension funds that do not, advocate for a one-size-fits-all governance structure that allows for the shifting of decision-making from the board of directors to shareholders.

Shareholder empowerment is strongly related to the concept of "shareholder democracy," a term coined in the 1940s that "carried the normative message that greater shareholder participation in corporate governance was both possible and desirable."[60] Shareholder democracy is currently

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[59] Larry Fink, Chairman and Chief Executive Officer, *Larry Fink's 2018 Letter to CEOs: A Sense of Purpose*, BLACKROCK, https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter.

[60] Harwell Wells, *A Long View of Shareholder Power: From the Antebellum Corporation to the Twenty-First Century*, 67 FLA. L. REV. 1033, 1069 (2015).

associated with the idea of one-share, one-vote[61] and provides the foundation for the movement's strong attacks on dual class shares.[62]

Shareholder empowerment is essentially the leveraging of shareholder democracy by certain institutional investors. How this concept is to be understood in practice has been powerfully articulated by Delaware Supreme Court Chief Justice Leo Strine:

> [T]here is only one set of agents who must be constrained -- corporate managers -- and the world will be made a better place when corporations become direct democracies subject to immediate influence on many levels from a stockholder majority comprised not of those whose money is ultimately at stake, but of the money manager agents who wield the endusers' money to buy and sell stocks for their benefit.[63]

Shareholder empowerment does not concern itself with the impact on private ordering, an individual company's performance, or on how the proposed governance arrangement will impact companies on an individual basis. As I have stated in the past:

> I cannot overstate the harm caused by an institutional investor adopting a shareholder empowerment approach to corporate governance. This is particularly true when it comes to the private ordering of corporate governance arrangements. Shareholder empowerment is a one-size-fits-all approach and should not be confused with our traditional understanding of private ordering. This understanding assumes that, "observed governance choices are the result of value-maximizing contracts between shareholders and management." For example, it may or may not include such corporate governance arrangements as dual class shares (with or without time-based sunset provisions), staggered boards, or super-majority shareholder voting. That is the whole point of private ordering and why it has value; it "allows the internal affairs of each corporation to be tailored to its own attributes and qualities, including its personnel, culture, maturity as a business, and governance practices."
>
> Private ordering that results from shareholder empowerment disregards what is wealth maximizing for shareholders at each company. I refer to this phenomenon as the "bastardization of private ordering" or "sub-optimal private ordering."[64]

Shareholder empowerment G results in sub-optimal private ordering because it is reflects the wishes and desires of institutional investment managers, not necessarily the financial interests of their beneficiaries. This is what I refer to as the "proactive agency costs of agency capitalism."[65] These "agency costs of agency capitalism are generated when an institutional investor," such as a public pension fund, ERISA manager, or investment advisor to a mutual fund, "utilizes its *voting power* to

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[61] Usha Rodrigues, *The Seductive Comparison of Shareholder and Civic Democracy*, 63 WASH. & LEE L. REV. 1389, 1390 (2006).
[62] *See infra*, Part III(C)(1).
[63] Leo E. Strine, Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449, 451 (2014).
[64] *See* Bernard S. Sharfman, *How the SEC can Help Mitigate the "Proactive" Agency Costs of Agency Capitalism*, 8 AM. U. BUS. L. REV. 1, 15-16 (2019).
[65] *Id.* at 3.

satisfy its own preferences," or the preferences of a third party, and not the preferences of the pension fund beneficiaries or the beneficial investors.[66]

The potential for these agency costs have been increasing in size as common stock holdings have become more and more concentrated in the hands of institutional investors.[67] We should not expect any institutional investor to be immune, including investment advisers to index mutual funds. These advisers have been accumulating delegated voting power at an alarming rate.[68] The more delegated voting power these investment advisers obtain, the more tempted they will be to use that power opportunistically.[69] For example, an adviser may use its voting power to support the activism of current and potential institutional clients in exchange for the ability to acquire more assets under management.[70]

D. Examples of Shareholder Empowerment G

Examples of shareholder empowerment G abound. The first example is the campaign to stop dual class shares.

1. Dual Class Shares

> [C]onsider the shareholder empowerment movement's take-no-prisoners approach to dual class share structures even though these structures have been successfully used by companies such as Berkshire Hathaway, Facebook, Comcast, Nike, and Alphabet (Google). Such zealous advocacy should not be a surprise since dual class shares are an obvious threat to the movement's power. As I have previously observed, "the more public companies that utilize a dual-class share structure, the more controlled companies exist and the less power the movement has."[71]

More recently, the Council of Institutional Investors (CII), the trade organization that represents public pension and union-related funds, published on its website a list of directors whose companies recently went public with a dual class share structure.[72] The objective of this initiative is both about retribution and putting pressure on these directors to stop supporting the use of dual class share structures.[73] According to Ken Bersch, Executive Director of CII, being on the list "may cause

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[66] *Id.* at 4.
[67] Charles McGrath, *80% of Equity Market Cap Held by Institutions*, PENSIONS & INV. (Apr. 25, 2017) (According to the article, institutional investors currently own approximately eighty percent of the market value of U.S. publicly traded equities.), https://www.pionline.com/article/20170425/INTERACTIVE/170429926/80-of-equity-market-cap-held-by-institutions.
[68] Based on projecting the historical trends in the growth of index funds, Bebchuk and Hirst estimate that the Big Three alone, Blackrock, State Street Advisors, and Vanguard, will control 34.3% of S&P 500 votes in 2028 and 40.8% in 2038. *See* Scott Hirst and Lucian Bebchuk, *The Specter of the Giant Three*, 99 BOSTON U. REV. 721, 739 (2019).
[69] Sharfman, *How the SEC can Help Mitigate the "Proactive" Agency Costs of Agency Capitalism*, *supra* note 64, at 3.
[70] *Id.*
[71] *Id.*
[72] Council of Institutional Investors, *Dual-Class Enablers*, https://www.cii.org/dualclassenablers and link.
[73] *Id.* ("Unequal structures generally render low-vote shareholders powerless to exert direct accountability on board members who facilitated dual-class structures at the critical juncture of the IPO. However, by voting

directors of private companies that are considering an IPO to think more carefully about the benefits and costs of adopting a dual-class structure," and "directors who serve on nominating committees at single-class companies may think twice about a candidate for board service who was responsible for taking a company public with an open-ended dual-class structure."[74]

This type of shareholder empowerment G continues despite a MSCI research report finding "that unequal voting stocks in aggregate outperformed the market over the period from November 2007 to August 2017, and that excluding them from market indexes would have reduced the indexes' total returns by approximately 30 basis points per year over our sample period."[75] Such a reduction in returns makes sense as there is a lot of positive skewness in stock market returns.[76] That is, there are a relatively small number of firms that will contribute, over time, the bulk of returns for the stock market as a whole.[77]

In the past, those best performing firms have been overrepresented by dual class share companies such as Alphabet, Berkshire Hathaway, Facebook, etc.[78] This should be no surprise. When a company is allowed by stock market participants to launch its IPO with a dual class share structure, it is a signal to the market that the company may just be one of those best performers. These are companies that should be included in a portfolio, not excluded.

2. Proxy Access

Another good example of shareholder empowerment G is the demand by institutional investors, especially public pension funds, for proxy access to be adopted at all U.S. public companies.[79] Proxy access is the ability of certain privileged shareholders to have their own slate of director nominees included in the company's proxy solicitation materials for purposes of voting at the annual meeting. The catalyst for this advocacy was the SEC's 2011 rule requiring shareholder proposals on proxy

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against or withholding support from these same individuals at other, single-class boards on which they sit, investors can bring some degree of accountability. *This voting strategy is not solely about retribution*, but also about improving director diligence during the pre-IPO process; widespread adoption of "porting" opposition to other company boards could cause private company directors to more carefully consider all sides of the issue before acceding to founders' and/or company-retained advisors' preference for long-term entrenchment.")

[74] Hazel Bradford, *CII identifies directors of companies with dual-class shares*, PENSIONS & INVESTMENTS (August 7, 2019), https://www.pionline.com/governance/cii-identifies-directors-companies-dual-class-shares

[75] Dimitris Melas, Managing Director and Global Head of Core Equity Research, *Putting the spotlight on Spotify: Why have stocks with unequal voting rights outperformed?*, MSCI (April 3, 2018), https://www.msci.com/www/blog-posts/putting-the-spotlight-on/0898078592.

[76] Hendrik Bessembinder, *Do Stocks Outperform Treasury Bills?* 129 J. FIN. ECON. 440, 440–41 (2018).

[77] *Id.*

[78] Bernard S. Sharfman, *The Undesirability of Mandatory Time-Based Sunsets in Dual Class Share Structures: A Reply to Bebchuk and Kastiel*, 93 S. CAL. L. REV. POSTSCRIPT 1, 8 (April 25, 2019), https://southerncalifornialawreview.com/2019/04/25/the-undesirability-of-mandatory-time-based-sunsets-in-dual-class-share-structures-a-reply-to-bebchuck-and-kastiel-postscript-comment-by-bernard-s-sharfman/.

[79] *See generally*, Bernard S. Sharfman, *What Theory and Empirical Evidence Tell Us About Proxy Access*, 13 J.L. ECON. & POL'Y 1 (2017).

access to become part of a public company's proxy statement.[80] As a result of institutional investor pressure, it has been implemented at most of our major public companies.[81]

Even though its' adoption has been greatly demanded, its use has been almost non-existent over the past eight years.[82] According to Lynnette C. Fallon, General Counsel of Axcelis Technologies, Inc., "As you know, proxy access provisions are now broadly adopted, but have almost never been implemented because it is a solution in the absence of a real world problem."[83] That is, there was no real corporate governance problem that proxy access was meant to fix.

This is especially true given that hedge fund activism already provides an alternative process of director appointment for institutional investors. According to Hamdani and Hannes, in 2018 "activists appointed 161 directors to the boards of sixty-eight public companies, and in 2017 they appointed one hundred directors to the boards of fifty companies."[84] That is an extremely impressive performance compared to proxy access that has resulted in zero director appointments during that same time period. Moreover, and perhaps most importantly, boards still possess a large informational advantage in identifying the best candidates to serve as board members,[85] an informational advantage that proxy access did not change.

So, what is the point of proxy access and the significant amount of resources that were spent on its implementation?[86] Perhaps, it is simply an end in itself,[87] a power grab by certain institutional investors. This cannot be good for determining the correct balance between board and shareholder authority at our public companies.[88] As so well stated by Lucian Bebchuk:

> [I] do not view increasing shareholder power as an end in and of itself. Rather, effective corporate governance, which enhances shareholder and firm value, is the objective underlying my analysis. From this perspective, increased shareholder power would be desirable only if it would operate to improve corporate performance and value.[89]

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[80] 17 C.F.R. §240.14a-8(i)(8) (2011).

[81] Matteo Tonello, *Corporate Board Practices in the Russell 3000 and S&P 500*, THE CONFERENCE BOARD at 34 (2019) ("some 61.5 percent of S&P 500 companies have adopted proxy access bylaws"), https://www.conference-board.org/publications/publicationdetail.cfm?publicationid=8412.

[82] Letter from Lynnette C. Fallon, Executive Vice President HR/Legal and General Counsel, Axcelis Technologies, Inc. to Mr. Brent J. Fields, Secretary, Securities and Exchange Commission, Re: File Number 4-725 SEC Staff 2018 Roundtable on the Proxy Process (June 19, 2019) at n. 2 ("The history of the use of proxy access provisions currently includes two events."),

[83] *Id.* at 2-3.

[84] Assaf Hamdani and Sharon Hannes, *The Future of Shareholder Activism*, 99 B.U.L. REV. 971, 993 (2019), http://www.bu.edu/bulawreview/files/2019/06/HAMDANI-HANNES.pdf.

[85] Bernard S. Sharfman, *Why Proxy Access is Harmful to Corporate Governance*, 37 J. CORP. L. 387, 402 (2011-12).

[86] Fallon, *supra* note 82, at 3 ("Significant corporate time, effort and expense was incurred in fighting and then adopting these provisions,…")

[87] James McConvill, *Shareholder Empowerment as an End in Itself: A New Perspective on Allocation of Power in the Modern Corporation*, 33 OHIO N.U. L. REV. 1013 (2007).

[88] Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 Colum. L. Rev. 767, 767 (2017) (This Essay introduces principal-cost theory, which posits that each firm's optimal governance structure minimizes the sum of principal costs, produced when investors exercise control, and agent costs, produced when managers exercise control.").

[89] Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv. L. Rev. 835, 842-43 (2005).

Or, perhaps proxy access has value to those institutional investors that want to use it as a threat to move corporate boards on their E and S objectives. That is, a corporate board may be forced to act on an E or S issue for fear that proxy access will be used as a threat to nominate board members that the board does not want. This is why proxy access has been adopted but not used and makes understandable the following comment by the CII: "Even if proxy access is *rarely* invoked, its availability makes boards more vigilant in their oversight of management and more responsive to the interests of the company's owners."[90]

In sum, when a corporate governance arrangement is implemented based on shareholder empowerment G, a vital step is missing in the analysis, the evaluation of the proposed governance arrangement on a company-by-company basis as seen through the lens of SWM. Without that, the financial interests of beneficial investors and pension fund beneficiaries and participants as represented by SWM cannot be maximized. As subsequently discussed, this is something that the fiduciary duties of ERISA plan managers cannot tolerate.

IV. How a Plan Manager's Fiduciary Duties Impacts Her Approach to ESG

An ERISA plan manager's duties of loyalty and care impact how she is to utilize ESG objectives and factors in her management decisions, including shareholder voting.

A. Duty of Loyalty

According to Schanzenbach and Sitkoff, "In making direct investment of plan assets, *voting shares* or otherwise exercising shareholder control rights associated with plan assets, or designing a menu of investment choices (typically mutual funds) from which a plan participant can choose to invest, a trustee of a pension or retirement plan must act in accordance with the fiduciary duty of *loyalty*."[91] This duty is of primary concern when a plan manager considers ESG objectives or factors in her decision making.

Under ERISA's *duty of loyalty*, '"a plan fiduciary "shall discharge his duties with respect to a plan *solely in the interest of* the participants and beneficiaries and . . . for the *exclusive purpose* of providing *benefits* to participants and their beneficiaries; ….'"[92] This sole interest rule creates a very specific and narrow path for an ERISA plan manager when devising an investment, mutual fund selection, and shareholder voting strategy. Basing our understanding on the common law of trusts, the sole interest rule provides that "the trustee has a duty to the beneficiaries not to be influenced by the interest of any third person or by motives *other than* the accomplishment of the purposes of the trust."[93] According to Schanzenbach and Sitkoff, "A trustee who is influenced by his own or a third party's interests is disloyal, because the trustee is no longer acting solely in the interest of the

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[90] *Id.* at n. 3 citing Council of Institutional Investors, *Proxy Access*, https://www.cii.org/proxy_access.
[91] Schanzenbach and Sitkoff, *supra* note 44, at 14-15.
[92] *Id.* citing 29 U. S. C. § 1104(a)(1)(A) and § 1103(c)(1).
[93] Schanzenbach and Sitkoff, *supra* note 44, at 13 quoting Restatement (Third) of Trusts § 78(1) cmt. f. (Am. Law Inst. 2007).

beneficiaries."[94] This means that the ERISA plan manager is duty bound not to be guided in its decision making by any third party interest, including, of course, his own.[95]

Moreover, an ERISA plan manager's *exclusive purpose* is to provide benefits that are financial in nature. According to the U.S. Supreme Court, "the term "benefits" … must be understood to refer to the sort of financial benefits (such as retirement income) that trustees who manage investments typically seek to secure for the trust's beneficiaries."[96] This common investor purpose, considering only the financial welfare of beneficiaries, is the only purpose that an ERISA plan manager is allowed to recognize. (As already noted, in terms of an ERISA plan's equity holdings, this means the pursuit of SWM.) This makes clear that the objectives of cleaning up the environment, raising labor wages, making the work place safer, providing better medical benefits for employees, or solving the numerous political problems that around the world, no matter how worthy, is not to substitute or stand alongside the objective of considering the financial welfare of beneficiaries.

1. Collateral Benefits ESG

Schanzenbach and Sitkoff "refer to ESG investing for moral or ethical reasons [based on an investment manager preferences] or to benefit a third party, … as *collateral benefits ESG*."[97] This type of ESG is in direct conflict with an ERISA plan manager's duty of loyalty: "Just as a pension trustee could not, consistent with the duty of loyalty, distribute pension plan assets for the purpose of advancing an ESG goal held by the trustee, so too under the sole interest rule the trustee cannot allow such a goal to influence the trustee's fiduciary investment decisions regarding the trust property."[98] Moreover, "authorizing a pension trustee to consider collateral benefits in making a fiduciary decision is no different than authorizing the trustee to consider the preferences of the President of the United States, the trustee's spouse, or the trustee's own heart. Each is a violation of the sole interest rule.[99]

The sole interest rule and the interpretation of benefits as implicating only financial benefits make readily apparent that collateral benefits ESG is problematic. That is, how can an ERISA plan manager ever take into consideration collateral benefits ESG when investing, providing mutual fund options for beneficiaries, or voting her proxies? The answer under ERISA is very simple, she can't.[100]

As further explained by Schanzenbach and Sitkoff:

> Under controlling Supreme Court precedent, therefore, a pension trustee breaches the duty of loyalty whenever the trustee acts other than to benefit the beneficiaries financially. Acting under any other motive, even without direct self dealing, is a breach of the duty of loyalty. Indeed, *even if the terms of a plan's governing instrument set forth a "specific nonpecuniary*

[94] *Id.* at 13.
[95] *Id.* at 13.
[96] Fifth Third Bancorp v. Dudenhoeffer at 2468.
[97] Schanzenbach and Sitkoff, *supra* note 44, at 5.
[98] *Id.* at 16-17.
[99] Id. at 19.
[100] *Id.* at 16. ("The foregoing discussion points irresistibly to the legal conclusion that ERISA forbids collateral benefits ESG investing by a pension trustee.").

goal," such a provision would be trumped by ERISA's imposition of a mandatory fiduciary duty to act with the sole or exclusive purpose of providing benefits, meaning financial benefits, to the plan's participants.[101]

This understanding of ERISA has significant implications for ERISA plan managers. For example, a plan manager provides to its participants and beneficiaries mutual fund options that purposely exclude companies with dual class shares. Let's assume she does so because she is a strong believer in shareholder democracy. Given that portfolios that include dual class shares offer superior returns,[102] then she would definitely be in breach of her fiduciary duties under ERISA. Most notably, this breach would occur if index funds that currently exclude newly issued IPOs with dual class share structures, such as the S&P 500 index, were to be included as mutual fund options for participants and beneficiaries.

2. Risk-Return ESG

It is important to note that under ERISA a distinction must be made between ESG as objectives of plan management versus ESG as factors in investment and voting analysis.[103] As just discussed, incorporating ESG objectives into a plan manager's decision making are not allowed. This is because the fiduciary duties of ERISA require a plan manager to focus exclusively on the financial interests of beneficiaries and participants without regard to the interests of third parties. Again, in regard to the equity holdings of an ERISA plan this means the pursuit of SWM.[104]

In regard to using ESG factors, an ERISA plan manager can use these factors in determining the value of a particular investment or how a particular shareholder vote may impact firm value. For example, determining that the present value of a company's liability exposure to customer privacy issues is either significantly greater or lesser than what is estimated by the stock market. However, both investment analysis and shareholder voting must be done through a risk-return framework. That is, through the lens of SWM. This is the lens that the fiduciary duties of ERISA require for the analysis of equity investments.

Schanzenbach and Sitkoff refer to "ESG investing for risk and return benefits - that is, to improve risk-adjusted returns - as risk-return ESG."[105] That is, ESG factors can be incorporated into the investment analysis of a plan manager if those factors are purely used to enhance the manager's evaluation of the risk and/or return of the investment.

This type of analysis was discussed with approval in the Field Assistance Bulletin:

IB [Interpretive Bulletin] 2015-01 also reiterated the view that when competing investments serve the plan's economic interests equally well, plan fiduciaries can use such collateral

[101] *Id.* at 15 citing Dudenhoeffer, 134 S.Ct. at 2468-69; *see also* Central States, Southeast & Southwest Areas Pension Fund, 472 U.S. 559, 568 (1985) ("trust documents cannot excuse trustees from their duties under ERISA").
[102] *See supra* text associated with note 75.
[103] Schanzenbach and Sitkoff, *supra* note 44, at 15.
[104] *Id.*
[105] *Id.* at 5.

considerations as tie-breakers for an investment choice. The preamble of IB 2015-01 added: "if a fiduciary prudently determines that an investment is appropriate based solely on economic considerations, including those that may derive from environmental, social and governance [(ESG)] factors, the fiduciary may make the investment without regard to any collateral benefits the investment may also promote."

The Field Assistance Bulletin then clarified that this use of ESG factors must be understood as consistent with a risk-return framework:

> In making that observation, the Department merely recognized that there could be instances when otherwise collateral ESG issues present material business risk or opportunities to companies that company officers and directors need to manage as part of the company's business plan and that qualified investment professionals would *treat as economic considerations* under generally accepted investment theories. In such situations, *these ordinarily collateral issues are themselves appropriate economic considerations*, and thus should be considered by a prudent fiduciary along with other relevant economic factors to evaluate the risk and return profiles of alternative investments. *In other words,* in these instances, the factors are more than mere tie-breakers. To the extent ESG factors, in fact, involve business risks or opportunities that are properly treated as economic considerations themselves in evaluating alternative investments, the weight given to those factors should also be appropriate to the relative level of risk and return involved compared to other relevant economic factors.
>
> Fiduciaries must not too readily treat ESG factors as economically relevant…. Rather, ERISA fiduciaries must always put first the economic interests of the plan in providing retirement benefits. A fiduciary's evaluation of the economics of an investment should be focused on financial factors that have a material effect on the return and risk of an investment based on appropriate investment horizons consistent with the plan's articulated funding and investment objectives.[106]

As stated by Sean Griffith, "In this way, the Trump-era guidance from the DOL allows plan fiduciaries to consider ESG issues only insofar as they can be shown to have a positive effect on investment returns, not as an otherwise desirable attribute that can be used to distinguish between two economically equal investments."[107]

B. Duty of Care

ERISA, like the common law of trusts, requires that a plan manager act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[108] Moreover, ERISA embodies the common law's "prudent investor rule"[109] by requiring a plan manager to adequately diversify her investment portfolios.[110]

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[106] Field Assistance Bulletin 2018-01, *supra* note 27 at 1/5-2/5.
[107] Sean J. Griffith, *supra* note 46, at 15, n. 78.
[108] Schanzenbach and Sitkoff, *supra* note 44, at 31 quoting ERISA § 404(a)(1)(B).

A plan manager's duty of care impacts how she goes about evaluating risk-return ESG."[111] Again, such an evaluation requires that ESG factors in investment, mutual fund selection, or voting are only to be used within a risk and financial return framework without regard to collateral interests or the plan manager's own preferences. The bottom line is that an ERISA plan manager "employing a risk-return ESG investing strategy must reasonably conclude that the strategy will in fact provide better [financial] returns with the same or less risk."[112] In terms of an ERISA plan's equity holdings, this means a sole and exclusive focus on SWM.

This prudent investor evaluation must take into consideration the additional costs involved in utilizing ESG factors. These costs include the additional research and analysis required to reasonably conclude that the market is not being efficient in properly reflecting ESG factors in the price of a company' stock or debt securities.[113] For example, the financial markets not properly taking into consideration the risk of a nuclear reactor meltdown when pricing the securities of a power company that is dependent on nuclear power.[114] This may result in an ERISA plan's underweight or overweight position in these securities and therefore a lack of diversification. This is another cost that must be taken into consideration when using ESG factors. Such costs will require higher financial returns as compensation.[115]

V. MANAGING AN ERISA PLAN'S VOTING RIGHTS AND THE NEED FOR PROXY ADVISORS

As already discussed, it has long been DOL policy that the fiduciary act of managing plan assets includes managing the voting rights associated with a plan's equity holdings. How that voting is to be approached by a plan manager was long ago summarized in footnote four of the Avon letter:

> Section 404(a)(1) requires, among other things, that a fiduciary of a plan act *prudently*, *solely* in the interest of the plan's participants and beneficiaries, and for the *exclusive purpose* of providing *benefits* to participants and beneficiaries. *To act prudently in the voting of proxies* (as well as in all other fiduciary matters), a plan fiduciary must consider those *factors which would affect the value of the plan's investment*. Similarly, the Department [DOL] has construed the requirements that a fiduciary act solely in their interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries as *prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives*.[116]

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[109] *Id.* at 33 ("The prudent investor rule applies … to private pensions subject to ERISA."). The DOL formally recognizes the prudent investor rule in 29 CFR § 2550.404a-1. *Id.* at n. 210.

[110] ERISA 404(a)(1)(C) ("by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so;").

[111] Schanzenbach and Sitkoff, *supra* note 44, at 32.

[112] *Id.*

[113] *Id.* at 40 ("Any active investment program, whether based on ESG factors or otherwise, can improve risk adjusted returns only if those factors are not already reflected by market prices.")

[114] *Id.* at 36. This is an example of what is referred to as a "tail risk," a low-probability, high impact event. *Id.* at 41 citing Nassim Nicholas Taleb, THE BLACK SWAN: THE IMPACT OF THE HIGHLY IMPROBABLE (2007).

[115] Schanzenbach and Sitkoff, *supra* note 44, at 33-34.

[116] Letter from U.S. Dep't of Labor to Helmuth Fandl, *supra* note 20, at n. 4.

Therefore, a plan manager's fiduciaries duties are no different when voting than when investing the plan's funds or selecting mutual fund options for its beneficiaries and participants. However, the potential economic costs of voting are also recognized. According to the DOL's Interpretive Bulletin 2016-01, "proxies should be voted as part of the process of managing the plan's investment in company stock unless a responsible plan fiduciary determined that the time and costs associated with voting proxies with respect to certain types of proposals or issuers may not be in the plan's best interest." [117]

To make sure that the costs are manageable, Interpretive Bulletin 2016-01 acknowledges the potential cost saving role that proxy advisors can play:

> In most cases, proxy voting and other shareholder engagement does not involve a significant expenditure of funds by individual plan investors because the activities are engaged in by institutional investment managers appointed as the responsible plan fiduciary pursuant to sections 402(c)(3), 403(a)(2) and 3(38) of ERISA. Those investment managers often engage consultants, *including proxy advisory firms*, in an attempt to further reduce the costs of researching proxy matters and exercising shareholder rights.

Moreover, this is an acknowledgement by the DOL that it is simply not feasible or economically desirable to internally perform independent research on the thousands of shareholder votes they may face each year. Instead, plan managers are expected to rely heavily on a proxy advisor to provide them with voting recommendations. Or, in this era where the index fund is on the rise, the investor stewardship team of a large investment adviser to an ERISA plan such as Blackrock, Vanguard, or State Street Global Advisors. However, no matter what their source, the ERISA plan manager can only use voting recommendations if they are in conformity with her fiduciary duties. If not, then they must not be relied upon when voting.

VI. ISSUES WITH THE VOTING RECOMMENDATIONS OF PROXY ADVISORS

The fiduciary duties of an ERISA plan manager, in the context of managing a plan's equity holdings and associated voting rights, require the use of voting recommendations that are targeted for the sole pursuit of SWM for the exclusive benefit of beneficiaries and participants. Unfortunately, it is doubtful that a proxy advisor's voting recommendations are in conformity with a plan manager's fiduciary duties. Below are the reasons why proxy advisors need to be designated investment advice fiduciaries.

A. **Traditional Reasons**

Traditional concerns include conflicts of interest where companies may feel pressured into purchasing ISS' (61% market share of proxy advisory market) corporate governance and executive

[117] Department of Labor, *Interpretive Bulletin Relating to the Exercise of Shareholder Rights*, *supra* note 26, at 95881.

compensation consulting services[118] and the majority owner of Glass Lewis (37% market share) being Ontario Teachers' Pension Plan, a large institutional investor.[119] The former may encourage a proxy advisor to create voting recommendations that are not a function of SWM, but a function of whether the consulting services are purchased, and the latter may result in voting recommendations being influenced by the wishes of the parent company.[120] If so, then the use of these recommendations may be a breach of an ERISA plan manager's duty of loyalty as they take into consideration the interests of third parties.

However, the main concern has been a lack of precision in the voting recommendations of proxy advisors. This is a result of a lack of resources to create informed voting recommendations.[121] As I discussed in another draft article:[122]

> There is strong evidence that the two major proxy advisors utilize a low cost, low value (not truly informed) approach to the creation of voting recommendations, leading to imprecise recommendations. This evidence is found in the resources that the two major proxy advisors, ISS (61% market share)[123] and Glass Lewis (37% market share),[124] devote to the creation of recommendations. In 2014 the ISS had a global staff of 250 research analysts to provide recommendations on 250,000 shareholder votes.[125] Based on this information, the U.S. Chamber of Commerce stated that "it is clear that, on average, each ISS analyst is responsible for researching and preparing reports on 1,000 issues in the truncated period of the *usual* 'proxy season. [primarily between March and June]"[126] As of June 2017, the ISS Global Research team covered 40,000 shareholder meetings with approximately 270 research

[118] Letter from John Engler, President, Business Roundtable to Office of Regulations and Interpretations, Employee Benefits Security Administration at 4/8 (February 3, 2011), https://www.businessroundtable.org/archive/resources/brt-letter-on-application-of-erisa-fiduciary-rules-to-proxy-advisory-firms; Doyle, *supra* note 15, at 7 ("In recent years, these institutions have drawn increased scrutiny for the conflicts of interest inherent in rating and providing voting recommendations concerning public companies while simultaneously offering consulting services to those same companies, including how they can improve their ratings and voting recommendations."), http://cdn.accf.org/wp-content/uploads/2018/05/ACCF-The-Conflicted-Role-of-Proxy-Advisor-FINAL.pdf.
[119] Letter from Timothy J. Bartl, *supra* note 35, at 5.
[120] *Id.*
[121] Sharfman, *Enhancing the Value of Shareholder Voting Recommendations*, *supra* note 15.
[122] *Id.*
[123] Center on Executive Compensation, *ISS*, http://www.execcomp.org/Issues/Issue/proxy-advisory-firms/iss (accessed on December 20, 2018).
[124] Center on Executive Compensation, *Glass Lewis*, http://www.execcomp.org/Issues/Issue/proxy-advisory-firms/glass-lewis (accessed on Dec. 20, 2018). Besides ISS and Glass Lewis, the U.S. proxy advisory industry is made up of only three other firms: Egan-Jones Proxy Services (Egan-Jones), Marco Consulting Group (Marco Consulting), and ProxyVote Plus. *See* U.S. Gov't Accountability Office, GAO-17-47, *Corporate Shareholder Meetings: Proxy Advisory Firms' Role in Voting and Corporate Governance Practices* (2016) at 6, http://www.gao.gov/assets/690/681050.pdf.
[125] U.S. Chamber of Commerce, *U.S. Chamber of Commerce Corporate Governance Update: Public Company Initiatives in Response to the SEC Staff's Guidance on Proxy Advisory Firms*, THE U.S. CHAMBER CENTER FOR CAPITAL MARKETS COMPETITIVENESS at 5, n. 7 (January 2015), http://www.centerforcapitalmarkets.com/wp-content/uploads/2015/01/021874_ProxyAdvisory_final.pdf.
[126] *Id.*

analysts and 190 data analysts.[127] However, it is not known how many research analysts are full-time, part-time or seasonal (proxy season only).

According to the U.S. Chamber of Commerce, "Glass Lewis purports to analyze fewer issues, but has fewer analysts [approximately 200 in 2014] available to do so, ensuring that its analysts are equally overwhelmed with their responsibilities in a very short period of time."[128] In 2018, Glass Lewis reported that it covers 20,000 meetings each year with approximately the same number of analysts it had in 2014.[129] However, it is not known if this number included data as well as research analysts.

Perhaps the most egregious example of where the lack of resources impacts the precision of a proxy advisor's voting recommendations is in the critically important areas of proxy contests and mergers and acquisitions (M&A).[130] For example, to provide these recommendations the ISS has created a Special Situations Research Team ("Research Team").[131] Remarkably, the Research Team is made up of only eight analysts.[132] As described below, this is simply not enough.

To begin, in 2018, there was an estimated 51 proxy contests in the U.S.[133] Informed voting on these types of decisions, which will determine whether there is going to be a significant change in business strategy or if the company should be preparing itself for sale, requires a significant amount of industry and company specific expertise.[134] Most likely, acquiring such expertise entails years of experience analyzing not just a specific industry but also the fine points of the specific company being targeted.[135] Such expertise would require being at the level of a seasoned equity analyst who has both industry and company specific expertise.[136]

It is extremely doubtful that the expertise required for any particular proxy contest could be found within the eight-member Research Team.[137] That is because there are close to 4,000 public companies in the US alone and they exist in numerous of industries.[138] For example, the Global Industry Classification Standard includes 11 sectors which are further subdivided

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[127] Institutional Shareholder Services Inc., *Due Diligence Compliance Package* (November 2017), https://www.issgovernance.com/file/duediligence/Due-Diligence-Package-November-2017.pdf.
[128] U.S. Chamber of Commerce, *supra* note 121, at 5, n. 7.
[129] Glass Lewis, *Company Overview* (accessed on September 24, 2018), http://www.glasslewis.com/company-overview/.
[130] Bernard S. Sharfman, *Beware a Proxy Advisor's M&A and Proxy Contest Advice*, *supra* note 15 ("If proxy advisors such as ISS are to provide informed and precise voting recommendations on proxy contests and M&A, then they must invest vastly greater resources into generating their voting recommendations.").
[131] *Id.*
[132] Michelle Celarier, *The Mysterious Private Company Controlling Corporate America*, INSTITUTIONAL INVESTOR (Jan. 29, 2018), https://www.institutionalinvestor.com/article/b16pv90bf0zbj8/the-mysterious-private-company-controlling-corporate-america.
[133] Sullivan & Cromwell LLP, REVIEW AND ANALYSIS OF 2018 U.S. SHAREHOLDER ACTIVISM at 26 (March 2019), https://www.sullcrom.com/files/upload/SC-Publication-SandC-MnA-2018-US-Shareholder-Activism-Analysis.pdf.
[134] Bernard S. Sharfman, *Beware a Proxy Advisor's M&A and Proxy Contest Advice*, *supra* note 15.
[135] *Id.*
[136] *Id.*
[137] *Id.*
[138] *Id.*

into 24 industry groups, 69 industries and 158 sub-industries.[139] In sum, it would be a rare occasion when the Research Team could find an analyst on staff that would have the expertise to do an adequate job in evaluating a proxy contest.[140]

This same lack of expertise would apply to M&A recommendations.[141] Moreover, there are many more to deal with.[142] On an average annual basis, approximately 5% of U.S. public companies delist as a result of M&A activity.[143] This percentage can vary, but let's assume that the Research Team is faced with around 150 to 300 M&A per year.[144] This number is several times greater than what the Research Team must deal with in terms of proxy contests.[145] For a team of eight without the proper expertise, doing an adequate job is an impossible task.[146]

Such a lack of resources in the face of the tens of thousands of votes that proxy advisors must opine on each year has resulted in "a one-size-fits-all approach to corporate governance, such as with executive compensation,[147] irrespective of the differences in companies' business models and the flexibility allowed under securities law;"[148] the inability to devote enough resources to properly

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[139] S&P Global Market Intelligence and MSCI, GLOBAL INDUSTRY CLASSIFICATION STANDARD (GICS) (2018), https://www.spglobal.com/marketintelligence/en/documents/112727-gics-mapbook_2018_v3_letter_digitalspreads.pdf.

[140] Bernard S. Sharfman, *Beware a Proxy Advisor's M&A and Proxy Contest Advice*, *supra* note 15.

[141] *Id.*

[142] *Id.*

[143] Benjamin Bennett and Robert A. Dam, *Merger Activity, Stock Prices, and Measuring Gains from M&A* (November 1, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3000574.

[144] Bernard S. Sharfman, *Beware a Proxy Advisor's M&A and Proxy Contest Advice*, *supra* note 15.

[145] *Id.*

[146] *Id.*

[147] According to ExxonMobil:

> [I]t is our experience that proxy advisory firms rely upon a one-size-fits-all model to measure each company's compensation program, which is not necessarily tied to the nature of the industry as a whole or a company's specific business needs. This analysis forms the basis for further qualitative assessment and, ultimately, the proxy advisory firm's voting recommendations. Over time this has resulted in a broad market standardization for executive compensation that does not necessarily account for industry or company-specific realities and may or may not tie to shareholders' returns at all. This can result in businesses disconnecting their executive compensation from their business model and orienting behavior towards the short-term, merely to earn a "FOR" recommendation.

Letter from Neil A. Hansen, Vice President, Investor Relations and Secretary, ExxonMobil to Vanessa Countryman, Acting Secretary, U.S. Securities and Exchange Commission, Re: Roundtable on the U.S. Proxy Process File No. 4-725 at 4 (July 26, 2019), https://www.sec.gov/comments/4-725/4725-5879063-188728.pdf.

[148] Letter from Chris Netram, Vice President, Tax and Domestic Economic Policy, National Association of Manufacturers to Brent J. Fields, Secretary, Securities and Exchange Commission at 2 (October 30, 2018). According to Tom Quaadman:

> One-size-fits-all recommendations, or overly broad "benchmark" policies developed by proxy advisory firms, cannot reflect the unique characteristics of individual issuers, and thus ultimately impair the quality of information that informs proxy voting decisions. A shareholder that trusts a fiduciary is not asking for "consistent" voting, but responsible voting that takes into account company-specific factors that will drive returns.

evaluate critically important votes such as those dealing with proxy contests and mergers and acquisitions (see above); an unwillingness to be transparent in the methodologies and models used in creating voting recommendations;[149] voting recommendations that incorporate "a profusion of errors and misleading statements, ranging from specific incorrect facts to disingenuous assumptions about, for instance, a company's peer group or compensation practices;[150] and proxy advisor resistance to allowing companies adequate time to respond to negative voting recommendations that may have incorporated significant errors or faulty analysis prior to their release and then implementing automatic voting (robo-voting) on behalf of their clients based on potentially inaccurate voting recommendations.[151]

In sum, the lack of resources used in the creation of a proxy advisor's voting recommendations may lead to a breach of a plan manager's duty of care if the lack of resources at the proxy advisor level has led to the creation of uninformed voting recommendations that do not meet the prudent man standard.

B. A Lack of Focus on SWM

Traditional concerns make the case that the DOL should designate proxy advisors as investment advice fiduciaries. However, proxy advisors focusing on ESG objectives and not SWM makes it even more imperative to do so. This lack of focus on SWM can be seen in the benchmark and specialty voting reports produced by ISS for its clients.

C. ISS Reports

Every proxy season, ISS produces a benchmark report and five additional specialty voting reports on each public company.[152] The five specialty reports are grouped by client type in the following manner: Taft-Hartley, Socially Responsible Investment (SRI), Sustainability, Public Fund (public pension funds), and Catholic Faith-Based.[153] The voting recommendations provided by ISS to its institutional investor clients, including investment managers of ERISA plans, vary by report type.[154]

Tom Quaadman, Executive Vice President, Center for Capital Markets, U.S. Chamber of Commerce to Brent J. Fields, Secretary, Securities and Exchange Commission at 3 (December 20, 2018), https://www.sec.gov/comments/4-725/4725-4826117-177028.pdf.

[149] Letter from Chris Netram, *supra* note 148, at 2-3.

[150] *Id.* at 3 citing Frank M. Placenti, ARE PROXY ADVISORS REALLY A PROBLEM? (October 2018). http://accfcorpgov.org/wp-content/uploads/2018/10/ACCF_ProxyProblemReport_FINAL.pdf.

[151] *Id.* at 3. ExxonMobil reports "that at least 15% of our shares are voted immediately upon the release of ISS' benchmark report (i.e., before shareholders could reasonably read the report or the company would have had an opportunity to address the analysis)." *See* Letter from Neil A. Hansen, *supra* note 137, at 21.

[152] Exxon Comment Letter, *supra* 147 at 7.

[153] *Id.*

[154] *Id.*

These reports, which may also be customized depending on a client's preferences,[155] create a default voting policy for each public company held in a client's equity portfolio.[156]

According to the ExxonMobil, the specialty reports "are not provided to companies to review and frequently contain serious inaccuracies and omissions."[157] In addition, "some of these alternative reports also appear to purposefully assume speculation and allegations are facts, raising concerns about the independence and integrity of the disclosure and voting recommendations."[158] Moreover, based on ExxonMobil's "conversations with ISS following this proxy season [2019], these specialty reports *default* to support all shareholder proposals, unless they conflict with the "theme" of the specialty report." Finally, these special reports are never sent to issuers for review and comment before being sent to clients.[159] If these allegations are true, then it would appear that the prudent man standard has been violated.

Most importantly, as comprehended through ISS statements and a reading of the proxy voting guidelines for each report type, none of these reports will have SWM as the exclusive and sole objective of its voting recommendations.[160] This is a serious divergence from what the fiduciary duties of ERISA require. Regarding the benchmark report, Gary Retelny, President and Chief Executive Officer ISS has made conflicting statements on its objective. He has alternatively stated that its' objective is "focused solely on protecting shareholder value *and* mitigating governance risk"[161] or being "focused solely on maximizing shareholder value and mitigating governance risk."[162] These are similar sounding statements, but they have significantly different meanings. The first makes clear that a stated objective is not even the pursuit of SWM, but something lesser, the protection of shareholder value. Perhaps this is an admission by ISS that while it does not have the resources available to pursue SWM, it will pursue a strategy of creating voting recommendations that do not result in a reduction of shareholder wealth. This, of course, is not sufficient for an ERISA plan manager.

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[155] Supposedly, in addition to the benchmark and specialty reports, ISS provides over 400 customized voting reports. Gary Retelny, President and Chief Executive Officer, Institutional Shareholder Services to Mr. Brent J. Fields, Secretary, U.S. Securities and Exchange Commission at 1 (August 7, 2018), https://www.sec.gov/comments/s7-09-18/s70918-4184213-172552.pdf. However, it is not known what parameters are used in developing these reports and how closely they follow the standard reports.
[156] *Id.*
[157] *Id.*
[158] *Id.*
[159] *Id.* at 10.
[160] *Id.* at 8, n. 12.
[161] Letter from Gary Retelny, supra note 155 at 1; Statement of Gary Retelny, President and CEO Institutional Shareholder Services Inc. to the Subcommittee on Capital Markets and Government Sponsored Enterprises Committee on Financial Services United States House of Representatives, Legislative Proposals to Enhance Capital Formation, Transparency and Regulatory Accountability at A-14 (May 17, 2016), https://www.issgovernance.com/file/duediligence/iss-statement-hfsc-17-may-2016.pdf.
[162] Letter from Gary Retelny, President and Chief Executive Officer, Institutional Shareholder Services to Bill Huizenga, Chairman and Carolyn B. Maloney, Ranking Member, Subcommitee on Capital Markets, Securities and Investment Committee on Financial Services, United States House of Representatives at 2 (July 27, 2017), https://www.issgovernance.com/file/duediligence/20170727-iss-letter-to-hfsc-subcommitee-on-captal-markets-securities-and-investment.pdf.

The second statement, by incorporating SWM, is closer to the mark, but like the first, it suffers from having dual objectives. The additional objective of "mitigating governance risk" causes a maximization problem in terms of shareholder wealth. As stated by Michael Jensen:

> It is logically impossible to maximize in more than one dimension at the same time unless the dimensions are what are known as "monotonic transformations" of one another. Thus, telling a manager to maximize current profits, market share, future growth in profits, and anything else one pleases will leave that manager with no way to make a reasoned decision. In effect, it leaves the manager with no objective.[163]

That is, having two simultaneous objectives, whatever they might be, means having "no objective" to maximize.

It is quite possible that what Mr. Retelny meant to say is that the objective of protecting shareholder value or SWM will be achieved through a strategy of "mitigating governance risk." Such an approach to voting recommendations makes economic sense when a proxy advisor is resource constrained. It is very similar to what Bebchuk and Hirst observe when resource constrained investor stewardship teams from the "Big Three" large index mutual fund families (Blackrock, Vanguard, and State Street Global Advisors) provide voting recommendations for their funds: "Our analysis of the voting guidelines and stewardship reports of the Big Three indicates that their stewardship focuses on governance structures and processes and pays limited attention to financial underperformance."[164] That is, instead of a proxy advisor investing the necessary resources to produce voting recommendations that are based on a thorough financial analysis of each issue as a means to pursue SWM; it takes a short-cut approach by creating voting recommendations based on corporate governance principles. This resource constrained strategy may also explain why ISS feels that an eight person team of analysts is sufficient to review all the proxy contests and M&A transactions that come before it on an annual basis.[165]

Moreover, a corporate governance approach to voting recommendations creates plenty of room for highly prized client groups, e.g., those who are provided specialty reports or other customized reports, to pressure the proxy advisor to move its benchmark proxy voting guidelines closer to what is found in these alternative reports. Looking at the proxy voting guidelines for the specialty reports, it should not be surprising to find statements that move voting recommendations even farther away from SWM and toward what has been previously described as ESG:

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[163] Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 14 J. OF APP. CORP. FIN. 10-11 (2001).

[164] Lucian A. Bebchuk and Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy* at 7 (forthcoming, Columbia Law Review, July 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3282794. *See also* Sean J. Griffith, *supra* note 46, at 17-18 ("Stewardship groups develop and work from a set of guidelines laying out a standard approach to recurring governance issues. These voting guidelines of each of the Big Three, for example, announce voting positions against staggered boards, poison pills and dual class shares. These positions lack nuance. In spite of recent research showing that these provisions can create value for some firms, stewardship group guidelines announce a one-size-fits-all approach to governance.").

[165] *See text* associated with notes 130-146.

- **Taft-Hartley Proxy Voting Guidelines:** "Taft-Hartley Advisory Services shall revise its guidelines as events warrant and will remain in full conformity with the AFL-CIO proxy voting policy."[166] This explicit lack of independence in the creation of voting recommendations is most disconcerting because Taft-Hartley plans come under the fiduciary duties of ERISA.

- **Socially Responsible Investment Proxy Voting Guidelines:** "Socially responsible investors invest for economic gain, as do all investors, but they also require that the companies in which they invest conduct their business in a socially and environmentally responsible manner." Moreover, "In voting their shares, socially responsible institutional shareholders are concerned not only with sustainable economic returns to shareholders and good corporate governance but also with the ethical behavior of corporations and the social and environmental impact of their actions." Therefore, ISS has "developed proxy voting guidelines that are consistent with the dual objectives of socially responsible shareholders."[167]

- **Sustainability Proxy Voting Guidelines:** "ISS recognizes the *growing view* among investment professionals that sustainability or environmental, social, and corporate governance (ESG) factors could present material risks to portfolio investments. Whereas investment managers have traditionally analyzed topics such as board accountability and executive compensation to mitigate risk, greater numbers are incorporating ESG performance into their investment making decisions in order to have a more comprehensive understanding of the overall risk profile of the companies in which they invest and ensure sustainable long-term profitability for their beneficiaries." Moreover, "in voting their shares, sustainability-minded investors are concerned not only with economic returns to shareholders and good corporate governance, but also with ensuring corporate activities and practices are aligned with the broader objectives of society." Therefore, ISS has "developed proxy voting guidelines that are consistent with the objectives of sustainability-minded investors and fiduciaries."[168]

- **Public Fund Proxy Voting Guidelines (public pension funds):** "These proxy voting guidelines are designed to help ensure that public funds fulfill all statutory and common law obligations governing proxy voting, with the intent of maximizing the long-term economic benefits of its plan participants, beneficiaries, and citizens of the state in which the fund resides." This statement appears to be most similar to how the benchmark is described. However, the statement continues with "This includes an obligation to vote proxies in a manner consistent with sound corporate governance and responsible corporate citizenship. Sound corporate governance and responsible corporate practices lead to increased long-term

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[166] Institutional Shareholder Services, UNITED STATES TAFT-HARTLEY PROXY VOTING GUIDELINES; 2019 POLICY RECOMMENDATIONS at 6 of 70 (January 28, 2019), https://www.issgovernance.com/file/policy/active/specialty/Taft-Hartley-Advisory-Services-US-Guidelines.pdf.
[167] Institutional Shareholder Services, Institutional Shareholder Services, UNITED STATES SRI PROXY VOTING GUIDELINES: 2019 POLICY RECOMMENDATIONS at 8 of 72 (January 28, 2019), https://www.issgovernance.com/file/policy/active/specialty/SRI-US-Voting-Guidelines.pdf.
[168] Institutional Shareholder Services, Institutional Shareholder Services, UNITED STATES SUSTAINABILITY PROXY VOTING GUIDELINES: 2019 POLICY RECOMMENDATIONS at 8 of 93 (January 28, 2019), https://www.issgovernance.com/file/policy/active/specialty/Sustainability-US-Voting-Guidelines.pdf.

shareholder value."[169] This divergence in the language allows for the promotion of shareholder empowerment, an important component of ESG and a movement strongly supported by public pension funds.

- **Faith Based Proxy Voting Guidelines:** "[F]aith-based and other socially responsible investors have dual objectives: financial and social. Religious and socially responsible investors invest for economic gain, as do all investors, but they also require that companies in which they invest conduct their business in a socially and environmentally responsible manner." Moreover, in voting their shares, faith-based socially responsible institutional shareholders are concerned not only with sustainable economic returns to shareholders and good corporate governance, but also with the ethical behavior of corporations and the social and environmental impact of their actions." Therefore, ISS "developed faith-based proxy voting guidelines for Catholic and other Christian religious institutions that are consistent with the objectives of socially responsible shareholders as well as the teachings of Catholicism and Christianity as a whole."[170]

In sum, what proxy advisors provide is not a straightforward financial analysis of the costs and benefits of each voting decision, but, in general, the application of corporate governance principles, based on a client's preferences, in order to economize on the overall cost of providing voting recommendations. While this is a rational approach from the perspective of the proxy advisor trying to maximize its own profits, it does not provide the kind of SWM voting recommendations that are necessary to comply with an ERISA plan manager's fiduciary duties.

VII. RECOMMENDATIONS

The recommendation at the heart of this Article is that the DOL must designate proxy advisors as investment advice fiduciaries under ERISA. Given all the old and new concerns, including a lack of focus on SWM, this is the only way to make sure that a proxy advisor's approach to the creation of voting recommendations for ERISA plans is consistent with the fiduciary duties of an ERISA plan manager when managing the voting rights associated with a plan's equity holdings. These fiduciary duties require a plan manager to not only be constantly guided by the fiduciary principles of *sole interest*, *exclusive purpose* and the *prudent man* standard, but also must have, without exception, SWM as her fiduciary objective. These fiduciary duties need to be shared by proxy advisors.

As discussed in Part I, Section B, given the DOL's policy of incorporating the "management of voting rights" into the "fiduciary act of managing plan assets," designating proxy advisors as fiduciaries is certainly within the regulatory authority of the DOL. Moreover, it only requires a small tweak of the DOL's five-part test. The question then becomes, how is the DOL to implement this

[169] Institutional Shareholder Services, Institutional Shareholder Services, UNITED STATES PUBLIC FUND PROXY VOTING GUIDELINES: 2019 POLICY RECOMMENDATIONS at 6 of 69 (January 28, 2019), https://www.issgovernance.com/file/policy/active/specialty/Public-Fund-US-Voting-Guidelines.pdf.
[170] Institutional Shareholder Services, Institutional Shareholder Services, UNITED STATES PUBLIC FUND PROXY VOTING GUIDELINES: 2019 POLICY RECOMMENDATIONS at 8 of 95 (January 28, 2019), https://www.issgovernance.com/file/policy/active/specialty/Catholic-US-Voting-Guidelines.pdf.

recommendation so that it is effective in allowing an ERISA plan manager to meet its fiduciary duties in the management of voting rights?

Implementation Recommendation #1 (SWM Specialty Report): Proxy advisors must provide voting recommendations for ERISA plans that are solely and exclusively focused on maximizing shareholder wealth. This is the only way to ensure that the plan manager's fiduciary duties are being met when she vote the plan's proxies. For ISS, this would require a new specialty report for each ERISA plan client. No other voting report, including the benchmark report, may be provided for use by ERISA plans. Moreover, because Taft-Hartley plans come under the authority of ERISA and its fiduciary duties, the ISS Taft-Hartley specialty report, notable for its policy of being in compliance with AFL-CIO guidelines, would need to be withdrawn and replaced with a SWM specialty report.

Implementation Recommendation #2 (Stewardship Teams): While the focus of this Article has not been on the *stewardship teams* of large mutual fund families, they also need to be designated investment advice fiduciaries. Like proxy advisors, stewardship teams provide shareholder voting recommendations. Unlike proxy advisors, they have a much more restricted client base, the mutual fund families that they have created and/or manage. The designation of investment advice fiduciary would be required when an investment adviser with a stewardship team has been appointed the investment manager of an ERISA plan, the trustee has delegated shareholder voting authority to the investment adviser, the investment adviser's mutual funds are investment options for ERISA beneficiaries and participants, and the stewardship teams are providing voting recommendations to these mutual funds.

Implementation Recommendation #3 (Proxy advisor recommendations on shareholder proposals): Proxy advisors must abstain from providing ERISA plans with voting recommendations on E and S shareholder proposals unless they have a compelling belief that the board is uninformed. In terms of evaluating how an E or S shareholder proposal impacts shareholder wealth, the board and executive management have a large comparative advantage. Unlike the proxy advisor, they have access to inside information and the ability and resources to do a thorough financial analysis.[171] Also, in terms of evaluating E and S proposals from the perspective of SWM, it can be assumed that the board is not conflicted.[172] That is, "[m]anagement has as strong an incentive to increase corporate value through ES as through any other initiative."[173] Moreover, because of resource constraints, the proxy advisor will most likely be limited to taking a corporate governance principles approach to its analysis. This is not sufficient for determining how an E or S shareholder proposal impacts the pursuit of SWM.

In terms of a G shareholder proposal, there is no one-size-fits-all approach in determining the optimal governance structure at a public firm.[174] This is so because "optimal governance arrangements are endogenous to firms,"[175] making "the general effect of a provision … of little use in

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[171] Sean J. Griffith, *supra* note 46, at 40 (In regard to E and S shareholder proposals, "Managers have access to private, company-specific information to determine the likely effect of any initiative on shareholder value. Shareholder proponents and institutional investors do not.")
[172] *Id.* at 8.
[173] *Id.* at 40.
[174] *Id.* at 43.
[175] *Id.*

understanding how it will affect value at a particular firm."[176] Moreover, empirical studies have been little help[177] in determining the existence of optimal governance structures.[178] Therefore, boards, with their informational advantages, are certainly in the best position to determine a firm's governance arrangements.

Nevertheless, it is also true that when a board evaluates a G shareholder proposal for SWM that threatens a sitting board with a reduction in tenure and/or authority, it may be that the board will be conflicted.[179] Here, the proxy advisor may provide a recommendation if it believes that the board is conflicted and can show that the prudent man standard has been met in the creation of its voting recommendation. Again, the voting recommendation must be solely and exclusively created for the purpose of SWM.

Implementation Recommendation #4 (DOL Monitoring): To help the DOL monitor a proxy advisor's compliance with their fiduciary duties, a proxy advisor should provide the following information to the DOL:

- Provide a description of "the essential features of the methodologies and models applied."[180]
- Provide information sources used in the creation of its voting recommendations.[181]
- Describe the procedures in place to make sure that the voting recommendations provided ERISA plans meet the prudent man standard.[182] This disclosure would appear to be particularly important when the voting recommendations deal with proxy contests and mergers & acquisitions.
- Describe the procedures in place to make sure that the voting recommendations are exclusively tied to the objective of SWM.[183]
- Require a proxy advisor to promptly identify and disclose to the DOL "any actual or potential conflict of interest or any business relationship that may influence" the creation of its voting recommendations. Moreover, it must provide the DOL with "a statement of the action" on how it will resolve the actual or potential conflict of interest.[184]
- Describe the procedures in place to make sure the following occurs if a recommendation is contested by the issuer: (1) Giving the issuer sufficient time to respond to a contested recommendation, (2) disclosing and justifying "the impact of any significant departures in

[176] *Id.*
[177] Id. at 43-45 (Griffith found that a review of recent empirical research yielded inconsistent results compared to past work.).
[178] *Id.* at 43 ("Recent empirical scholarship demonstrates that many widely held views concerning the effects of corporate governance are wrong or, at least, overstated.")
[179] *Id.* at 8.
[180] Bernard Sharfman, *From Across the Atlantic, Guidance for the SEC's Oversight of Proxy Advisors, supra* note 15.
[181] *Id.*
[182] *Id.*
[183] *Id.*
[184] *Id.*

methodology between the proxy firm and the issuer (e.g., differences in determining peer group, disclosed compensation, or business metrics)," (3) including in the voting report provided to the ERISA plan manager "a dissenting opinion from the issuer explaining the reasoning behind management's preferred course of action and/or highlighting errors in the firm's report," and (4) disabling "any robo-voting policies on the contested recommendation."[185]

- It is hard to see how a proxy advisor can fulfill its fiduciary obligations as an investment advice fiduciary if it provides voting recommendations that are uninformed.[186] Therefore, a proxy advisor must disclose the procedures in place to determine when it will abstain from providing voting recommendations. As a resource constrained institution, there will be times when there are not enough resources available, e.g., expertise on a certain merger, proxy contest, or executive compensation in a certain industry or at a specific company, to make a voting recommendation that meets the prudent man standard.

In sum, if proxy advisors are designated as investment advice fiduciaries and the substance of these supplemental recommendations are implemented, then the voting recommendations of proxy advisors can be used by an ERISA plan manager to successfully comply with her fiduciary duties when managing the voting rights of her plan's equity holdings.

[185] Letter from Chris Netram, *supra* note 148, at 5.
[186] Sharfman, *Enhancing the Value of Shareholder Voting Recommendations*, *supra* note 15.