March 18, 2020

Ms. Vanessa Countryman
Secretary, Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549
rule-comments@sec.gov

File Number S7-22-19

RE: Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice

Submitted By: Bernard S. Sharfman[*]

Dear Ms. Countryman,

Please find attached an article I just published in the Stanford Journal of Law, Business & Finance, "Now Is the Time to Designate Proxy Advisors as Fiduciaries under ERISA." This is the lead article in volume 25 of the journal. The article presents my fiduciary duty approach to how proxy advisors should be regulated under ERISA. By providing an understanding of what ERISA requires of investments advisers when voting their proxies and what should be required of proxy advisors when providing voting recommendations, this writing will help facilitate the Commission's coordination with the Department of Labor when implementing its changes to the proxy rules for proxy voting advice.

On a matter of less importance, but still of some significance, I would like to point out some inaccuracies that appeared in a comment letter submitted by Glass Lewis on February 3, 2020.[1] In footnote 104 of the letter, the authors state:

> Apparently sensing this problem in the SEC's economic analysis, an industry-funded group submitted a comment letter arguing, based on an academic study from 1982, that shareholders face a "collective action problem" in voting proxies. See Comments of Bernard Sharfman, Chairman, Advisory Council, Main Street Investors Coalition (Dec. 20, 2019). But, to the extent this is meant to provide the missing economic need for this rulemaking, there are at least two problems with it. First, there have been significant changes in the size and share of securities held by institutional investors over the last 40 years, greatly mitigating the issue discussed in the article. Second, SEC guidance says: "Frequently, the proposed rule will be a response to a market failure **that market participants cannot solve because of collective action problems**." Current Guidance at 5 (emphasis added). Here, proxy advisors are a private market solution that helps address the

[*] Bernard S. Sharfman is a member of the Journal of Corporation Law's editorial advisory board. The opinions expressed here are the author's alone and do not represent the official position of any organization with which he has been affiliated.
[1] Comment Letter from Glass Lewis to Vanessa Countryman, Sec'y, Sec. & Exch. Comm'n, RE: Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice Release No. 34-87457 (Feb. 3, 2018), https://www.sec.gov/comments/s7-22-19/s72219-6745349-207938.pdf.

collective action problem Sharfman describes (which exists much less today than 1982). This is not a logical reason to regulate proxy advice.

This footnote states that the comment letter of December 20, 2019[2] was submitted by the Main Street Investors Coalition. This is totally wrong. While the Coalition did provide me with grant money to support the writing of the letter, it was submitted by me, and only me, not the Main Street Investors Coalition. Moreover, the comment letter only represented my views, not the views of the Coalition. This was clearly disclosed in the unnumbered footnote at the bottom of page one.

The footnote also makes the claim that the comment letter was written in response to the Coalition sensing a "problem in the SEC's economic analysis." As I recollect from my notes, the comment letter was written in response to Michael T. Cappucci's very well written Harvard Forum blog post,[3] a post that I strongly disagreed with.

In addition, the first sentence of the footnote refers to a 1982 academic study which it claims I used to argue that a "collective action problem" exists in shareholder voting. I have no idea what academic study the authors of the Glass Lewis comment letter are referring to as they did not provide a cite to that study. As far as I know, there is no such study. Moreover, my authority for the current existence of a collective action problem in shareholder voting, found in the voting of both retail and institutional investors, comes not from that phantom study but from the writings of a number of noted corporate governance scholars. Please see footnotes 2, 3, 4, 8, and 11 of my comment letter. As stated by Jill Fisch, Asaf Hamdani, and Steven Davidoff Solomon: "This collective action problem, however, characterizes all institutional investor engagement in corporate governance - by both active and passive funds.[4]

Finally, the argument found in my comment letter, that the collective action problem of shareholder voting has created a market failure in the market for proxy advisors, so interested John Coffee, the Adolf A. Berle Professor of Law at Columbia Law School and one of our country's foremost securities law scholars, that he requested I do a blog post of my comment letter for Columbia Law School's Blue Sky Blog. This post, "Why the SEC's Proposed Rules on Proxy Advisors Are Necessary,"[5] appeared as a point/counterpoint in conjunction with one posted by Ken Bertsch of the Council of Institutional Investors.[6]

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[2] Letter from Bernard S. Sharfman to Ms. Vanessa Countryman, Sec'y, Sec. & Exch. Comm'n, RE: Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice (December 20, 2019), https://www.sec.gov/comments/s7-22-19/s72219-6571096-201082.pdf.

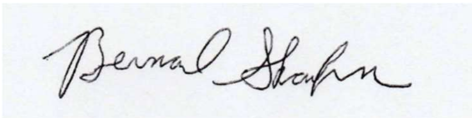
[3] Michael T. Cappucci, Harvard Management Co., *The Proxy War Against Proxy Advisors*, HARV. L. SCHOOL F. ON CORP. GOV. & FIN. REG. (Nov. 27, 2019), https://corpgov.law.harvard.edu/2019/11/27/the-proxy-war-against-proxy-advisors/.

[4] Jill E. Fisch, Asaf Hamdani, and Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, forthcoming, U. PENN. L. REV. (2020) at 14, https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=2985&context=faculty_scholarship.

[5] Bernard S. Sharfman, *Why the SEC's Proposed Rules on Proxy Advisors Are Necessary*, Columbia Law School's Blue Sky Blog (February 19, 2020), https://clsbluesky.law.columbia.edu/2020/02/19/why-the-secs-proposed-rules-on-proxy-advisors-are-necessary/.

[6] Ken Bertsch, *Why the SEC Proposal to Regulate Proxy Advisors Is Flawed*, Columbia Law School's Blue Sky Blog (February 19, 2020), https://clsbluesky.law.columbia.edu/2020/02/19/why-the-sec-proposal-to-regulate-proxy-advisors-is-flawed/.

Very truly yours,



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Bernard S. Sharfman

Now Is the Time to Designate Proxy Advisors as Fiduciaries under ERISA

Bernard S. Sharfman*

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 an investment advice fiduciary under ERISA would require proxy advisors, like plan managers, to be constantly guided by fiduciary principles in the creation of their voting recommendations for ERISA plans. These fiduciary principles include making decisions *solely* in the interest of the participants and beneficiaries of the plans with the *exclusive purpose* of providing benefits to them, and the application of the *prudent man* standard to proxy advisor actions. The investment advice fiduciary designation would also require proxy advisors to consider, without exception, SWM as the 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.

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* Bernard S. Sharfman is the former Chairman of the Main Street Investors Coalition Advisory Council and a member of the Journal of Corporation Law's editorial advisory board. Mr. Sharfman would like to thank Arthur Laby, Paul Rose, Lynnette C. Fallon, Benjamin Means, and Leon Yehuda Anidjar for their very helpful comments. This writing was supported by a grant provided by the Main Street Investors Coalition. The opinions expressed here are the author's alone and do not represent the official position of any organization with which he is affiliated. Mr. Sharfman is dedicating this article to his wife, Susan Thea David, his daughter, Amy David Belchatovski and his son-in-law, Elliot Belchatovski.

I. 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 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 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]

ERISA also provides that a person is a fiduciary if he renders investment advice for a fee with respect to the assets held in a plan's portfolio. However, ERISA leaves it to the discretion of the DOL to designate what persons are deemed to be rendering investment advice and are therefore fiduciaries under Section 3(21)(A)(ii).[8] Given that the shareholder voting of ERISA plan managers carries with it fiduciary duties, it is somewhat surprising to find that proxy advisors such as Institutional Shareholder Services (ISS) and Glass Lewis, the primary providers of shareholder voting recommendations to ERISA plan managers, have yet to be designated *investment advice fiduciaries*.

However, the time is now at hand for the DOL to make such a designation. 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

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1. *See* Anita K. Krug, *The Other Securities Regulator: A Case Study in Regulatory Damage*, 92 TUL. L. REV. 339, 340-41 (2017).

2. Marlene Satter, *Retirement Assets Hit $29.2T: ICI Report*, THINKADVISOR (Dec. 27, 2018), https://www.thinkadvisor.com/2018/12/27/retirement-assets-hit-29-2t-ici-report/ [https://perma.cc/4YXH-TJH3] (noting that there is $8.1 trillion in employer-sponsored Defined Contribution plans and $3.2 trillion in private-sector Defined Benefit plans).

3. 29 U.S.C. § 1001 *et seq.*, § 1002(2) (2017) ("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. *See id.* § 1002(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. *See id.* § 1002(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 III.

7. *Id.*

8. 29 U.S.C. § 1002(21)(A)(ii).

"(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."[9]

In addition, the DOL announced a related forthcoming proposed rule specifically targeting investment advice fiduciaries ("forthcoming Proposed Rule 2").[10] This forthcoming proposed rule will address the defects in the highly criticized and recently vacated 2016 fiduciary rule.[11] 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.[12] If the forthcoming Proposed Rule 2 is going to continue to pursue 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 rulemaking coincides with similar work going on at the SEC. At the SEC, Chair 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.[13] 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.[14]

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9. U.S. DEP'T OF LABOR, RIN: 1210-AB91, PROXY VOTING UPDATE (2019), https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201904&RIN=1210-AB91 [https://perma.cc/FK26-UA4E]. Note that being designated as an investment advice fiduciary under ERISA is distinct from being defined as an investment adviser under the Investment Advisers Act of 1940. For the definition of "investment adviser" under the Investment Advisers Act of 1940, see 15 U.S.C. § 80b-2(a)(11).

10. Request for Information Regarding the Fiduciary and Prohibited Transaction Exemptions, 82 FED. REG.31278 (proposed July 6, 2017).

11. Chamber of Commerce of the U.S. v. U.S. Dep't of Labor, 885 F.3d 360, 379 (5th Cir. 2018).

12. *Id*. at 366 ("Consequently, it encompasses virtually all financial and insurance professionals who do business with ERISA plans and IRA holders.").

13. JAY CLAYTON, U.S. SEC. & EXCH. COMM'N, STATEMENT ANNOUNCING SEC STAFF ROUNDTABLE ON THE PROXY PROCESS (2018), https://www.sec.gov/news/public-statement/statement-announcing-sec-staff-roundtable-proxy-process [https://perma.cc/54D8-FVP3].

14. *See, e.g.*, National Association of Manufacturers, Comment Letter on File No. 4-725: SEC Staff Roundtable on the Proxy Process (Mar. 5, 2019), https://www.sec.gov/comments/4-725/4725-5020171-182986.pdf [https://perma.cc/R3WV-BEU6]; Bernard S. Sharfman, Comment Letter on Submission in Advance of Staff Roundtable on the Proxy Process (Proxy Advisors) (Oct. 12, 2018), https://www.sec.gov/comments/4-725/4725-4513625-175932.pdf [https://perma.cc/S466-SCXN]; FRANK M. PLACENTI, AM. COUNCIL FOR CAPITAL FORMATION, ARE PROXY ADVISORS REALLY A PROBLEM? (2018); Bernard S. Sharfman, *Enhancing the Value of Shareholder Voting Recommendations*, 87 TENN. L. REV. (forthcoming 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3305372 [https://perma.cc/5EHW-RVDS]; Timothy M. Doyle, *The Conflicted Role of Proxy Advisors*, AM. COUNCIL FOR CAP. FORMATION (May 2018), http://accfcorpgov.org/wp-content/uploads/2018/05/ACCF_The-Conflicted-Role-of-Proxy-Advisors.pdf [https://perma.cc/R4Y5-F3K8]; Bernard S. Sharfman, *Beware a Proxy Advisor's M&A and*

Being designated investment advice fiduciaries under ERISA would require proxy advisors, like ERISA plan managers (trustees who retain investment and voting authority or investment managers who receive such authority through delegation by the trustees), 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 shareholder wealth maximization (SWM) as their sole objective when creating voting recommendations for ERISA plan managers.

This means that traditional concerns such as a lack of precision in the voting recommendations of proxy advisors due to a lack of resources and newer concerns such as the rise in the use of Environmental, Social, and Governance (ESG) "objectives" cannot creep into the voting recommendations that are used by ERISA plan managers.[15] However, this does not mean that ESG "factors" cannot be used in the creation of voting recommendations. Under ERISA, the use of these factors is acceptable, but only in the context of a risk-return analysis with SWM as the sole objective.[16] That is, the purpose of utilizing ESG factors is "to take into account . . . financially material risks and opportunities that arise out of environmental, social and governance information; it is not about achieving particular environmental, social or governance goals."[17]

The importance of ERISA fiduciaries correctly dealing with ESG objectives and factors cannot be overstated. It has been reported that their use by institutional investors has increased dramatically over the last ten years.[18] It has also been reported that institutional investors managing approximately $83 trillion of assets have signed the United Nation's Principles for Responsible Investment, an initiative that promotes factoring ESG into asset allocation.[19] Moreover, at the end of 2018, it was reported that

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Proxy Contest Advice, REAL CLEAR MARKETS (May 28, 2019), https://www.realclearmarkets.com/articles/2019/05/28/beware_a_proxy_advisors_ma_and_proxy_contest_advice_103753.html [https://perma.cc/LWV7-C2EQ] ("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,* CONF. BOARD: CORP. GOVERNANCE BLOG (June 24, 2019), https://www.conference-board.org/blog/postdetail.cfm?post=7076 [https://perma.cc/4497-UMN3].

15. *See infra*, Part VII.

16. *See infra*, Part V.

17. Randy Bauslaugh & Dr. Hendrik Garz, *Pension Fund Investment: Managing Environmental, Social and Governance (ESG) Factor Integration*, MCCARTHY TÉTRAULT (May 1, 2019), https://www.mccarthy.ca/en/insights/articles/pension-fund-investment-managing-environmental-social-and-governance-esg-factor-integration [https://perma.cc/9J8T-VLJ7].

18. *See* Georg Kell, *The Remarkable Rise Of ESG*, FORBES (July 11, 2018), https://www.forbes.com/sites/georgkell/2018/07/11/the-remarkable-rise-of-esg/#68decd1f1695 [https://perma.cc/QL2R-FL2X].

19. *See* Antony Currie & Neil Unmack, *Breakingviews - Breakdown: ESG Investing Faces Sustainability Test*, REUTERS (May 28, 2019), https://www.reuters.com/article/us-global-asset-management-breakingviews/breakingviews-breakdown-esg-investing-facessustainability-test-idUSKCN1SY1VM [https://perma.cc/SMR9-D69G].

$1.2 trillion had been invested in funds that followed "non-economic guidelines."[20]

No doubt, as a means to satisfy their clients, this puts significant pressure on proxy advisors to utilize ESG objectives and factors as well, which adds another layer of complexity to the voting recommendation process. This complexity is enhanced by ESG objectives and factors being extremely subjective[21] and easily conflated,[22] creating additional risk that their use may end up with the wrong result. Therefore, this Article finds it important to explain exactly what ESG is, why under ERISA ESG objectives are not acceptable in the creation of voting recommendations, and how under ERISA ESG factors can be used in voting recommendations.

The increasing use of ESG objectives and factors is another reason why the time is now ripe for the DOL to designate proxy advisors as investment advice fiduciaries. It is now a necessary means to keep proxy advisors focused on providing voting recommendations that help ERISA plan managers comply with their fiduciary duties when managing the voting rights of their equity holdings.

Finally, there are several supplemental recommendations that the DOL must implement to support the primary recommendation of designating proxy advisors as investment advice fiduciaries. These are discussed in much more detail in Part VIII, but include:

First, 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.

Second, while the focus of this Article is not on the stewardship teams of large mutual fund families, they also need to be designated investment advice fiduciaries when required.

Third, 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. Unlike the proxy advisor, the board and executive management have access to inside information and the ability and resources to do a thorough financial analysis. Perhaps most importantly, in terms of evaluating such proposals from the perspective of SWM, it can be assumed that the board is not conflicted.

Fourth, 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: a description of the essential features of the methodologies and models applied; information sources used in the creation of its voting recommendations; a description of the procedures in place to make sure that the voting recommendations

20. *Id.*

21. *Id.* ("Analyzing ESG factors involves a fair degree of subjectivity. It's possible to measure a company's carbon footprint, but much harder to assess its social impact or business ethics. It's also hard to bundle such different and complex issues together, or work out which is the most important.").

22. Bauslaugh & Garz, *supra* note 17 ("A major barrier to understanding the legal obligation of plan fiduciaries relating to ESG factor integration seems to be the confusing language that *shades the boundary* between taking into account financially relevant ESG factors on the one hand and promoting ethical or social behaviour for its own sake on the other." (emphasis added)).

provided to ERISA plans meet the prudent man standard; a description of the procedures in place to make sure that the voting recommendations are exclusively tied to the objective of SWM; a description of the procedures in place to deal with a voting recommendation that is contested by a public company; a prompt identification and disclosure to the DOL of any actual or potential conflict of interest or any business relationship that may influence the creation of its voting recommendations; and disclosure of the procedures in place to determine when it will abstain from providing voting recommendations.

Part II establishes the feasibility of designating proxy advisors as investment advice fiduciaries. Part III 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 their fiduciary objective. This Part also describes the fiduciary duties of proxy advisors if they are designated as investment advice fiduciaries. Part IV defines what is meant by ESG. This discussion is necessary before analyzing how ESG, as either objectives or factors, impact shareholder voting by plan managers and the creation of voting recommendations for these managers. Part V will discuss how ESG impacts shareholder voting by plan managers. Part VI discusses why plan managers need the help of proxy advisors. Part VII 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 VIII 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.

II. Fiduciaries under ERISA

The arguments and recommendations made in this Article require an understanding of the fiduciary duties of plan managers and investment advice fiduciaries under ERISA. The latter is the type of fiduciary a proxy advisor can be designated under ERISA.

A. Plan Managers

ERISA Section 3(21)(A) 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 . . . ."[23] Fiduciaries include trustees[24] who retain management control over the assets and investment managers[25] who are com-

23. 29 U.S.C. § 1002(21)(A).
24. *See id.* § 1105(c)(3).
25. *See id.* § 1102(c)(3).

monly 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,"[26] 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,[27] stated that "[i]n general, the *fiduciary* act of managing plan assets which are shares of corporate stock would include the voting of proxies *appurtenant* to those shares of stock."[28] This DOL policy has been affirmed by the DOL in 1990,[29] 1994,[30] 2008,[31] 2016,[32] and 2018.[33]

Such a policy presumes that significant, not *de minimis*, financial value will accrue to beneficiaries and participants if a plan manager, in accordance with their fiduciary duties,[34] properly manages the shareholder voting rights associated with their plan's equity holdings. This value manifests itself in several ways. As argued by Thompson and Edelman, shareholder voting (an uncommon occurrence because corporate decision making is typically delegated to the board and executive management) is most needed when (1) "replacing entrenched directors who are blocking a value-increasing transaction" and (2) "blocking an empire building merger proposed by directors and

26. U.S. Dep't of Labor, Pension & Welfare Benefit Admin., Opinion Letter on Avon Products, Inc. Employees' Retirement Plan (Feb. 23, 1988).

27. *History of EBSA and ERISA*, U.S. DEP'T LAB., https://www.dol.gov/agencies/ebsa/about-ebsa/about-us/history-of-ebsa-and-erisa [https://perma.cc/687X-KZ2G] ("Until February 2003, EBSA was known as the Pension and Welfare Benefits Administration (PWBA).").

28. U.S. Dep't of Labor, *supra* note 26, at 7 (emphasis added).

29. U.S. Dep't of Labor, Pension & Welfare Benefit Programs, Opinion Letter on Responsibilities of Plan Fiduciaries under ERISA with Respect to Voting Proxies (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.").

30. Interpretive Bulletins Relating to the Employee Retirement Income Security Act of 1974, 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.").

31. Interpretive Bulletin Relating to Exercise of Shareholder Rights, 73 FED. REG. 61732 (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.").

32. 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 . . . .").

33. U.S. DEP'T OF LABOR, EMP. BENEFITS SEC. ADMIN., FIELD ASSISTANCE BULLETIN NO. 2018-01, INTERPRETIVE BULLETINS 2016-01 AND 2015-01 (2018), https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-01 [https://perma.cc/M9XZ-T8NL].

34. *See infra*, Part III for a discussion of the objective of a plan manager's fiduciary duties.

managers."[35] More generally, "[w]hen shareholders vote they are also participating, alongside the board, in corporate decision making. That is, they are temporarily transformed into a locus of corporate authority that rivals the authority of the board."[36] But perhaps most importantly:

> Shareholder voting, when it happens, has an obvious and very important impact on a publicly traded company; it shines light on corporate decision making, moving decision making away from the private confines of the boardroom and into the public arena where the board's approach on how to proceed can be debated by those who have the authority to vote. According to Leo Strine, Chief Justice of the Delaware Supreme Court, shareholder voting, even in its limited scope, is one of the components of corporate law that encourages the board to view decision making through the lens of shareholder interests. However, at the same time, shareholder voting makes corporate decision making much more unwieldy and potentially subject to the whims of uninformed and/or opportunistic shareholders.[37]

When corporate law provides shareholder voting as a means to send the necessary message to the board that it should be doing its work through the lens of shareholder interests, it is taking a risk that shareholders will either be uninformed or acting opportunistically when they participate in corporate decision making through voting. Such voting can create havoc in a firm and lead to a significant reduction in shareholder wealth and a corresponding drop in the value of an ERISA plan's equity holdings. However, the voting recommendations of proxy advisors can help mitigate this situation.

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 . . . ."[38] This is exactly what proxy advisors do. However, ERISA does not define what is meant by "renders investment advice,"[39] 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).[40]

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35. Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. 129, 132 (2009).

36. Sharfman, *Enhancing the Value of Shareholder Voting Recommendations*, *supra* note 14, at 3.

37. *Id.* at 5.

38. 29 U.S.C. § 1002(21)(A)(ii).

39. Chamber of Commerce of the U.S. v. U.S. Dep't of Labor, 885 F.3d 360, 390 (5th Cir. 2018) (Stewart, C.J., dissenting).

40. 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 Krug, *supra* note 1.

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.[41]

C. Proxy Advisors as Investment Advice Fiduciaries

Given that the proxy advisory industry was not even in its infancy in 1975,[42] it should not be surprising that the test, when applied to proxy advisors, does not explicitly 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.

As discussed below in Part II.D, the DOL has made attempts to designate proxy advisors as investment advice fiduciaries. Unfortunately, these attempts failed for the reasons subsequently discussed. However, this does not mean that the DOL does not have the legal authority to do so now.

When a proxy advisor provides shareholder voting recommendations to an ERISA plan manager for a fee, it is providing investment advice under both Section 3(21)(A)(ii) and the DOL's five-part test. As observed by Anita Krug, the five-part test captures the definition of investment adviser under the Investment Advisers Act of 1940.[43] This makes the following and very eloquent SEC statement about proxy advisors coming under the Advisers Act's definition of investment adviser relevant to the argument that proxy advisors render investment advice and therefore can be designated investment advice fiduciaries by the DOL:

> We understand that typically proxy advisory firms represent that they provide their clients with advice designed to enable institutional clients [ERISA plan managers] to *maximize* the value of their investments. In other words, proxy advisory firms provide analyses of shareholder proposals, director candidacies or corporate actions and

41. Definition of the Term "Fiduciary," 75 FED. REG. 65263-65264 (proposed Oct. 22, 2010) (emphasis added) (citing 29 C.F.R. 2510.3-21(c)).

42. It does not appear that proxy advisors existed in 1975. *See* U. S. GOV'T ACCOUNTABILITY OFFICE, GAO 07-765, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING, GAO-07-765 7-8 (2007).

43. Krug, *supra* note 1, at 352.

> provide advice concerning particular votes in a manner that is intended to assist their institutional clients [ERISA plan managers] in achieving their investment goals with respect to the voting securities they hold. In that way, proxy advisory firms meet the definition of investment adviser [rendering investment advice] because they, for compensation, engage in the business of issuing reports or analyses concerning securities and providing advice to others as to the value of securities.[44]

This statement, with the addition of insertions to show how it would apply to ERISA plan managers, reflects the understanding that a proxy advisor who provides voting recommendations to its clients that are adequately precise and lack bias may significantly increase a company's intrinsic *value* and its stock price. Moreover, if the voting recommendations and research of a proxy advisor are created in an informed (the first step in making sure that voting recommendations are adequately *precise*, not just a flip of the coin)[45] and unbiased manner, then they can go a long way to help cure the defects in corporate decision making that may result from shareholder voting. However, if a recommendation lacks precision and/or was created with significant bias, then it may significantly decrease firm value. Providing this type of advice is clearly within the authority of the *value* component of the five-part test.

In addition, when proxy advisers create voting recommendations in regard to "corporate transactions such as mergers, acquisitions, or spinoffs, they are engaged in" providing advice that pertains directly to the purchase or sale of securities.[46] For example, if a voting recommendation pertains to the cash sale of the company stock to a prospective acquirer, then a voting recommendation that approves the recommendation may lead to the sale of the company's stock. Providing this type of advice is within the authority of the *purchasing or selling securities* component of the five-part test.

Moreover, when proxy advisors provide shareholder voting recommendations to ERISA plan managers for a fee, they do not just provide plan managers with access to their general voting guidelines as found on their websites, which is available to the public, but specific voting recommendations for each vote the plan manager must make during the proxy season. These specific voting recommendations are based on a proxy advisor's voting guidelines, public information available on the company, analysis of the public information (whatever that may be), and any particular voting customization requested by clients.[47]

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44. Concept Release on the US Proxy System, 75 FED. REG. 42982, 43010 (proposed July 22, 2010) (emphasis added).

45. *See* Sharfman, *Enhancing the Value of Shareholder Voting Recommendations*, *supra* note 14, at 3-4.

46. Complaint at 9, Institutional Shareholder Services Inc. v. SEC, No. 1:19-cv-03275 (D.D.C. Oct. 31, 2019) (arguing that proxy advisers are subject to regulation under the Investment Advisers Act of 1940).

47. For example, ISS reports that it provides over 400 customized voting reports. *See* Institutional Shareholder Services Inc., Comment Letter on Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisors; Request for Comment on Enhancing Investment Advisor Regulations, S7-09-18 (Aug. 7, 2018), at p. 1, https://www.sec.gov/comments/s7-09-18/s70918-4184213-172552.pdf

Finally, based on the DOL guidance provided in the Avon letter and other subsequent DOL documents, if "the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock,"[48] then it follows that the providing of voting recommendations, where these recommendations are the primary or only source of information on how to vote, must also be a fiduciary act under ERISA.

D. History of Proxy Advisors as Potential Fiduciaries

In 2010, thirty-five years after the five-part test was released, 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 type of persons that were to be considered fiduciaries.[49] By specifically including "advice and recommendations as to the exercise of rights appurtenant to shares of stock (e.g., voting proxies)" in the proposed rule, those additional persons would have included proxy advisors.[50] However, implementation of the rule failed as a result of strong public opposition to the general expansion.[51]

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.[52] 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,"[53] for example, when a proxy advisor posts general voting guidelines on its website. The Fiduciary Rule of 2016 was heavily criticized for being an overreach of statutory authority[54] and was vacated by

[https://perma.cc/32YC-8U6V]. Glass Lewis reports that it provides customized reports to a "supermajority" of its clients. Perhaps this is so because it does not have specialty reports, only one benchmark report. *See* GLASS LEWIS, BEST PRACTICE PRINCIPLES FOR PROVIDERS OF SHAREHOLDER VOTING RESEARCH & ANALYSIS: GLASS LEWIS STATEMENT OF COMPLIANCE FOR THE PERIOD OF 1 JANUARY 2018 THROUGH 31 DECEMBER 2018 9-10 (2019).

48. U.S. Dep't of Labor, *supra* note 26, at 7.

49. Definition of the Term "Fiduciary," 75 FED. REG. 65263 (proposed Oct. 22, 2010).

50. *Id.* at 65266.

51. *See, e.g.*, Center on Executive Compensation, Comments on Definition of Fiduciary Proposed Rule (Feb. 3, 2011), http://www.execcomp.org/Docs/c11-21%20COEC%20Comments%20to%20DOL%20re%20Defn%20of%20Fiduciary.pdf [https://perma.cc/K39L-PXZG] ("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.").

52. Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 81 FED. REG. 20946 (proposed Apr. 8, 2016) (to be codified at 29 C.F.R. pts. 2509, 2510, 2550).

53. *Id.* at 20967.

54. Krug, *supra* note 1, at 347 (noting that "the DOL's adoption of it [the fiduciary rule] is an episode of failed rulemaking").

the 5th Circuit Court of Appeals in its 2018 decision, *Chamber of Commerce of the United States v. United States Department of Labor*.[55]

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 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.

III. 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."[56] 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.[57] These duties are very similar to what is found under the common law of trusts.[58]

A. Duty of Loyalty

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 benefitting them."[59] 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."[60] 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 beneficiaries."[61] 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.[62]

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55. 885 F.3d 360, 388 (5th Cir. 2018).

56. *Id.* at 363-64 (quoting Shaw v. Delta Air Lines, Inc., 463 U.S. 85, 90 (1983)).

57. Cent. States, Southeast & Southwest Areas Pension Fund v. Cent. Transp., Inc., 472 U.S. 559, 570-71 (1985).

58. *See id.*

59. Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. (forthcoming 2020) (manuscript at 15), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3244665 [https://perma.cc/LF5K-PMR5] (citing 29 U.S.C. § 1104(a)(1)(A)(i)).

60. *Id.* (citing Restatement (Third) of Trusts § 78(1) cmt. f. (Am. Law Inst. 2007)).

61. *Id.*

62. *See id.*

i. Pursuit of Financial Benefits

The duty of loyalty also requires an exclusive focus on the "pursuit of '*financial* benefits' for the plan beneficiaries."[63] The U.S. Supreme Court in *Fifth Third Bancorp v. Dudenhoeffer* describes the "exclusive purpose" to be pursued by ERISA fiduciaries as:

> "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.[64]

Therefore, ERISA's fiduciary duties also incorporate a *mandatory* "common investor purpose,"[65] the "pursuit of *financial* benefits for the plan beneficiaries."[66] Even if the ERISA plan documents stated that other objectives could or must be pursued, such as cleaning up the environment, raising labor wages, making the workplace safer, providing better medical benefits for employees, or solving the numerous political problems that exist around the world, no matter how worthy, this cannot trump ERISA's fiduciary duties and would be void as a matter of public policy.[67] In sum, ERISA explicitly constrains plan managers to focus solely 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.

ii. 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 fiduciary 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 that this is 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, may be at 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

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63. *Id.* at 15 (citing Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409, 421 (2014)).

64. 573 U.S. at 420-21.

65. 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 [https://perma.cc/G9EU-PT23].

66. Schanzenbach & Sitkoff, *supra* note 59, at 15.

67. *See* Fifth Third Bancorp, 573 U.S. at 421 ("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."' (citing 29 U.S.C. § 1110(a)).

Sean Griffith, "[s]hareholder wealth maximization is reducible, essentially, to return on equity, which in efficient markets, can be simplified even further to share price."[68] 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 their 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, "[i]t 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."[69] Consider, 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 their fiduciary duties. However, the determination of fact patterns where, as a matter of public policy, an ERISA plan manager can veer from SWM in their 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.

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."[70] This is the "prudent man standard" and would certainly apply to proxy advisors if they were to be designated as fiduciaries. Moreover, ERISA embodies the common law's "prudent investor rule"[71] by requiring a plan manager, in the context of managing their investments, to adequately diversify their investment portfolios.[72] And, where relevant, the prudent investor rule would apply to proxy advisors as fiduciaries.

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68. Griffith, *supra* note 65, at 22-23.

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

70. Schanzenbach & Sitkoff, *supra* note 59, at 31 (quoting 29 U.S.C. § 1104(a)(1)(B) (2017)).

71. *Id.* at 33 ("The prudent investor rule applies . . . to private pensions subject to ERISA."). The DOL formally recognizes the prudent investor rule in 29 C.F.R. § 2550.404a-1(b). *Id.* at 33 n.210.

72. 29 U.S.C. § 1104(a)(1)(C) (requiring a fiduciary to discharge his duties "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").

IV. What is Meant by ESG

Being guided by ERISA's strict fiduciary principles should 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. These strict fiduciary principles will also impact the voting recommendations of proxy advisors if they are eventually designated as fiduciaries. However, before such a discussion can begin (found in Part V) it is important to understand the meaning of ESG.

A. ESG as an Undefined Concept

ESG has its roots in the practice of avoiding investment in firms that make antisocial products.[73] This practice can be traced back to the 18th century.[74] 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.[75] 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.[76]

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."[77]

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73. Schanzenbach & Sitkoff, *supra* note 59, at 6.
74. *Id.* at 6-7.
75. For a good discussion of this evolution, see *id.* at 6-11.
76. Hester M. Peirce, *Scarlet Letters: Remarks Before the American Enterprise Institute*, SEC. & EXCHANGE COMMISSION (June 18, 2019), https://www.sec.gov/news/speech/speech-peirce-061819 [https://perma.cc/45LR-FR6M] (emphasis added).
77. *Id.*

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."'[78] 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."[79] In sum, "[t]he corporation, the idea goes, should consider its impact on society as a whole."[80]

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 the 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 environmental category. 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.[81]

Of course, what is missing in this statement is that a company's primary "social purpose" should always be the providing of goods and services for its customers. If not, then no matter how much you might benefit other stakeholders, the rationale for the company's existence is in question. For example, if a company pays extremely good wages but produces a product that no one wants, then the rationale for the company's

78. Hester M. Peirce, *My Beef with Stakeholders: Remarks at the 17th Annual SEC Conference, Center for Corporate Reporting and Governance*, SEC. & EXCHANGE COMMISSION (Sept. 21, 2018), https://www.sec.gov/news/speech/speech-peirce-092118 [https://perma.cc/SV73-YBEQ].

79. David F. Larcker et al., *Stakeholders and Shareholders: Are Executives Really 'Penny Wise and Pound Foolish' About ESG?*, STAN. CLOSER LOOK SERIES, July 2, 2019, at 1, https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-closer-look-78-esg-programs.pdf [https://perma.cc/C46T-L7XG].

80. Peirce, *supra* note 78.

81. Larry Fink, *Larry Fink's 2018 Letter to CEOs: A Sense of Purpose*, BLACKROCK, https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter [https://perma.cc/8KF6-6VYA].

existence is definitely in question.

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 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."[82] Shareholder democracy is currently associated with the idea of one-share, one-vote[83] and provides the foundation for the movement's strong attacks on dual class shares.[84]

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 end-users' money to buy and sell stocks for their benefit.[85]

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.

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

83. *See* Usha Rodrigues, *The Seductive Comparison of Shareholder and Civic Democracy*, 63 WASH. & LEE L. REV. 1389, 1390 (2006).

84. *See infra* Part IV.D.i.

85. Leo E. Strine, Jr., Essay, *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).

> 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."[86]

Shareholder empowerment G results in sub-optimal private ordering because it 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."[87] These "[a]gency 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 satisfy its own preferences," or the preferences of a third party, and not the preferences of the pension fund beneficiaries or the beneficial investors.[88]

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.[89] 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.[90] The more delegated voting power these

86. 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).

87. *Id.* at 3.

88. *Id.* at 3-4.

89. *See* Charles McGrath, *80% of Equity Market Cap Held by Institutions*, PENSIONS & INV. (Apr. 25, 2017), https://www.pionline.com/article/20170425/INTERACTIVE/170429926/80-of-equity-market-cap-held-by-institutions [https://perma.cc/N7QS-MAWX] According to the article, institutional investors currently own approximately eighty percent of the market value of U.S. publicly traded equities.

90. 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. Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721, 739 (2019).

investment advisers obtain, the more tempted they will be to use that power opportunistically.[91] 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.[92]

D. Examples of Shareholder Empowerment G

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

i. 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."[93]

For example, the Council of Institutional Investors (CII), the trade organization that represents public pension and union-related funds, and a leader in the shareholder empowerment movement, published on its website a list of directors whose companies recently went public with a dual class share structure.[94] The objective of this initiative is to put pressure on directors to stop supporting the use of dual class share structures through a strategy based, at least in part, on retribution.[95] According to Ken Bertsch, Executive Director of CII, being on the list "may cause 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."[96]

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91. *See* Sharfman, *supra* note 86, at 3.

92. *Id.*

93. *Id.* at 14 (citing Bernard Sharfman, *Dual-class Shares and the Shareholder Empowerment Movement*, R STREET INST. BLOG (June 12, 2017), https://www.rstreet.org/2017/06/12/dual-class-shares-and-the-shareholder-empowerment-movement/ [https://perma.cc/AX4J-6QZE]).

94. *Dual-Class Enablers*, COUNCIL INSTITUTIONAL INV., https://www.cii.org/dualclassenablers [https://perma.cc/DUT7-CR3K] (archived Nov. 16, 2019).

95. The CII statement admits this strategy by stating that "this voting strategy is not *solely* about retribution . . . ." *Id.* (emphasis added).

96. Hazel Bradford, *CII Identifies Directors of Companies with Dual-class Shares*, PENSIONS & INV. (Aug. 7, 2019), https://www.pionline.com/governance/cii-identifies-directors-companies-dual-class-shares [https://perma.cc/367W-BCRH].

Another recent example is the letter the CII submitted to the Delaware State Bar Association. In that letter the CII proposed to the Delaware State Bar Association an amendment to the Delaware General Corporation Law limiting the use of dual class shares such that "no multi-class voting structure would be valid for more than seven years after an initial public offering (IPO), a shareholder adoption, or an extension approved by the vote of a majority of outstanding shares of each share class, voting separately, on a one-share, one-vote basis."[97]

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."[98] Such a reduction in returns makes sense as there is a lot of positive skewness in stock market returns.[99] 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.[100]

In the past, those best performing firms have been overrepresented by dual class share companies such as Alphabet, Berkshire Hathaway, Facebook, etc.[101] 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.

ii. 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.[102] 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 access to become part of a public company's proxy statement.[103] As a result of institutional

97. Ken Bertsch & Jeff Mahoney, *Letter to Delaware State Bar Association: Limiting Multi-Class Voting Structures*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Sept. 24, 2019), https://corpgov.law.harvard.edu/2019/09/24/letter-to-delaware-state-bar-association-limiting-multi-class-voting-structures/.

98. Dimitris Melas, *Putting the Spotlight on Spotify: Why Have Stocks with Unequal Voting Rights Outperformed?*, MSCI (Apr. 3, 2018), https://www.msci.com/www/blog-posts/putting-the-spotlight-on/0898078592 [https://perma.cc/SMN8-KAC8].

99. *See* Hendrik Bessembinder, *Do Stocks Outperform Treasury Bills?* 129 J. FIN. ECON. 440, 440-41 (2018).

100. *Id.*

101. 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 (2019).

102. *See* Bernard S. Sharfman, *What Theory and Empirical Evidence Tell Us About Proxy Access*, 13 J. L. ECON. & POL'Y 1, 3 (2017).

103. 17 C.F.R. § 240.14a-8(i)(8) (2011).

investor pressure, it has been implemented at most of our major public companies.[104]

Even though its adoption has been greatly demanded, its use has been almost non-existent over the past eight years.[105] According to Lynnette C. Fallon, General Counsel of Axcelis Technologies, Inc., "[a]s 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."[106] 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."[107] 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,[108] 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?[109] Perhaps, it is simply an end in itself,[110] 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.[111] 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

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104. MATTEO TONELLO, THE CONFERENCE BD., RESEARCH REPORT R-1687-19-RR, CORPORATE BOARD PRACTICES IN THE RUSSELL 3000 AND S&P 500, at 34 (2019) (noting that "some 61.5 percent of S&P 500 companies have adopted proxy access bylaws").

105. Axcelis Technologies, Inc., Comment Letter on File Number 4-725 – SEC Staff 2018 Roundtable on the Proxy Process, at 2 n.2 (June 19, 2019), https://www.sec.gov/comments/4-725/4725-5707991-185967.pdf [https://perma.cc/Y2Z2-5LGY] (noting that "[t]he history of the use of proxy access provisions currently includes two events").

106. *Id.* at 2-3 (citations omitted).

107. Assaf Hamdani & Sharon Hannes, *The Future of Shareholder Activism*, 99 B.U.L. REV. 971, 993 (2019).

108. Bernard S. Sharfman, *Why Proxy Access is Harmful to Corporate Governance*, 37 J. CORP. L. 387, 402 (2012).

109. Axcelis Technologies, Inc., *supra* note 105, at 3 ("Significant corporate time, effort and expense was incurred in fighting and then adopting these provisions . . . .").

110. *See* 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, 1013-17 (2007).

111. *See* 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.").

would operate to improve corporate performance and value.[112]

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 current board does not want. This 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."[113]

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 cannot tolerate.

V. How a Plan Manager's Fiduciary Duties Impact Their Approach to ESG

An ERISA plan manager's duties of loyalty and care impact how she is to utilize ESG objectives and factors in their management decisions, including shareholder voting. These duties would apply to proxy advisors if they were to be designated as investment advice fiduciaries.

A. 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*."[114] 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."[115] 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."[116]

112. Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 835, 842-43 (2005).

113. Axcelis Technologies, Inc., *supra* note 105, at 3 n.3 (citing *Proxy Access*, COUNCIL INSTITUTIONAL INV., https://www.cii.org/proxy_access [https://perma.cc/L8GC-U44Y] (archived Nov. 16, 2019)).

114. Schanzenbach & Sitkoff, *supra* note 5959, at 5.

115. *Id.* at 16-17.

116. *Id.* at 19.

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 their proxies? The answer under ERISA is very simple, she can't.[117]

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 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.[118]

This understanding of ERISA has significant implications for ERISA plan managers. For example, suppose 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,[119] then she would definitely be in breach of their 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,[120] were to be included as mutual fund options for participants and beneficiaries.

i. 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.[121] 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

117. *Id.* at 16. ("The foregoing discussion points irresistibly to the legal conclusion that ERISA forbids collateral benefits ESG investing by a pension trustee.").

118. *Id.* at 15 (citing Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409, 420-23 (2014)); *see also* Cent. States, Southeast & Southwest Areas Pension Fund v. Cent. Transp., Inc., 472 U.S. 559, 568 (1985) (noting that "trust documents cannot excuse trustees from their duties under ERISA").

119. *See* Melas, *supra* note 98.

120. *See Press Release: S&P Dow Jones Indices Announces Decision on Multi-Class Shares and Voting Rules*, S&P DOW JONES INDICES (July 31, 2017), https://www.spice-indices.com/idpfiles/spice-assets/resources/public/documents/561162_spdjimulticlasssharesandvotingrulesannouncement7.31.17.pdf?force_download=true [https://perma.cc/E6ZM-7VEQ].

121. Schanzenbach & Sitkoff, *supra* note 59, at 15.

of an ERISA plan this means the pursuit of SWM.[122]

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, an ERISA plan manager can determine 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*."[123] 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 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."[124]

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

122. *Id.*

123. *Id.* at 5.

124. U.S. DEP'T OF LABOR, *supra* note 33, at 2.

> 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.[125]

As stated by Sean Griffith, "[i]n 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."[126]

C. Duty of Care

A plan manager's duty of care impacts how they go about evaluating risk-return ESG.[127] 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."[128] 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.[129] 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.[130] 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.[131]

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125. *Id.*

126. Griffith, *supra* note 65, at 15 n.78.

127. Schanzenbach & Sitkoff, *supra* note 59, at 32.

128. *Id.*

129. *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.").

130. *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)).

131. *Id.* at 33-34.

VI. 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 [of Labor] has construed the requirements that a fiduciary act solely in the 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.[132]

This SWM approach to shareholder voting is consistent with what is found in corporate law: "What legitimizes the stockholder vote as a decision-making mechanism [and not simply leaving it in the hands of the board of directors] is the premise that stockholders with economic ownership are expressing their collective view as to whether a particular course of action serves the corporate goal of stockholder wealth maximization."[133] In sum, 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." [134]

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,

132. U.S. Dep't of Labor, *supra* note 26, at 11 n.4.

133. Kurz v. Holbrook, 989 A.2d 140, 178 (Del. Ch. 2010), *aff'd in part rev'd in part*, Crown Emak Partners, LLC v. Kurz, 992 A.2d 377, 388–90 (Del. 2010).

134. Interpretive Bulletin Relating to the Exercise of Shareholder Rights, *supra* note 32, at 95881.

> in an attempt to further reduce the costs of researching proxy matters and exercising shareholder rights.[135]

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 that plan managers may face each year. Instead, they 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 their fiduciary duties. If not, then they must not be relied upon when voting.

VII. 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's (61 percent market share of proxy advisory market) corporate governance and executive compensation consulting services[136] and the majority owner of Glass Lewis (37 percent market share) is Ontario Teachers' Pension Plan, a large institutional investor.[137] 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.[138] 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.

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135. *Id.* (citation omitted).

136. *See* John Engler, *BRT Letter on Application of ERISA Fiduciary Duties to Proxy Advisor Firms*, BUS. ROUNDTABLE (Feb. 3, 2011), https://www.businessroundtable.org/archive/resources/brt-letter-on-application-of-erisa-fiduciary-rules-to-proxy-advisory-firms [https://perma.cc/6VFW-Y7E5]; *see also* Doyle, *supra* note 14, 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.").

137. Center on Executive Compensation, *supra* note 51, at 5.

138. *Id.*

However, the main concern has been a lack of precision in the voting recommendations of proxy advisors. This is the result of a lack of resources to create informed voting recommendations.[139] As I discuss in a forthcoming article:[140]

> 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 . . . and Glass Lewis . . . devote to the creation of recommendations. . . . As of June 2017, the ISS Global Research team covered 40,000 shareholder meetings [approximately 250,000 votes] with approximately 270 research analysts and 190 data analysts. However, it is not known how many research analysts are full-time, part-time or seasonal (proxy season only). . . .
>
> In 2018, Glass Lewis reported that it covers 20,000 meetings each year with approximately the same number of analysts it had in 2014 [200]. 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). For example, to provide these recommendations the ISS has created a Special Situations Research Team ("Research Team"). Remarkably, the Research Team is made up of only eight analysts. . . .
>
> It is extremely doubtful that the expertise required for any particular proxy contest could be found within the eight-member Research Team. That is because there are close to 4,000 public companies in the US alone and they exist in numerous industries. For example, the Global Industry Classification Standard includes 11 sectors which are further subdivided into 24 industry groups, 69 industries and 158 subindustries. 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.
>
> This same lack of expertise would apply to M&A recommendations. Moreover, there are many more to deal with. On an average annual basis . . . let's assume that the Research Team is faced with around 150 to 300 M&A per year. . . . For a team of eight without the proper expertise, doing an adequate job is an impossible task.

Such a lack of resources in the face of the tens of thousands of votes that proxy

139. Sharfman, *Enhancing the Value of Shareholder Voting Recommendations*, *supra* note 14, at 16-19.

140. *Id*. at 16-18 (citations omitted).

advisors must opine on each year has resulted in "a one-size-fits-all approach to corporate governance, such as with executive compensation,[141] irrespective of the differences in companies' business models and the flexibility allowed under securities law;"[142] the inability to devote enough resources to properly 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;[143] 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;[144] 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.[145]

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

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141. ExxonMobil, Comment Letter on Roundtable on the U.S. Proxy Process (July 26, 2019), at 4, https://www.sec.gov/comments/4-725/4725-5879063-188728.pdf [https://perma.cc/5A9Y-8KNS]. 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.

Id.

142. National Association of Manufacturers, Comment Letter on File No. 4-725: SEC Staff Roundtable on the Proxy Process (Oct. 30, 2018), at 2, https://www.sec.gov/comments/4-725/4725-4581799-176285.pdf [https://perma.cc/638M-JRZY]. 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.

Center for Capital Markets, Comment Letter on Roundtable on the U.S. Proxy Process: File No. 4-725 (Dec. 20, 2018), at 3, https://www.sec.gov/comments/4-725/4725-4826117-177028.pdf [https://perma.cc/6B7F-J7GG].

143. *Id.* at 2-3.

144. *Id.* at 3 (citing FRANK M. PLACENTI, AM. COUNCIL FOR CAPITAL FORMATION, ARE PROXY ADVISORS REALLY A PROBLEM? (2018)).

145. *Id.* at 3; *see also* ExxonMobil, *supra* note 141, at 21 (noting "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).").

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.[146] The five specialty reports are grouped by client type in the following manner: Taft-Hartley (multiemployer pension plans), Socially Responsible Investment (SRI), Sustainability, Public Fund (public pension funds), and Catholic Faith-Based.[147] The voting recommendations provided by ISS to its institutional investor clients, including investment managers of ERISA plans, vary by report type.[148] These reports, which may also be customized depending on a client's preferences,[149] create a default voting policy for each public company held in a client's equity portfolio.[150]

According to ExxonMobil's comment letter to the SEC, the specialty reports "are not provided to companies to review and frequently contain serious inaccuracies and omissions."[151] 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."[152] Moreover, based on ExxonMobil's comment letter, "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."[153] Finally, these special reports are never sent to issuers for review and comment before being sent to clients.[154]

146. ExxonMobil, *supra* note 141, at 7.
147. *Id*. at 7 n.7.
148. *Id*. at 8.
149. Supposedly, in addition to the benchmark and specialty voting reports, ISS provides over 400 customized voting reports. *See* Institutional Shareholder Services, Inc., *supra* note 47, at 1. However, it is not known what parameters are used in developing these reports and how closely they follow the standard reports. Glass Lewis reports that it provides customized voting reports to a "supermajority" of its clients. Perhaps this is so because it does not have specialty voting reports, but only one benchmark voting report (i.e. the "Glass Lewis Proxy Paper Report" or "House" policy). *See* GLASS LEWIS, *supra* note 47, at 9-11.
150. ExxonMobil, *supra* note 141, at 7.
151. *Id.*
152. *Id.*
153. *Id.* at 8.
154. *Id.* at 10.

If these allegations are true, then it would appear that, at the very least, 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.[155] 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"[156] while also stating that its objective is "focused solely on maximizing shareholder value and mitigating governance risk."[157] 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.

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.[158]

155. *Id.* at 8 n.12.

156. Institutional Shareholder Services, Inc., *supra* note 47, at 1 (emphasis added); *see also* Statement of Gary Retelny, President & CEO, Institutional S'holder Servs. Inc., to Subcomm. on Capital Mkts. & Gov't Sponsored Enters., Comm. on Fin. Servs., U.S. House of Representatives, Legislative Proposals to Enhance Capital Formation, Transparency and Regulatory Accountability (May 17, 2016), at A-14, https://www.issgovernance.com/file/duediligence/iss-statement-hfsc-17-may-2016.pdf [https://perma.cc/NC9Y-W6WT].

157. Letter from Gary Retelny, President & CEO, Institutional S'holder Servs. Inc., to Bill Huizenga, Chairman, Subcomm. on Capital Mkts., Sec., & Inv., Comm. on Fin. Servs., U.S. House of Representatives, & Carolyn B. Maloney, Ranking Member, Subcomm. on Capital Mkts., Sec., & Inv., Comm. on Fin. Servs., U.S. House of Representatives, Re: July 18, 2017, Hearing Entitled "The Cost of Being a Public Company in Light of Sarbanes-Oxley and the Federalization of Corporate Governance" (July 27, 2017), at 2, https://www.issgovernance.com/file/duediligence/20170727-iss-letter-to-hfsc-sub-commitee-on-captal-markets-securities-and-investment.pdf [https://perma.cc/PMQ4-3XKH].

158. Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 14 J. APPLIED CORP. FIN. 8, 10-11 (2001).

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."[159] 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.[160]

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:

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."[161] This explicit lack of independence in the creation of voting recommendations is most disconcerting because multiemployer pension 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

159. Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. (forthcoming 2019) (manuscript at 7), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3282794 [https://perma.cc/CR8X-4SLR]; *see also* Griffith, *supra* note 65, 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." (citations omitted)).

160. *See supra*, Part VII.A.

161. INSTITUTIONAL S'HOLDER SERVS., UNITED STATES TAFT-HARTLEY PROXY VOTING GUIDELINES: 2019 POLICY RECOMMENDATIONS 6 (2019) (emphasis added).

the companies in which they invest conduct their business in a socially and environmentally responsible manner."[162] Moreover, "[i]n 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."[163] Therefore, ISS has "developed proxy voting guidelines that are consistent with the dual objectives of socially responsible shareholders."[164]

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." [165] 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."[166] Therefore, ISS has "developed proxy voting guidelines that are consistent with the objectives of sustainability-minded investors and fiduciaries."[167]

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."[168] This statement appears to be most similar to how the benchmark is described. However, the statement continues with "[t]his 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 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 respon-

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162. INSTITUTIONAL S'HOLDER SERVS., UNITED STATES SRI PROXY VOTING GUIDELINES: 2019 POLICY RECOMMENDATIONS 8 (2019).

163. *Id.*

164. *Id.*

165. INSTITUTIONAL S'HOLDER SERVS., UNITED STATES SUSTAINABILITY PROXY VOTING GUIDELINES: 2019 POLICY RECOMMENDATIONS 8 (2019).

166. *Id.*

167. *Id.*

168. INSTITUTIONAL S'HOLDER SERVS., UNITED STATES PUBLIC FUND PROXY VOTING GUIDELINES: 2019 POLICY RECOMMENDATIONS 6 (2019).

169. *Id.*

sible 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."[170] Moreover, "[i]n 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."[171] 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."[172]

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. Thus, the need for proxy advisors to be designated investment advice fiduciaries.

VIII. 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 their fiduciary objective. These fiduciary duties need to be shared by proxy advisors.

As discussed in Part II.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 to make explicit that it includes the voting recommendations and research of proxy advisors. The question then becomes, how is the DOL to implement this recommendation so that it is effective in allowing an ERISA plan manager to meet its fiduciary duties in the management of voting rights? The following are supplemental recommendations that the DOL must implement to support the primary recommendation of designating of proxy

170. INSTITUTIONAL S'HOLDER SERVS., UNITED STATES CATHOLIC PROXY VOTING GUIDELINES: 2019 FAITH-BASED POLICY RECOMMENDATIONS 8 (2019).

171. *Id.*

172. *Id.*

advisors as investment advice fiduciaries:

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. Any type of customization based on *client preferences* must also meet this requirement. If not, then the customization cannot be allowed.[173] It must always be remembered that the clients of proxy advisors are ERISA plan managers, the agents of beneficiaries and participants, and that ERISA's fiduciary duties are owed to the beneficiaries and participants, not their agents. This requirement is the only way to ensure that the plan manager's fiduciary duties are being met when voting the plan's proxies.

For ISS, this would require a new SWM 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. But 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.[174] As publicly stated by Glass Lewis, it does not invest in the acquiring of private information in the creation of voting recommendations, using only what is publicly available.[175]

Also, in terms of evaluating E and S proposals from the perspective of SWM, it

173. Glass Lewis reports that it goes through an extensive review of a client's customized voting policy prior to implementation. *See* GLASS LEWIS, *supra* note 47, at 9-10.

174. Griffith, *supra* note 65, at 40 (regarding E and S shareholder proposals, "[m]anagers have access to private, company-specific information to determine the likely effect of any initiative on shareholder value" while "[s]hareholder proponents and institutional investors do not").

175. GLASS LEWIS, *supra* note 47, at 7.

can be assumed that the board is not conflicted.[176] That is, "[m]anagement has as strong an incentive to increase corporate value through ES as through any other initiative."[177] 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.[178] This is so because "optimal governance arrangements are endogenous to firms,"[179] making "the general effect of a provision . . . of little use in understanding how it will affect value at a particular firm."[180] Moreover, empirical studies have been little help[181] in determining the existence of optimal governance structures.[182] 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.[183] 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:

First, a description of "the essential features of the methodologies and models applied."[184]

Second, information sources used in the creation of its voting recommendations.[185]

176. Griffith, *supra* note 65, at 8.

177. *Id.* at 40.

178. *Id.* at 43.

179. *Id.* at 44.

180. *Id.*

181. For example, Griffith found that a review of recent empirical research yielded inconsistent results compared to past work. *See id.* at 43-45.

182. *Id.* at 44 ("Recent empirical scholarship demonstrates that many widely held views concerning the effects of corporate governance are wrong or, at least, overstated.").

183. *Id.* at 8.

184. Sharfman, *From Across the Atlantic, Guidance for the SEC's Oversight of Proxy Advisors, supra* note 14.

185. *Id.*

Third, a description of the procedures in place to make sure that the voting recommendations provided to ERISA plans meet the prudent man standard.[186] This disclosure would appear to be particularly important when the voting recommendations deal with proxy contests and mergers & acquisitions.

Fourth, a description of the procedures in place to make sure that the voting recommendations are exclusively tied to the objective of SWM.[187] The monitoring for compliance with this objective is critical as proxy advisors should not be providing recommendations to ERISA plan managers if their voting recommendations turn on factors other than the pursuit of SWM.

Fifth, prompt identification and disclosure to the DOL of "any actual or potential conflict of interest or any business relationship that may influence" the creation of its voting recommendations.[188] Moreover, it must provide the DOL with "a statement of the action" on how it will resolve the actual or potential conflict of interest.[189]

Sixth, a description of 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 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."[190]

Seventh, 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.[191] 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.

The proxy advisor abstaining from the providing of a voting recommendation does not mean that the plan manager is left without a voting recommendation. The board of directors also provides recommendations on each vote. As I have stated in a prior article, "[t]he combination of being the most informed locus of authority and the one with the most analytical firepower at its disposal, executive management, provides the board with the greatest potential for creating the most precise shareholder

186. *Id.*

187. *Id.*

188. *Id.*

189. *Id.*

190. National Association of Manufacturers, *supra* note 142, at 5.

191. *See* Sharfman, *Enhancing the Value of Shareholder Voting Recommendations*, *supra* note 14, at 26.

voting recommendations."[192] Of course, "significant bias may exist in some board recommendations, reducing their precision, either because of agency costs or having too narrow a focus, but voting recommendations have no value if they are not informed."[193]

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 their fiduciary duties when managing the voting rights of the plan's equity holdings.

192. *Id.* at 10.

193. *Id.* at 4.