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Washington, DC 20210
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RE: Fiduciary Duties Regarding Proxy Voting and Shareholder Rights (RIN 1210-AB91)

Submitted by: Bernard S. Sharfman[*]

Ladies and Gentlemen,

The Department of Labor ("DOL"), through its administration of ERISA,[1] has a critical role to play in the regulation of "employee pension benefit plans."[2] Most importantly, the DOL is tasked with enforcing the fiduciary duties of ERISA plan managers (trustees who retain investment and voting authority or "investment managers"[3] that receive such authority through delegation by the trustees).

A plan manager is an agent of the plan's participants[4] and beneficiaries.[5] The fiduciary duties imposed upon a plan manager by ERISA help mitigate what is referred to as "agency costs," i.e., the gap in interests between a plan manager and the plan's participants and beneficiaries.[6] Therefore, the

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[1] Pub. L. No. 93-406, 88 Stat. 829; Title 1 of the Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001 *et seq.*
[2] *See id.* § 1002(2) ("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").
[3] *See* ERISA § 1002(8).
[4] *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").
[5] *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").
[6] Agency costs are the expected costs of the agency relationship. According to Michael Jensen and William Meckling:

> We define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal. The

objective of the proposed rule, *Fiduciary Duties Regarding Proxy Voting and Shareholder Rights*,[7] is to mitigate the agency costs of shareholder voting and engagement within the framework of these statutorily required fiduciary duties.

Under ERISA, plan managers owe the strictest duties of loyalty and care to their participants and beneficiaries. The duty of loyalty requires a plan manager to act "*solely* in the interest of the participants and beneficiaries" and for the *exclusive purpose* of providing *financial benefits*[8] to them.[9]

A plan manager also has a duty of prudence.[10] This duty requires a plan manager to perform a careful, impartial, and reasonable investigation prior to making an investment decision.[11]

The shareholder voting of a plan manager is to be treated in the same manner. According to footnote 4 of the Avon Letter, the DOL opinion letter that identified shareholder voting rights as being part of a plan manager's fiduciary duties:[12]

> 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*

> principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities, of the agent. In addition in some situations it will pay the agent to expend resources (bonding costs) to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions. However, it is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal's viewpoint. In most agency relationships the principal and the agent will incur positive monitoring and bonding costs (non-pecuniary as well as pecuniary), and in addition there will be some divergence between the agent's decisions and those decisions which would maximize the welfare of the principal. The dollar equivalent of the reduction in welfare experienced by the principal due to this divergence is also a cost of the agency relationship, and we refer to this latter cost as the "residual loss." We define *agency costs* as the sum of:
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> (1) the monitoring expenditures by the principal,
> (2) the bonding expenditures by the agent,
> (3) the residual loss.

Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

[7] Department of Labor, Employee Benefits Security Administration, *Fiduciary Duties Regarding Proxy Voting and Shareholder Rights* (proposed Aug. 31, 2020), 85 FED. REG. 55219 (Sept. 4, 2020).

[8] Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409, 420–21 (2014).

[9] *See* 29 U.S.C. § 1104(a)(1)(A)(i).

[10] 29 U.S.C. § 1104(a)(1)(B); ERISA § 404(a)(1)(B).

[11] Craig C. Martin, Michael A. Doornweerd, Amanda S. Amert, and Douglas A. Sondgeroth, Jenner & Block, ERISA LITIGATION HANDBOOK (2012), citing Flanigan v. GE, 242 F.3d 78, 86 (2d Cir. 2001); quoting Bussian v. RJR Nabisco, Inc., 223 F.3d 286, 300 (5th Cir. 2000), https://jenner.com/system/assets/publications/11324/original/ERISA_Litigation_Handbook.pdf?1353351675.

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

> *subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives*.[13]

As an affirmation of the latter point, DOL's Field Assistance Bulletin No. 2018-01 states: "The Department has a similarly longstanding position that ERISA fiduciaries may not sacrifice investment returns or assume greater investment risks as a means of promoting collateral social policy goals."[14]

DOL guidance on shareholder engagement, whether narrowly defined to include only a plan manager's direct engagement with the management of the plan's portfolio companies or more broadly defined to include all resources expended in the process of shareholder voting, is also clear and unambiguous. Not surprisingly, engagement is allowed as long as it resides within the confines of a plan manager's fiduciary duties. Engagement must be utilized only if there is "a reasonable expectation that such activities are likely to enhance the [financial] value of the plan's investments after taking into account the costs involved."[15]

Given this understanding of how the fiduciary duties of ERISA apply to a plan manager's shareholder voting and engagement,[16] it is easy for me to strongly support the approach taken by the DOL in its recently proposed rule, *Fiduciary Duties Regarding Proxy Voting and Shareholder Rights*.[17] I agree with the DOL when it states in the proposed rule that:

- "A fiduciary's exercise of voting rights (or other shareholder rights) must be performed solely for the plan's economic interests, which under no circumstances may be subordinated to non-pecuniary goals";[18]

- "fiduciaries manage voting rights prudently and for the "exclusive purpose" of securing economic benefits for plan participants and beneficiaries—which may or may not require a proxy vote to be cast" and that "there is no presumption that abstaining from voting proxies appurtenant to shares of stock is a per se fiduciary breach";[19]

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[13] *Id.* at 11 n. 4.
[14] 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).
[15] *Id.*
[16] This understanding is consistent with the understanding applied by the DOL in its other recently proposed rule, *Financial Factors in Selecting Plan Investments*, 85 FED. REG. 39113 (June 30, 2020). I strongly supported this understanding in my comment letter, Letter from Bernard S. Sharfman to Office of Regulations and Interpretations, Employee Benefits Security Administration, *RE: Financial Factors in Selecting Plan Investments Proposed Regulation (RIN 1210-AB95)* (July 22, 2020), https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB95/00147.pdf. Please note that my July 22, 2020, letter will form the foundation for a forthcoming law review article in the YALE JOURNAL ON REGULATION BULLETIN, the online companion to the print version of the YALE JOURNAL ON REGULATION.
Bernard S. Sharfman (July 22, 2020), https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB95/00147.pdf.
[17] Department of Labor, Employee Benefits Security Administration, *Fiduciary Duties Regarding Proxy Voting and Shareholder Rights* (proposed Aug. 31, 2020), 85 FED. REG. 55219 (Sept. 4, 2020).
[18] *Id.* at 55222.
[19] *Id.* at 55223.

- "A fiduciary's duty is only to vote those proxies that are prudently determined to have an economic impact on the plan after the costs of research and voting are taken into account";[20]

- "proxy advice [from a third-party] that is not rigorous or not aligned with a plan's interest could lead to a responsible plan fiduciary voting shares when voting costs exceed any benefit, or when voting would otherwise run counter to the plan's interest";[21] and

- "plans may incur substantially larger costs to exercise shareholder rights more vigorously, such as by sponsoring or campaigning for shareholder proposals. Such activities may deliver little or no benefit to plans because they concern issues that have little bearing on share value or other plan interests."[22]

In sum, a plan manager's shareholder voting and engagement must be utilized only if there is "a reasonable expectation that such activities are likely to enhance the economic value of the plan's investment in that corporation after taking into account the costs involved."[23]

Part I of this comment letter provides a theoretical framework for shareholder voting and the creation of voting recommendations. This Part focuses on the collective action problem found in shareholder voting and its ramifications for both voting and the creation of voting recommendations by proxy advisors. I discuss this framework in more detail in my law review article *The Risks and Rewards of Shareholder Voting* (forthcoming, SMU Law Review).[24] Part II recommends, as a means to help mitigate the collective action problem found in shareholder voting, that proxy advisors, such as Institutional Shareholder Services (ISS) and Glass Lewis, be designated *investment advice fiduciaries* under Section 3(21)(A)(ii) of ERISA. This is something I discuss in detail in my law review article *Now Is the Time to Designate Proxy Advisors as Fiduciaries under ERISA* (Stanford Journal of Law, Business and Finance).[25] Part III supports the proposed rule's approach of increasing the role of board voting recommendations in the voting policies of ERISA plans. My support is based mainly on another recent law review article I wrote, *Enhancing the Value of Shareholder Voting Recommendations* (Tennessee Law Review).[26] Part IV provides support for the proposed rule's approach to shareholder voting proposals.

Part V discusses an issue that is not currently in the proposed rule but that should be considered for inclusion, i.e., how an ERISA plan manager is to incorporate into its decision-making the shareholder activism of investment advisers of mutual funds and exchange-traded funds (ETFs) with large amounts

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[20] *Id.*
[21] *Id.* at 55529.
[22] *Id.*
[23] 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).
[24] Bernard S. Sharfman, *The Risks and Rewards of Shareholder Voting*, SMU L. REV. (forthcoming), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3550077. **Please note** that the authority listed in footnote 39 of the proposed rule may be enhanced by the inclusion of this article.
[25] Bernard S. Sharfman, *Now Is the Time to Designate Proxy Advisors as Fiduciaries under ERISA*, 25 STAN. J.L. BUS. & FIN. 1 (2020).
[26] Bernard S. Sharfman, *Enhancing the Value of Shareholder Voting Recommendations*, 86 TENN. L. REV. 691, 713–15 (2019).

of delegated voting authority. This activism is reflected in an investment advisor's rhetoric disclosing the objectives of its activism, shareholder voting, and engagement with portfolio companies. The incorporation of this new consideration would occur when deciding to invest in such funds or considering them as options for self-directed accounts. This Part argues that a plan manager's *duty of prudence* requires it to *investigate* how this shareholder activism will be used prior to making these decisions. The fiduciary objective in this investigation is to ensure that the investment adviser is utilizing shareholder activism consistent with a plan manager's duty of loyalty, i.e., "*solely* in the interest of the participants and beneficiaries" and for the *exclusive purpose* of providing financial benefits to them. If that is not happening, these funds should be excluded from an ERISA plan. This Part has at its foundation a recent white paper that I wrote, *The Conflict between BlackRock's Shareholder Activism and ERISA's Fiduciary Duties*.[27]

I. A THEORETICAL FRAMEWORK FOR SHAREHOLDER VOTING AND THE CREATION OF VOTING RECOMMENDATIONS

Before discussing the DOL's proposed rule, it is important to have a theoretical understanding of shareholder voting and the voting recommendations generated by proxy advisors. This understanding, as presented in sections A through D of this Part, comes directly from my article *The Risks and Rewards of Shareholder Voting*.[28]

A. The Collective Action Problem Embedded in Shareholder Voting

Shareholder voting can certainly provide a corporation with value. As I have previously stated:

> 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. Hence, a good rationale for why shareholders are given limited opportunities to weigh in and participate in corporate decision-making.[29]

Notwithstanding this endorsement of shareholder voting, the latter part of the above quotation points to a significant weakness in the use of shareholder voting for purposes of corporate decision-making. In a public company, where many shareholders exist, shareholder voting suffers from a significant "collective action" problem, leading them to become uninformed and reluctant voters. Frank

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[27] Bernard S. Sharfman, *The Conflict between BlackRock's Shareholder Activism and ERISA's Fiduciary Duties*, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3691957. This writing will be presented at the George A. Leet Business Law Symposium on Nov. 6, 2020 (Case Western Reserve University School of Law) and is expected to be published in the Case Western Reserve Law Review's symposium issue.
[28] Sharfman, *The Risks and Rewards of Shareholder Voting*, *supra* note 24.
[29] *Id.*

Easterbrook and Daniel Fischel explain what this means: "When many are entitled to vote, none of the voters expects his votes to decide the contest. Consequently none of the voters has the appropriate incentive at the margin to study the firm's affairs and vote intelligently."[30] According to Paul Edelman, Randall Thomas, and Robert Thompson, "There is a serious collective action problem in shareholder voting: the benefits of a successful vote accrue to all shareholders *but the costs of voting* (for example, information acquisition, preparation and distribution of materials, mustering support) *are borne by each voter* separately so that shareholders may have inadequate incentives to vote."[31] Interestingly, when shareholders act in this way, they are not considered to be irresponsible but "rationally apathetic."[32]

1. The Impact

Empirically, this collective action problem results in a low percentage of retail investors casting their ballots at stockholder meetings. Based on recent research by Alon Brav, Matthew Cain, and Jonathon Zytnick, retail investors are not inclined to vote unless they own a significant percentage of the company's stock or the company has experienced a recent track record of poor financial performance.[33]

The collective action problem also exists at the institutional investor level but is manifested in a different way. As a result of SEC and DOL regulatory guidance that makes shareholder voting a fiduciary duty, institutional investors such as investment advisers and ERISA plan managers now feel compelled to cast their ballots on almost all issues presented for a vote at a public company (as noted in the proposed rule, this is an understanding that the DOL is trying to correct). This has resulted in many institutional investors casting ballots by proxy on tens, if not hundreds, of thousands of votes per year.[34] However, because of the collective action problem, the amount of resources that they are willing to spend on the acquisition of information internally or externally, in order to be adequately informed on each and every vote, is minimal, requiring them to seek the services of a low-cost provider of voting recommendations such as Institutional Shareholder Services or Glass Lewis (proxy advisors).

2. The Collective Action Problem at Passive and Actively Managed Funds

Consider how the collective action problem and the regulatory pressure to vote encourages our largest investment advisers to index mutual funds (BlackRock, Vanguard, State Street Global Advisors,

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30 Frank H. Easterbrook and Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 402 (1983).
31 Paul H. Edelman, Randall S. Thomas, and Robert B. Thompson, *Shareholder Voting in an Age of Intermediary Capitalism*, 87 S. CAL. L. REV. 1359, 1379 (2014).
32 *See, generally*, Robert C. Clark, CORPORATE LAW 390–92 (1986) (discussing rational apathy).
33 Alon Brav, Matthew D. Cain, and Jonathon Zytnick, *Retail Shareholder Participation in the Proxy Process: Monitoring, Engagement, and Voting*, HARV. L. SCHOOL F. ON CORP. GOV. & FIN. REG. (Nov. 19, 2019), https://corpgov.law.harvard.edu/2019/11/19/retail-shareholder-participation ("On the decision whether to cast a ballot, we find that retail shareholders cast 32% of their shares, on average, which is significantly lower than the 80% rate of participation by the entire shareholder base. In total, 12% of the average firm's retail accounts choose to vote. Retail voter participation is higher among smaller firms. The decision to cast a ballot varies predictably with anticipated costs and benefits. It increases with stake size, when the company's return on assets is poor, and when there are ISS-opposed proposals on the ballot").
34 *See*, e.g., VANGUARD, INVESTOR STEWARDSHIP 2018 ANNUAL REPORT 34 (2018), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2018_investment_stewardship_annual_report.pdf (on a global basis, Vanguard's Investor Stewardship team cast nearly 169,000 votes in the 2018 proxy year).

Fidelity, etc.) to adopt a low-cost approach to shareholder voting. The management of passive funds exists in a supercompetitive industry with extremely thin profit margins, providing investment advisors with very little room to spend resources on shareholder voting. Moreover, since the goal of an index fund is to meet, not beat, the market, the adviser would not derive any competitive benefit from receiving highly informed and precise recommendations and therefore would have no incentive to spend the money that the creation of such recommendations would require.[35]

According to Lucian Bebchuk and Scott Hirst, when investor stewardship teams from the "Big Three" mutual fund families (BlackRock, Vanguard, and State Street Global Advisors) provide voting recommendations to their index fund clients: "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."[36] This "mitigating governance risk" strategy results in a significant economization of an investment advisers resources. It also results in a one-size-fits-all voting policy. As described by Sean Griffith:

> 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 poison pills, staggered boards, and dual-class shares can create value for some firms, stewardship group guidelines apply a one-size-fits-all approach to governance, tempered only by the discretion to depart from the guidelines on a case-by-case basis.[37]

Hence, the strategy of mitigating governance risk in the creation of voting recommendations, whether used by proxy advisors or investor stewardship teams, is a one-size-fits-all approach that leads to the creation of voting recommendations that are not very informed or precise, at least in terms of enhancing shareholder value.

This collective action problem also applies to actively managed funds. In general, it will always be more profitable for them to use their limited resources to invest in stock valuation, such as fundamental analysis provided by equity analysts, than to spend their resources on costly high-value voting recommendations.[38] While the benefits of fundamental analysis will be a private gain for that specific portfolio manager, the benefits of investing in high-value voting recommendations will be shared by its competitors.

Of course, there are always exceptions to the rule—for example, "quality shareholders,"[39] such as Berkshire Hathaway, which does intense up-front research using fundamental analysis to determine

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[35] Lucian A. Bebchuk, Alma Cohen, and Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 98 (2017).
[36] Lucian A. Bebchuk and Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2039 (2019).
[37] Sean J. Griffith, *Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority*, 98 Tex. L. Rev. 983, 1001-02 (2020) .
[38] Sharfman, *Enhancing the Value of Shareholder Voting Recommendations*, *supra* note 26, at 713–15.
[39] Lawrence Cunningham refers to these types of investors, such as Warren Buffett and the company he runs, Berkshire Hathaway, as "quality shareholders." See Lawrence A. Cunningham, *The Case for Empowering Quality Shareholders*, B.Y.U. L. REV. (2020), https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=634696.

which companies to invest in and then to hold these companies in a relatively concentrated portfolio for perhaps decades at a time.[40] However, its strategy of buy and hold means that it lacks incentives for continually making additional investments in staying informed. Therefore, while informed at the purchase, it might not be so informed as time passes. Also, activist hedge funds, those unregulated hedge funds that take significant stock positions in a particular company in order to advocate for strategic change prior to selling their shares, will have strong financial motivations to vote on an informed basis.[41] They also hold a small number of stocks in their portfolios.

While quality shareholders as well as activist hedge funds have roles to play in the stock market, their roles appear small and can be viewed as forms of arbitrage, one focusing on the long term[42] and the other on the short term.[43] Therefore, in general, as stated by Jill Fisch, Asaf Hamdani, and Steven Davidoff Solomon, the following holds true:

> This collective action problem, however, characterizes all institutional investor engagement in corporate governance—by both active and passive funds. Costly steps that investors may take to improve the performance of companies in their portfolio benefit all the investors that hold shares of these companies.[44]

In sum, rational investors are compelled not to invest in being informed when voting because the expected payoff from making such an investment is simply not adequate.

B. Proxy Advisors Do Not Solve the Collective Action Problem

Institutional investors or large retail investors cannot solve their collective action problem through the use of proxy advisors because the collective action problem necessarily affects proxy advisors as well. Proxy advisors must exist in an environment where their clients are willing to pay only a minimal fee for voting recommendations. This makes proxy advisors resource-constrained. It also explains why institutional investors are not leading the charge for regulatory reform or demanding that proxy advisors provide them with better-informed and more precise voting recommendations. In sum, institutional investors simply don't want better recommendations if it means having to spend more money.

The evidence appears to bear out that proxy advisors are resource-constrained:[45]

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[40] *Id.*
[41] Edelman, Thomas, and Thompson, *supra* note 31, at 1379.
[42] Samuel Lee refers to the investment strategy utilized by quality shareholders as "time-horizon arbitrage," i.e., "buying assets with long-term value underappreciated by the market." *See* Samuel Lee, *Warren Buffett and Time-Horizon Arbitrage*, Morningstar (Nov. 27, 2013), https://www.morningstar.com/articles/620888/warren-buffett-and-timehorizon-arbitrage. *See also* Michael W. Roberge, Joseph C. Flaherty, Jr., Robert M. Almeida, Jr., and Andrew C. Boyd, *Lengthening the Investment Time Horizon*, MFS (May 2014), http://shareholderforum.com/access/Library/20140500_MFS.pdf (identifying the increasing dispersion of equity returns over time as a time-horizon arbitrage opportunity).
[43] Alon Brav, Wei Jiang, Frank Partnoy, and Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1774 (2008).
[44] Jill E. Fisch, Asaf Hamdani, and Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, U. PENN. L. REV. (forthcoming, 2020), at 14, https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=2985&context=faculty_scholarship.
[45] Sharfman, *Enhancing the Value of Shareholder Voting Recommendations*, *supra* note 26, at 713–15.

> There is strong evidence that the two major proxy advisor firms 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 advisor firms, Institutional Shareholder Services ("ISS"; 61% market share) and Glass Lewis (37% market share), devote to the creation of recommendations.
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> As of June 2017, the ISS Global Research team covered 40,000 shareholder meetings [approximately 250,000 votes] with approximately 270 research analysts [an estimated 800-plus votes per analyst during the proxy season] and 190 data analysts. However, it is not known how many research analysts are full-time, part-time or seasonal (proxy season only)….
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> 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.
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> 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….
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> 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 sub-industries. 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.
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> This same lack of expertise would apply to M&A recommendations. On an average annual basis, "approximately 5% of U.S. public companies delist as a result of M&A activity." The delist percentage may vary, but we will assume that the Research Team has between 150 and 300 M&A per year. This assumption is several times larger than the number the Research Team actually deals with in terms of proxy contests. For an eight-person team lacking the proper expertise, doing an adequate job of providing voting recommendations is an impossible task.

This resource-constrained business environment is further evidenced in a recent study by Ana Albuquerque, Mary Ellen Carter, and Susanna Gallani.[46] They find that the negative assessments provided by ISS on the executive compensation of public companies are significantly correlated with poor future accounting performance. However, this occurs only when the assessments are provided during the time of year not associated with the proxy season:[47]

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[46] Ana Albuquerque, Mary Ellen Carter, and Susanna Gallani, *Are ISS Recommendations Informative? Evidence from Assessments of Compensation Practices* (June 4, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3590216.
[47] *Id.*

> We provide empirical evidence showing that ISS appears to identify poor compensation practices *mainly* for the subsample of observations that have a non-December fiscal year end (FYE). This result suggests that during the proxy season, when ISS is busier (evaluating firms with December FYE, which represent the majority of ISS's coverage) and more constrained regarding resources needed to analyze firms' compensation packages, their recommendations are of lower quality.[48]

Their empirical results provide evidence that ISS simply does not have sufficient resources to provide value-enhancing recommendations during the proxy season, the time of year (March and April) when it creates the overwhelming majority of its voting recommendations.

In sum, proxy advisors exist in an industry where there is a clear mandate to produce low-cost, low-value voting recommendations within a resource-constrained business environment.[49] Combining this result with a proxy advisory industry that has developed into an oligopoly where there are only two primary providers of these low-cost voting recommendations, ISS and Glass Lewis, an excessive amount of conformity in voting recommendations may also result.

C. A Market Failure in the Market for Voting Recommendations

In the market for voting recommendations, two parties contract with each other: the providers of voting recommendations—proxy advisors; and their clients—institutional investors. Unfortunately, the two parties most affected by the quality of the voting recommendations are not parties to the contract: the public companies whose shareholders are being asked to vote; and the beneficial investors of the proxy advisor's clients, including ERISA plan participants and beneficiaries.[50]

As already argued, a collective action problem in shareholder voting has resulted in a resource-constrained proxy advisory industry, creating the need for cost-minimizing strategies in the creation of voting recommendations. These strategies, not based on financial analysis, lead to voting recommendations that are not adequately informed or precise. As a result, two significant negative externalities are created.

The first negative externality is the negative impact that uninformed and inadequately precise voting recommendations will have on the decision-making of public companies[51]—for example, if an activist hedge fund is utilizing a proxy contest to change the strategic direction of the company and the

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[48] *Id.* In the sample used by Albuquerque, Carter, and Gallani, over 70% of the sample firms had a December FYE. *Id.* This is consistent with the Conference Board finding that approximately 85% of Russell 3000 companies hold their annual meetings during the first half of the year. *See* Matteo Tonello, *Proxy Voting Analytics (2016–19)*, THE CONFERENCE BOARD (2019), https://www.conference-board.org/press/pressdetail.cfm?pressid=9287.
[49] As observed by Chester Splatt, former chief economist of the SEC: "During the SEC's roundtable on the proxy process held in November 2018, individual asset managers focused concern about greater regulation of proxy advisory firms upon the potential implications for the costs and resulting pricing of their services, rather than the equilibrium effects on the quality of governance." *See* Chester S. Splatt, *Proxy Advisory Firms, Governance, Market Failure, and Regulation*, MILKEN INSTITUTE, at 6 (2019).
[50] Bryce C. Tingle, *The Agency Cost Case for Regulating Proxy Advisory Firms*, 49 U.B.C. L. REV. 725, 746–47 (2016), at 782.
[51] *Id.*

shareholder vote is significantly influenced by inadequate voting recommendations. As a result, the company's market and financial performance will suffer, as well as its ability to successfully compete against its rivals.

The second externality is the negative impact that such voting recommendations will have on beneficial investors and ERISA plan participants and beneficiaries.[52] These investors will suffer economic losses because suboptimal voting recommendations will lead to value-reducing decisions at public companies[53]—for example, if the result of a merger vote is significantly influenced by imprecise voting recommendations.

Without these negative externalities, "market forces rather than regulation are the most appropriate and effective oversight mechanism for the proxy advisory industry."[54] However, that is not where we are. Even if the voting recommendations are tainted with significant errors in facts, conflicts, or methodological weaknesses, institutional investors are very happy to purchase and use them. This is another significant weakness in shareholder voting, especially when, as they do today, institutional investors dominate the voting of proxies.

D. Summary

This shareholder voting framework was summarized in the following quotations from the SEC's recent final rule on proxy voting advice:

> One commenter [Bernard Sharfman] suggested that there is a different source of *market failure* inherent to the proxy voting process and proxy voting advice businesses stemming from the collective action problem inherent in shareholder voting. According to the commenter, investors do not value expending resources to determine their position on a given proxy vote because, on the margin, their vote does not matter and they do not fully internalize all of the benefits associated with any resources they do expend. The commenter further asserts that

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[52] *Id.*
[53] The empirical research on how voting recommendations affect shareholder value is not extensive. *See* David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, *Outsourcing Shareholder Voting to Proxy Advisory Firms*, 58 J. L. & ECON. 173 (Feb. 2015) ("These results suggest that the outsourcing of voting to proxy advisory firms appears to have the unintended economic consequence that boards of directors are induced to make choices that decrease shareholder value"); David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, *Proxy Advisory Firms and Stock Option Repricing*, 56 J. OF ACCT. AND ECON. 149 (2013) ("Using a comprehensive sample of stock option repricings announced between 2004 and 2009, we find that repricing firms following the restrictive policies of proxy advisors exhibit statistically lower market reactions to the repricing, lower operating performance, and higher employee turnover. These results are consistent with the conclusion that proxy advisory firm recommendations regarding stock option repricings are not value increasing for shareholders"); James R. Copland, David F. Larcker, and Brian Tayan, *The Big Thumb on the Scale: An Overview of the Proxy Advisory Industry*, STANFORD CLOSER LOOK SERIES (May 30, 2018) ("The research literature therefore shows mixed evidence on the degree to which proxy advisory firms influence firm voting and the impact they have on corporate behavior and shareholder returns. For the most part, their influence on voting is shown to be—at a minimum—moderate and their influence on corporate behavior and shareholder value is shown to be negative. Nevertheless, conflicting evidence exists").
[54] Tingle, *supra* note 50, at 779, quoting Comment letter from Debra L Sisti, Vice President, and Martha Carter, Managing Director of Institutional Shareholder Services, *Re: Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms*, at 15 (Aug. 10, 2012), https://www.osc.gov.on.ca/documents/en/Securities-Category2-Comments/com_20120810_25-401_sistid_carterm.pdf.

> proxy voting advice businesses, in turn, can therefore only charge modest fees for their services, which leads them to be resource-constrained in performing their own research. Thus, according to the commenter, this arrangement leads to voting recommendations that are not adequately informed or precise, and thus imposes negative externalities on shareholders. The commenter argues that, because market forces are unable to improve the quality of voting recommendations and reduce these externalities, there is a need for regulatory action.[55]

Moreover,

> Both commenters [Bernard Sharfman and James Copland of the Manhattan Institute] argued that the shareholder proxy voting process is beset with collective action problems, whereby both institutional and retail investors are not motivated to incur large expenses to collect information to become better informed about a company, particularly when the company is just one of a portfolio. According to the commenters, this results in resource-constrained proxy voting advice businesses that produce voting recommendations that are not adequately informed or precise. Such voting recommendations could lead to suboptimal voting decisions by clients of the proxy voting advice businesses.[56]

II. PROXY ADVISORS AS FIDUCIARIES UNDER ERISA

Given the collective action problem in shareholder voting and its negative impact on the voting recommendations provided by proxy advisors, it is easy for me to agree with the following statement from the proposed rule:

> A number of stakeholders have questioned whether third-party proxy advice is impartial, sufficiently rigorous, and consistent with ERISA's fiduciary duties, as would be necessary to reliably advance ERISA investors' interests. Some question whether proxy advisory firms' practices are sufficiently transparent for investors to be able to determine whether their interests are being advanced. Some stakeholders also question whether the market for proxy advice is too concentrated and insufficiently competitive, which could impair investors' access to quality, affordable advice. Proxy advice that is not rigorous or not aligned with a plan's interest could lead to a responsible plan fiduciary voting shares when voting costs exceed any benefit, or when voting would otherwise run counter to the plan's interest.[57]

As a means to mitigate this negative impact on the informational quality and possibly conflicted nature of a proxy advisor's voting recommendations, I recommend, as I have in my recent article *Now*

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[55] Securities and Exchange Commission, *Exemptions from the Proxy Rules for Proxy Voting Advice*, Release No. 34–89372 (Final Rule), 85 FED. REG. 55126 (Sept. 3, 2020), citing Letter from Bernard S. Sharfman, Chairman, Advisory Council, Main Street Investors Coalition to Ms. Vanessa Countryman, Secretary, Securities and Exchange Commission, *Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice* (Dec. 20, 2019), https://www.sec.gov/comments/s7-22-19/s72219-6571096-201082.pdf. Please note that this letter served as the foundation for Mr. Sharfman's article *The Risks and Rewards of Shareholder Voting*, *supra* note 24.
[56] 85 FED. REG. 55126.
[57] 85 FED. REG. 55229.

Is the Time to Designate Proxy Advisors as Fiduciaries under ERISA,[58] that it is time for the DOL to consider designating proxy advisors, such as Institutional Shareholder Services (ISS) and Glass Lewis, as *investment advice fiduciaries* under Section 3(21)(A)(ii) of ERISA.

ERISA 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. 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).

When a proxy advisor provides shareholder voting recommendations to an ERISA plan manager for a fee, it is rendering investment advice. If these recommendations are followed by the client and other institutional investors, the quality of the voting recommendations in terms of both precision and bias can have a significant impact on the value of a stock held in portfolio. If a voting recommendation is very precise and lacks bias, it may, if utilized by shareholders, help increase company value and its stock price. If a recommendation lacks precision and/or was created with significant bias, it may, if utilized, decrease its value. The significance of such investment advice justifies the DOL in using its discretionary authority to designate proxy advisors as fiduciaries under ERISA.

Being designated investment advice fiduciaries under ERISA would require proxy advisors, like ERISA plan managers, not only to 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 duty of prudence in the creation of its voting recommendations for ERISA plans, but also to have, without exception, the financial welfare of the plan as their sole objective when creating voting recommendations for ERISA plan managers.

ERISA's fiduciary duties require that Environmental, Social, and Governance ("ESG") objectives ("non-pecuniary objectives"), cannot creep in to the voting recommendations used by ERISA plan managers. 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 financial benefits as the sole objective, i.e., 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."[59]

The importance of ERISA fiduciaries correctly dealing with ESG objectives and factors cannot be understated. It adds an additional layer of complexity to the voting recommendation process. This

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[58] Sharfman, *Now Is the Time to Designate Proxy Advisors as Fiduciaries under ERISA*, *supra* note 25. *See also* Bernard S. Sharfman, *On Governance: Now Is the Time to Designate Proxy Advisors as Fiduciaries under ERISA*, THE CONFERENCE BOARD (Sept. 27, 2019), https://conference-board.org/blog/environmental-social-governance/Proxy-Advisers-as-Fiduciaries-Under-ERISA?blogid=3.

[59] Randy Bauslaugh and Dr. Hendrik Garz, *Pension Fund Investment: Managing Environmental, Social and Governance (ESG) Factor Integration*, MCCARTHY TÉTRAULT, https://www.mccarthy.ca/en/insights/articles/pension-fund-investment-managing-environmental-social-and-governance-esg-factor-integration. *See also* Albert Feuer, *Ethics, ESG, and ERISA: Ethical-Factor Investing of Savings and Retirement Benefits Part 2*, 48 COMP. PLAN. J. 11 (Jan. 3, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3513645 (Feuer refers to this as the incorporation approach).

complexity is enhanced by ESG objectives and factors being extremely subjective and easily conflated, creating additional risk that their use may end up with the wrong result. Therefore, ensuring that ESG objectives are being excluded while ESG factors are being properly used in the creation of voting recommendations is another reason that the time is ripe for the DOL to designate proxy advisors as investment advice fiduciaries under ERISA.

Finally, the DOL must implement several supplemental recommendations to support the primary recommendation of designating proxy advisors as investment advice fiduciaries:

- Proxy advisors must provide voting recommendations for ERISA plans that are exclusively focused on increasing the financial benefits of an ERISA plan. Any type of customization based on *client preferences* must also meet this requirement. If not, the customization cannot be allowed. 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.

  For ISS, this would require a new specialty report for each ERISA plan client. Moreover, since Taft-Hartley plans come under the fiduciary duties of ERISA, the ISS Taft-Hartley specialty report, notable for its policy of being in compliance with AFL-CIO guidelines, would need to be withdrawn and replaced with the same new specialty report.

- 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 that the board is uninformed. This is so because in terms of evaluating how such E&S proposals affect shareholder wealth, the board and executive management have a large comparative advantage. Unlike the proxy advisor, they have access to inside information and the ability and resources to do a thorough financial analysis. Also, and perhaps most important, in terms of evaluating such proposals from the perspective of striving for shareholder wealth maximization, it can be assumed that the board is not conflicted.

- To help the DOL monitor a proxy advisor's compliance with its 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 ensure that the voting recommendations provided to ERISA plans meet the prudent man standard.

  - A description of the procedures in place to ensure that the voting recommendations are exclusively tied to the sole and exclusive objective of enhancing the financial value of ERISA plans.

- A description of the procedures in place to deal with a voting recommendation that is contested by a public company; these procedures must be consistent with a fiduciary's duty of prudence.

- 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.

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

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

III. THE VALUE OF BOARD VOTING RECOMMENDATIONS

The following statement from the proposed rule reflects the understanding that a voting policy based on the voting recommendations generated by the board of directors will be of significant value to ERISA plan managers, as well as being provided to them at no cost:

> In paragraph (e)(3)(iii)(A), the Department proposes that a fiduciary may adopt a policy of voting proxies in accordance with the voting recommendations of a corporation's management on proposals or types of proposals that *the fiduciary has prudently determined are unlikely to have a significant impact on the value of the plan's investment*, subject to any conditions determined by the fiduciary as requiring additional analysis because the matter being voted upon concerns a matter that may present heightened management conflicts of interest or is likely to have a significant economic impact on the value of the plan's investment. Under this permitted practice, a fiduciary may, consistent with its obligations set forth in ERISA section 404(a)(1)(A) and (B), maintain a proxy voting policy that relies on the fiduciary duties that officers and directors owe to a corporation based on state corporate laws. On that basis, the proxy voting policy may state that the responsible plan fiduciary, if it so determines, ordinarily will follow the recommendations of a corporation's management.[60]

I strongly agree with this understanding. The value of board voting recommendations is what I discuss in my recent article *Enhancing the Value of Shareholder Voting Recommendations*[61] and what is summarized here.

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[60] 85 FED. REG. 55225.
[61] Sharfman, *Enhancing the Value of Shareholder Voting Recommendations*, *supra* note 26.

A. Where the Value Originates

Board voting recommendations, which are provided free of charge to shareholders, are of the highest informational value, much more so than the voting recommendations provided by resource-constrained proxy advisors.[62] Directors, as well as executive management, are often referred to as "insiders." According to Zohar Goshen and Gideon Parchomovsky: "*Insiders* have access to inside information due to their proximity to the firm; they also have the knowledge and ability to price and evaluate this information."[63] According to Charles Korsmo: "Even a sophisticated activist investor will find it difficult or impossible to acquire the information—including properly non-public information—that corporate managers acquire in the process of their day-to-day work."[64] The voting recommendations of the board, like all its decisions, take advantage of this inside information, as well as the expertise of executive management, and are presumably generated through the lens and norm of shareholder wealth maximization.

B. Potential for Bias

However, even with its significant informational and analytical advantages, it is not guaranteed that the board will be able to deliver the maximum precision in its voting recommendations. Bias may have a significant negative impact on the precision of the board's recommendations.[65] First, the board, being so close in proximity to the firm, may sometimes have difficulty in being objective in its voting recommendations.[66] Second is the issue of agency costs ("the economic losses resulting from managers' natural incentive to advance their personal interests even when those interests conflict with the goal of maximizing their firm's value").[67]

C. How Agency Costs Are Mitigated

But this does not mean that the board of directors and its executive management are simply unconstrained actors generating agency costs at will. They are constrained by the law and their ethics. They are human beings, after all, fearful of violating criminal law and potentially facing imprisonment or financial penalties, breaching their fiduciary duties of care and loyalty and thereby potentially facing financial liability, damaging their reputations, and violating their own ethical norms. According to Milton Friedman:

> In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much

[62] *Id.*
[63] Zohar Goshen and Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 722 (2006).
[64] Charles R. Korsmo, *Delaware's Retreat from Judicial Scrutiny of Mergers*, 10 UC IRVINE L. REV. 55, 98 (2019).
[65] Sharfman, *Enhancing the Value of Shareholder Voting Recommendations*, *supra* note 26, at 705.
[66] *See* Goshen and Parchomovsky, *supra* note 63, at 722.
[67] Zohar Goshen and Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 775 (2017). *See also supra*, n.6.

> money as possible *while conforming to their basic rules of the society, both those embodied in law and those embodied in ethical custom*.[68]

Such legal and ethical rules create boundaries that discourage the board of directors and executive management from entering into unacceptably harmful corporate decisions.

Moreover, shareholder desires are what must guide the board of directors.[69] For example, while shareholders are not generally involved in the governance of a public company, this being delegated to the board under corporate law,[70] the governance role that shareholders do play signals to board members that the interests of shareholders must be their primary concern. In that way, corporate law establishes the foundation for a shareholder wealth maximization norm. According to Leo Strine:

> In American corporate law, only stockholders get to *elect directors*, *vote on corporate transactions and charter amendments*, and *sue to enforce the corporation's compliance with the corporate law and the directors' compliance with their fiduciary duties*. An unsubtle mind might believe that this statutory choice to give only stockholders these powers might have some bearing on the end those governing a for-profit corporation must pursue. But regardless of whether that is so as a matter of law, this allocation of power has a profound effect as a matter of fact on how directors govern for-profit corporations. When only one constituency has the power to displace the board, it is likely that the interests of that constituency will be given primacy.[71]

As noted in the proposed rule,[72] one aspect of corporate governance that drives the board of directors to create value-enhancing voting recommendations for shareholders is the fiduciary duties that board members owe to the corporation for the benefit of shareholders.[73] These duties, enforced by the courts by applying equitable principles, require directors to focus on shareholder interests or else be the subject of a shareholder suit for breach of those duties. According to the Delaware Supreme Court in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*:

> Delaware corporate law provides for a separation of control and ownership. The directors of Delaware corporations have "the legal responsibility to manage the business of a corporation for the benefit of its stockholder owners." Accordingly, fiduciary duties are imposed upon the directors to regulate their conduct when they perform *that* function.[74]

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[68] Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970, at 17 (emphasis added).
[69] *See* Christopher Conas, *Does Milton Friedman Support a Vigorous Business Ethics?*, 87 J. BUS. ETHICS 391, 392 (2009). Conas interprets Friedman's quote to mean that "[p]rofits are not ends-in-themselves; the only reason why executives are obligated to increase profits is because that is what the stockholders desire." *Id.*
[70] *See* DEL. CODE ANN. tit. 8, §141(a) (2019).
[71] Leo E. Strine, Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449, 453–55 (2014) (emphasis added) (internal citations omitted).
[72] 85 FED. REG. 55225.
[73] *See* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007).
[74] *Id.* at 101 (quoting Malone v. Brincat, 722 A.2d 5, 9 (Del. 1998)).

Also, the *Gheewalla* court stated that even when a corporation is in the zone of insolvency, a board still owes fiduciary duties to stockholders and not to creditors because the "focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its stockholders by exercising their business judgment in the best interests of the corporation for the benefit of its stockholder owners."[75]

In sum, these fiduciary duties of care and loyalty (good faith is subsumed under the duty of loyalty under Delaware law),[76] enforced under corporate law, direct a board to make decisions, including voting recommendations, that enhance shareholder value.[77]

But the requirements of corporate law are not the only means by which agency costs are mitigated in favor of shareholders. Federal securities laws covering insider trading and securities fraud (as found under Section 10(b) of the Securities Exchange Act of 1934[78] and Rule 10b-5 as promulgated thereunder),[79] laws that may lead to civil penalties, criminal penalties, or both, keep shareholder interests clearly at the fore in board decision-making.

In addition, the listing requirements of U.S. stock exchanges ensure that boards are composed of a majority of independent directors.[80] These requirements are to ensure that directors have ties to the corporation that are not so significant as to influence their judgment in corporate matters. That is, they help keep the board independent of management and focused on the interests of shareholders. The listing requirements also demand that a board's audit, compensation, and nominating committees be composed entirely of independent members.[81] According to Spencer Stuart, 85% of S&P 500 directors were independent in 2019.[82]

Given these mitigating factors, it is hard to believe that even a small minority of board voting recommendations are riddled with significant agency costs. But like the issue of a board's narrow focus, a determination of whether board voting recommendations of any particular company are insufficiently precise, and therefore whether a third-party source of informed voting recommendations is required, can be made based only on the independent judgment of each plan manager.

If bias can interfere with the ability of boards to provide precise voting recommendations, perhaps the role best played by proxy advisors is not to provide voting recommendations, which may not be adequately informed, but to provide assessments on how much bias may be contained in each board's voting recommendations and how they affect the value of a board's recommendations. This focus on bias would mean a huge change in the business model of a proxy advisor, but one that may yield huge returns for institutional investors.

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[75] *Id.*
[76] *See* Stone v. Ritter, 911 A.2d 362, 369–70 (Del. 2006).
[77] *See, generally*, Bernard S. Sharfman, *The Importance of the Business Judgment Rule*, 14 N.Y.U. J.L. & BUS. 27, 63–67 (2017) (discussing how fiduciary duties are directed toward satisfying shareholder interests).
[78] 15 U.S.C. § 78j(b) (2012).
[79] 17 C.F.R. § 240.10b-5 (2017).
[80] *See, e.g.*, NYSE, Listed Company Manual §§ 303A.01–.02 (2009), https://nyseguide.srorules.com/listed-company-manual (setting forth the New York Stock Exchange's independent director requirement).
[81] *See, e.g.*, *id.* §§ 303A.04–.06.
[82] SPENCER STUART U.S. BOARD INDEX (2019), https://www.spencerstuart.com/-/media/2019/ssbi-2019/us_board_index_2019.pdf.

IV. SHAREHOLDER PROPOSALS

Consistent with the fiduciary duties of ERISA, the DOL expressed its concern in the proposed rule that "responsible plan fiduciaries, in their efforts to decide whether or how to vote plan shares—and where applicable, to vote them—and exercise other shareholder rights, may impose costs on plans that exceed the consequent economic benefits to them."[83] It elaborates on this concern in the following statement:

> As shareholders, ERISA-covered plans have the right to vote on proposals. Some of these proposals may have an economic impact on a plan's investment, while others may not. The responsible plan fiduciary generally must decide whether (and how) to vote the plan's shares on each proposal…. [T]he determination of whether or not the vote will affect the economic value of a plan's investment portfolio is critical in triggering a fiduciary's obligations under ERISA to vote or abstain from voting…. Fiduciaries may need to conduct an analytical process that could in some cases be resource-intensive (requiring, among other things, organizing proxy materials, diligently analyzing portfolio companies and the matters to be voted on, determining how the votes should be cast, and submitting proxy votes to be counted), and these activities may often impose burdens on fiduciaries that are disproportional to any potential economic benefit to the plan.[84]

Of course, stockholders have a right under corporate law not to vote if that is what they want to do.[85] Therefore, the DOL has suggested the following general approach for ERISA plan managers to follow:

> The cost of determining whether or how a responsible fiduciary should vote a plan's shares on a proposal is generally borne by the plan. If the proposal has no or negligible implications for the value of the plan's investment, it would be better for the plan to simply refrain from voting than to incur even small costs making this determination. *Even if the proposal has substantial implications for the company*, the cost of voting still may be higher than the potential benefit to the plan, especially if each fiduciary separately must collect and analyze the information necessary to reach an appropriate conclusion. The cost may be lower if the fiduciary can rely on an impartial, expert third-party advisor who specializes in such matters and provides similar services to many shareholders. Likewise, the cost may be lower if the fiduciary can rely on recommendations from the company's management on proposals where the interests of the plan and management are aligned.[86]

This statement reflects the collective action problem that shareholders face—a problem that results in shareholder voting generally having very limited financial value for any one investor, including an ERISA plan. In the context of an ERISA plan manager's fiduciary duties, this means that a plan manager is obligated to abstain from voting on a proposal when it determines that the financial cost of

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[83] 85 FED. REG. 55228.
[84] *Id.*
[85] *See* Berlin v. Emerald Partners, 552 A.2d 482, 493 (Del. 1988) ("[S]tockholders right not to attend a meeting, his *right not to vote on any matter*, even if he is in attendance, and his right to be represented by a general or a limited proxy").
[86] 85 FED. REG. 55228.

analysis and research exceeds the financial benefits to be gained from voting. In sum, "A fiduciary's duty is only to vote those proxies that are prudently determined to have an economic impact on the plan after the costs of research and voting are taken into account."[87]

To be compliant with this general approach, the DOL has presented some permitted practices for plan managers to follow, including:

> A fiduciary could also utilize the permitted practices to create a proxy voting policy that votes in accordance with management's recommendations for uncontested elections of directors and ratification of independent auditors and certain types of non-binding proposals, but primarily reserves its proxy voting resources for corporate events that are expected to have a significant economic impact on the value of the plan's holding, such as share buy-backs, dilutive issuances of securities, and contested elections for directors of the board.[88]

I strongly endorse this permitted practice, especially with regard to uncontested elections of directors. When it comes to nominating directors, "the board nominating committee has an informational advantage over even the most informed shareholders because of the inside information it has on how the current board interacts with each other and executive officers, expectations on how a particular nominee will meld with other board members and executive officers, and the needs of the corporation in terms of directors, based on both public and confidential information."[89]

Regarding "certain types of non-binding proposals," I would include all non-binding shareholder proposals dealing with environmental and social issues. As previously mentioned, in terms of evaluating how an environmental or social shareholder proposal affects 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.[90] 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.[91]

Also, as previously mentioned, in terms of evaluating environmental and social proposals from the perspective of providing financial benefits to investors, it can be assumed that the board is not conflicted.[92] That is, "[m]anagement has as strong an incentive to increase corporate value through E&S as through any other initiative."[93] Moreover, because of resource constraints, the proxy advisor will most likely be limited to taking a one-size-fits-all approach to its analysis. This is not sufficient for

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[87] *Id.* at 55221.
[88] *Id.* at 55226.
[89] Bernard S. Sharfman, *Why Proxy Access Is Harmful to Corporate Governance*, 37 J. CORP. L. 387, 402 (2012).
[90] Griffith, *supra* note 37, at 1029 (regarding E and S shareholder proposals: "Managers 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").
[91] 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, but 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 7 (2019), https://www.glasslewis.com/wp-content/uploads/2019/02/GL-Compliance-Statement-2019.pdf.
[92] Griffith, *supra* note 37, at 1029.
[93] *Id.*

determining how an environmental or social shareholder proposal affects the value of a company's stock.

In terms of a shareholder proposal dealing with non-binding *governance* issues, deferring to the voting recommendation of the board of directors is not as clear. Even though a board has informational advantages over all other stakeholders in the corporation, including shareholders, it may be that the board will be conflicted if the proposal threatens the tenure of current board members or the authority of existing management.[94] Therefore, the ERISA plan manager will need to gauge the level of bias at the board before deciding to follow the board's recommendation, abstain, or seek a third-party recommendation if the marginal cost of doing so is very low.

V. THE CONFLICT BETWEEN AN INVESTMENT ADVISER'S SHAREHOLDER ACTIVISM AND A PLAN MANAGER'S FIDUCIARY DUTIES

This Part discusses an issue that is not currently in the proposed rule but that should be considered for inclusion: how an ERISA plan manager is to incorporate into its decision-making process the shareholder activism of an investment adviser to mutual funds or exchange-traded funds (ETFs) with large amounts of delegated voting authority. This activism is reflected in such an investment adviser's rhetoric disclosing the objectives of its activism, shareholder voting, and engagement with portfolio companies. Taking this activism into consideration would occur when a plan manager decides to invest in such funds or considers them as options for the self-directed accounts of plan participants and beneficiaries.

This Part argues that a plan manager's *duty of prudence* requires it to *investigate* this shareholder activism prior to making investment decisions. The fiduciary objective in this investigation is to ensure that the investment adviser is utilizing shareholder activism consistent with a plan manager's duty of loyalty. That is, "*solely* in the interest of the participants and beneficiaries" and for the *exclusive purpose* of providing financial benefits to them. If that is not happening, these funds should be excluded from an ERISA plan.

This Part has at its foundation a recent white paper I wrote, *The Conflict between BlackRock's Shareholder Activism and ERISA's Fiduciary Duties*,[95] which provides a more detailed discussion of the issue and is attached to this letter.

[94] *Id.*
[95] Sharfman, *supra* note 27.

A. The Source of the Problem

The largest investment advisers to mutual funds, the Big Three, have an enormous amount of proxy voting power[96] but without having any underlying economic interest in the shares that they vote.[97] Such power, as discussed in this Part and in more detail in my white paper, has the potential to be abused, resulting in financial harm to ERISA plan participants and beneficiaries.

This relatively new concentration of shareholder voting power is a result of both the large movement of assets into the index funds of a relatively small number of investment advisers[98] and the industry practice of mutual funds and ETFs delegating voting authority into the hands of their respective advisers.

Moreover, these large investment advisers have centralized this enormous amount of voting authority into the hands of investment stewardship teams. These teams comprise a relatively small number of professionals. For example, BlackRock has approximately 45 professionals globally, with only 21 based in the U.S., who are, on an annual basis, responsible for the voting of tens of thousands of proxies and engaging on various matters with the management of hundreds of publicly traded companies.[99] Therefore, at many public companies, BlackRock's investment stewardship team, like its chief rivals, may now control the fate of a shareholder or management proposal, whether a nominated director receives a required majority of votes to remain on the board of directors, whether a proxy contest succeeds or fails,[100] or even, through engagement with a company's management, how that company conducts its business.

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[96] Caleb Griffin estimates that the Big Three combined "serve as the largest shareholders at 96% of the largest 250 publicly traded companies in the United States, that Vanguard and BlackRock combined (the 'Big Two') serve as the largest shareholder at 94.4% of such companies, and that Vanguard alone (the 'Big One') is the single largest shareholder at 65.6% of such companies." Additionally, he finds that, on average, the Big Three control 20.1% of shares at these companies, and he estimates that the Big Three cast a combined 25% of the proxy votes, on average, at these companies. He further estimates Vanguard's average voting influence as 10.6%, BlackRock's as 9.0%, and State Street's as 4.4%. See Caleb N. Griffin, *Margins: Estimating the Influence of the Big Three on Shareholder Proposals* (forthcoming, SMU Law Review), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3588031.

[97] In essence, not only is portfolio management delegated to the investment advisor but also the voting of proxies. I have referred to this as the "empty voting of mutual fund [and ETF fund] advisors." I.e., the investment adviser has the voting rights but not the economic interest in the underlying shares. *See* Bernard S. Sharfman, *Mutual Fund Advisers' "Empty Voting" Raises New Governance Issues*, COLUM. L. SCHOOL: BLUE SKY BLOG (July 3, 2017), http://clsbluesky.law.columbia.edu/2017/07/03/mutual-fund-advisors-empty-voting-raises-new-governance-issues.

[98] *See* Carmel Shenkar, Eelke M. Heemskerk, and Jan Fichtner, *The New Mandate Owners: Passive Asset Managers and the Decoupling of Corporate Ownership*, CPI ANTITRUST CHRON. 51 (vol. 3, June 2017), https://www.competitionpolicyinternational.com/wp-content/uploads/2017/06/CPI-Shenkar-Heemskerk-Fichtner.pdf. *See also* Jan Fichtner, Eelke M. Heemskerk, and Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 328 (2017).

[99] BlackRock, Inc., BLACKROCK INVESTMENT STEWARDSHIP (2020), https://www.blackrock.com/corporate/literature/publication/blk-profile-of-blackrock-investment-stewardship-team-work.pdf.

[100] Bernard S. Sharfman, *How the SEC Can Help Mitigate the "Proactive" Agency Costs of Agency Capitalism*, 8 AM. U. BUS. L. REV. 1, 13 (2019).

B. The Duty of Prudence

The proposed rule correctly notes that the fiduciary duties of ERISA do not apply to investment advisers of mutual funds and ETFs when they are engaged in shareholder voting and engagement.[101] However, that does not mean that plan managers are absolved of monitoring this type of shareholder activity for the benefit of their participants and beneficiaries.

The Avon Letter states: "In 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."[102] There is no doubt that the letter was referring to "the voting of proxies on plan owned stock,"[103] i.e., the proxies associated with the common stock of public companies held in portfolio. However, since 1988, the year when the Avon Letter was written, the nature of shareholder voting has changed dramatically.[104] When a plan manager utilizes mutual funds or ETFs for its portfolio or offers them as selections in the self-directed individual accounts of its participants and beneficiaries, the plan still has voting authority but now only in the shares of the mutual funds or ETFs that it owns. Because it no longer has direct ownership of the common stock of public companies, it no longer has direct voting authority in the public companies that reside in a fund's portfolio. That authority now resides in the funds themselves. In turn, those funds will typically turn over their voting authority to its investment adviser. That is why investment advisers such as the Big Three can accumulate so much shareholder voting authority.

However, it is doubtful that the intent of the Avon Letter and all subsequent guidance in this regard was meant to absolve a plan manager of any fiduciary duty associated with the shareholder voting of shares that it now owns only indirectly through its share ownership in mutual funds and ETFs. If so, the question becomes: Is the use of an investment adviser's delegated shareholder voting power consistent with a plan manager's fiduciary duties? That is, is it "*solely* in the interest of the participants and beneficiaries" and for the *exclusive purpose* of providing financial benefits to them?

To answer this question, it is incumbent on the plan manager to *investigate* how this shareholder voting power will be used prior to making the decision[105] to invest in mutual funds and ETFs where the

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[101] 85 FED. REG. 55234 ("ERISA does not govern the management of the portfolio internal to a fund registered with the SEC, *including* such fund's exercise of its shareholder rights appurtenant to the portfolio of stocks it holds"). Presumably, this determination was based on its reading of ERISA 3(21)(B), which states:

> If any money or other property of an employee benefit plan is invested in securities issued by an investment company registered under the Investment Company Act of 1940 [(15 U.S.C. 80a-1 *et seq*.)], such investment shall not by itself cause such investment company or such investment company's investment adviser or principal underwriter to be deemed to be a fiduciary or a party in interest as those terms are defined in this title, except insofar as such investment company or its investment adviser or principal underwriter acts in connection with an employee benefit plan covering employees of the investment company, the investment adviser, or its principal underwriter. Nothing contained in this subparagraph shall limit the duties imposed on such investment company, investment adviser, or principal underwriter by any other law.

[102] Avon Letter, *supra* note 12.
[103] *Id.* at 1.
[104] 85 FED. REG. 55221.
[105] As a DOL advisory opinion stated, "Section 3(21)(B) provides that a plan's investment in a registered investment company 'shall not by itself cause such investment company or such investment company's investment adviser or principal underwriter to be deemed to be a fiduciary or a party in interest as those terms are

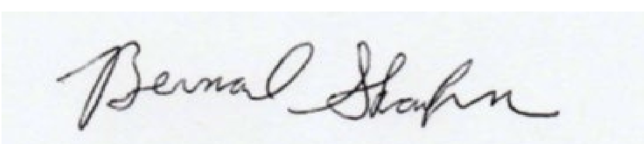
investment adviser has delegated voting authority or making those funds available for self-directed individual accounts. This may be a newly recognized aspect of the *duty of prudence* but one that is now required when the investment adviser to mutual funds and ETFs has a large amount of delegated voting power that can be used as a tool for behavior that is not within the bounds of a plan manager's fiduciary duties.

The fiduciary objective in this investigation is to ensure that an investment adviser to mutual funds and ETFs is utilizing shareholder activism consistent with a plan manager's duty of loyalty under ERISA. That is, "*solely* in the interest of the participants and beneficiaries" and for the *exclusive purpose* of providing financial benefits to them. If that is not happening, these funds should be excluded from an ERISA plan.

Given this fiduciary duty of investigation, the attached white paper argues that if a plan manager were to investigate BlackRock's shareholder activism, it would find this use to be in conflict with its (the plan manager's) fiduciary duties. For example, BlackRock's first objective is to increase the marketing of its investment products to millennials. Its second objective is to appease shareholder activists who threaten to attack the business decisions, procedures, and objectives of its own corporate management. In both cases, shareholder voting and engagement is not being executed *solely* in the interest of its beneficial investors, including those beneficial investors who are participants and beneficiaries of an ERISA plan. As a result, those BlackRock-managed funds where its investment stewardship team has been delegated voting and engagement authority should not be allowed to become part of an ERISA plan until remedial action is taken.

The DOL needs to provide guidance to plan managers on when the investment products of investment adviser's with delegated voting authority need to be excluded from their portfolios or as options in self-directed accounts. Hopefully, this guidance will be provided in the final form of the rule.

Very truly yours,



Bernard Sharfman

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defined in [Title I of ERISA], except insofar as such investment company or its investment adviser or principal underwriter acts in connection with an employee benefit plan covering employees of the investment company, the investment adviser, or its principal underwriter.' " However, "ERISA's exclusion for mutual funds is not absolute. It does not apply to a plan fiduciary's decision to invest plan assets in a mutual fund." *See* Department of Labor Advisor Opinion 2009-04a (Dec. 4, 2009), https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/advisory-opinions/2009-04a.

THE CONFLICT BETWEEN BLACKROCK'S SHAREHOLDER ACTIVISM AND ERISA'S FIDUCIARY DUTIES

Bernard S. Sharfman*

09.13.20

The world is full of surprises. One of those surprises is that BlackRock, Inc. ("BlackRock"), an investment adviser[1] that primarily markets and manages index funds to millions of passive investors around the globe, has become a leading shareholder activist. Based on the extremely large amount of assets it has under management, approximately $7.3 trillion with approximately $3.5 trillion of that being the common stock of publicly traded companies,[2] its importance as an activist cannot be overstated.

BlackRock, like its major index-fund rivals Vanguard and State Street Global Advisors (the "Big Three"), has an enormous amount of proxy voting power[3] but without having any underlying economic interest in the shares it votes.[4] This relatively new concentration of shareholder voting power is a result of both the large movement of assets into the index funds of a relatively small number of investment advisers[5] and the industry practice of mutual funds and electronically traded funds ("ETFs") delegating voting authority into the hands of their respective advisers.

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[1] 15 U.S.C. 80b-2(a)(11) (2018) (defining investment adviser under the Investment Advisers Act of 1940).

[2] BlackRock, Inc., 10-Q (for the quarterly period ended June 30, 2020) at 46, http://d18rn0p25nwr6d.cloudfront.net/CIK-0001364742/ac685253-accc-48fb-bacc-4a81d52c6f40.pdf.

[3] Caleb Griffin estimates that the Big Three combined "serve as the largest shareholders at 96% of the largest 250 publicly traded companies in the United States, that Vanguard and BlackRock combined (the 'Big Two') serve as the largest shareholder at 94.4% of such companies, and that Vanguard alone (the 'Big One') is the single largest shareholder at 65.6% of such companies. Additionally, it [he] finds that, on average, the Big Three control 20.1% of shares at these companies, and it [he] estimates that the Big Three cast a combined 25% of the proxy votes, on average, at these companies. It [He] further estimates Vanguard's average voting influence as 10.6%, BlackRock's as 9.0% and State Street's as 4.4%." See Caleb N. Griffin, *Margins: Estimating the Influence of the Big Three on Shareholder Proposals* (forthcoming, SMU Law Review), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3588031.

[4] In essence, not only is portfolio management delegated to the investment adviser but also the voting of proxies. I have referred to this as the "empty voting of mutual fund [and ETF fund] advisers." That is, the investment adviser has the voting rights but not the economic interest in the underlying shares. *See* Bernard S. Sharfman, *Mutual Fund Advisors' "Empty Voting" Raises New Governance Issues*, COLUM. L. SCHOOL: BLUE SKY BLOG (July 3, 2017), http://clsbluesky.law.columbia.edu/2017/07/03/mutual-fund-advisors-empty-voting-raises-new-governance-issues.

[5] *See* Carmel Shenkar, Eelke M. Heemskerk, and Jan Fichtner, *The New Mandate Owners: Passive Asset Managers and the Decoupling of Corporate Ownership*, CPI ANTITRUST CHRON. 51 (vol. 3, June 2017), https://www.competitionpolicyinternational.com/wp-content/uploads/2017/06/CPI-Shenkar-Heemskerk-Fichtner.pdf. *See also* Jan Fichtner, Eelke M. Heemskerk, and Javier Garcia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 328.

Moreover, BlackRock, like the other members of the Big 3, has centralized this enormous amount of voting authority into the hands of an investment stewardship team. This team is made up of a relatively small of number of professionals. For example, BlackRock has approximately 45 professionals globally with only 21 based in the U.S., who are, on an annual basis, responsible for the voting of tens of thousands of proxies and engaging on various matters with the management of hundreds of publicly traded companies.[6] Therefore, at many public companies, BlackRock's investment stewardship team, like its chief rivals, may now control the fate of a shareholder or management proposal, whether a nominated director receives a required majority of votes to remain on the board of directors, whether a proxy contest succeeds or fails,[7] or even, through engagement with a company's management, how that company conducts its business.

The issue I address in this white paper is whether the fiduciary duties of a plan manager of an "employee pension benefit plan," as authorized under the Employee Retirement Income Security Act of 1974 ("ERISA"),[8] requires it to investigate BlackRock's delegated voting authority and the shareholder activism that it empowers. BlackRock's shareholder activism is reflected in its rhetoric disclosing the objectives of its activism, shareholder voting, and engagement with portfolio companies.

A plan manager (trustees who retain investment and voting authority or "investment managers"[9] that receive such authority through delegation by the trustees) of an "employee pension benefit plan"[10] owes a duty of loyalty[11] to participants[12] and beneficiaries.[13] A plan manager also has a duty of prudence.[14] This latter duty requires a plan manager to perform a careful and impartial investigation prior to making an investment decision. How these duties affect a plan manager's evaluation of an investment adviser's shareholder activism has been little examined in the academic literature. However, because the shareholder voting power of our public companies is now so concentrated in the hands of a small number of investment advisers, the time is ripe for its study.

This white paper takes the position that a plan manager has a fiduciary duty, the duty of prudence, to investigate BlackRock's shareholder activism. This duty applies not only to the BlackRock mutual funds or ETFs that an ERISA plan invests in but also to those BlackRock fund selections that it makes

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[6] BlackRock, Inc., BLACKROCK INVESTMENT STEWARDSHIP (2020), https://www.blackrock.com/corporate/literature/publication/blk-profile-of-blackrock-investment-stewardship-team-work.pdf.
[7] Bernard S. Sharfman, *How the SEC Can Help Mitigate the "Proactive" Agency Costs of Agency Capitalism*, 8 AM. U. BUS. L. REV. 1, 13 (2019).
[8] Pub. L. No. 93-406, 88 Stat. 829; Title 1 of the Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001 *et seq.*
[9] *See* ERISA § 1002(8).
[10] *See id.* § 1002(2) ("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").
[11] *See* 29 U.S.C. § 1104(a)(1)(A)(i).
[12] *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").
[13] *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").
[14] *See* 29 U.S.C. § 1104(a)(1)(B); ERISA § 404(a)(1)(B).

available to its participants and beneficiaries in self-directed accounts. The fiduciary objective in this investigation is to ensure that BlackRock's shareholder activism is consistent with a plan manager's duty of loyalty under ERISA. That is, "*solely* in the interest of the participants and beneficiaries" and for the *exclusive purpose* of providing financial benefits to them. If that is not happening, these funds should be excluded from an ERISA plan.

Given these fiduciary duties, this white paper argues that if a plan manager were to investigate BlackRock's shareholder activism, it would find this use to conflict with its (the plan manager's) fiduciary duties. As a result, those BlackRock-managed funds where its investment stewardship team has been delegated shareholder voting and engagement authority should not be allowed to become part of an ERISA plan until remedial action is taken.[15]

While the focus of this paper is on BlackRock's delegated voting authority and associated shareholder activism, it is meant to apply to any and all investment advisers who attempt to leverage their delegated voting authority for purposes of engaging in shareholder activism. Moreover, the Department of Labor ("DOL") should provide guidance on when the investment products of investment advisers with delegated voting authority need to be excluded.

I. BLACKROCK'S RHETORIC

For some time, Larry Fink (CEO of BlackRock) has been signaling to the management of public companies and BlackRock's competitors—Vanguard, State Street Global Advisors, Fidelity, etc.—that BlackRock was going to use its huge amount of delegated voting authority to become one of the world's largest shareholder activists, advocating for *all stakeholders*, not just shareholders. These stakeholders include shareholders, directors, managers, employees, independent contractors, consultants, consumers, creditors, vendors, distributors, communities affected by the company's operations, federal, state, and local governments, and society in general, when it is positively affected by the social value created by the company or negatively affected when the company generates third-party costs such as air or water pollution.

In Fink's 2018 letter to CEOs, he set the stage for his stakeholder approach:

> 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.[16]

[15] *See infra*, CONCLUSION.
[16] 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.

In this context, *social purpose* seems to mean something much different from simply having the purpose of producing those goods and services that consumers value. In Fink's 2019 letter to CEOs, he explained what BlackRock's new focus on *social purpose* and *benefiting all stakeholders* was all about: the marketing of its investment products to millennials, a group that it believes sees the primary objective of business to be the improvement of society rather than the generation of profits:[17]

> Companies that fulfill their purpose and responsibilities to stakeholders reap rewards over the long-term. Companies that ignore them stumble and fail. This dynamic is becoming increasingly apparent as the public holds companies to more exacting standards. And it will continue to accelerate as *millennials*—who today represent 35 percent of the workforce—express new expectations of the companies they work for, buy from, and invest in….
>
> Over the past year, we have seen some of the world's most skilled employees stage walkouts and participate in contentious town halls, expressing their perspective on the importance of corporate purpose. This phenomenon will only grow as millennials and even younger generations occupy increasingly senior positions in business. In a recent survey by Deloitte, *millennial* workers were asked what the *primary purpose* of businesses should be—63 percent more of them said "improving society" than said "generating profit."
>
> In the years to come, the sentiments of these generations will drive not only their decisions as employees but also as investors, with the world undergoing *the largest transfer of wealth in history: $24 trillion from baby boomers to millennials.* As wealth shifts and investing preferences change, *environmental, social, and governance issues* **[ESG]** will be increasingly material to corporate valuations. This is one of the reasons why BlackRock devotes considerable resources to improving the data and analytics for measuring these factors, integrates them across our entire investment platform, and engages with the companies in which we invest on behalf of our clients to better understand your approach to them.[18]

In Fink's 2020 letter to CEOs[19] and in a companion letter to clients,[20] he announced how BlackRock was going to implement its millennial marketing strategy. First, BlackRock will be dictating its own vision of what a public company's (a company traded on a U.S. stock exchange or over-the-counter) *stakeholder relationships* should be by requiring its portfolio companies (virtually every public company) to disclose data on "how each company serves its full set of stakeholders."[21] Moreover, noncompliance is not acceptable. According to Fink, "we will be increasingly disposed to vote against management and board directors when companies are not making sufficient progress on sustainability-related disclosures and the business practices and plans underlying them."[22] Second, and

[17] Larry Fink, *Larry Fink's 2019 Letter to CEOs: Purpose and Profit*, BLACKROCK, https://www.blackrock.com/corporate/investor-relations/2019-larry-fink-ceo-letter. This letter was apparently the inspiration for Michal Barzuza, Quinn Curtis, and David Webber's recent article *Shareholder Value(s): Index Fund Activism and the New Millennial Corporate Governance* (forthcoming, 93 SO. CAL. L. REV.), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3439516.
[18] *Id.*
[19] Larry Fink, *Larry Fink's 2020 Letter to CEOs: A Fundamental Reshaping of Finance*, BLACKROCK, https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter.
[20] Larry Fink, *Larry Fink's 2020 Letter to Client: Sustainability as BlackRock's New Standard for Investing*, BLACKROCK, https://www.blackrock.com/corporate/investor-relations/blackrock-client-letter.
[21] Larry Fink, *Larry Fink's 2020 Letter to CEOs*, *supra* note 19.
[22] *Id.*

definitely not a surprise, he also announced the *launch of a large number of new ESG funds and a refocusing of shareholder engagement such that it puts a greater emphasis on stakeholders who are affected by climate change* and gender equality.

BlackRock's focus on millennials appears to make good business sense. Millennials will increasingly be the ones holding most of the wealth in the U.S., making it essential for it to start catering to their needs and developing brand loyalty now, not later.[23] As discussed in Part IV, it should also enhance BlackRock's profitability, as ESG funds charge significantly higher fees. However, as also discussed in Part IV, this millennial strategy clashes with the fiduciary duties of ERISA plan managers. This will have ramifications not just for these managers but also for BlackRock and its ability to continue as a provider of equity-based funds to ERISA plans.

Finally, it needs to be noted that external pressure has also added fuel to BlackRock's activism. In November 2019, Boston Trust Walden and Mercy Investment Services submitted a shareholder proposal to BlackRock demanding that it provide a review explaining why its climate-change rhetoric does not correspond with how it actually votes at shareholder meetings.[24] The proposal was reportedly withdrawn after BlackRock agreed to give increased consideration to shareholder proposals on climate change and join Climate Action 100, an investor group that targets its shareholder activism at fossil fuel producers and greenhouse gas emitters.[25]

II. PUTTING WORDS INTO ACTION: BLACKROCK'S VOTING AND ENGAGEMENT RECORD

Besides its rhetoric, BlackRock's shareholder activism is made up of shareholder voting and engagement (direct or indirect communication) with the management of portfolio companies. Voting and engagement are intertwined activities, with voting being the stick that BlackRock uses to pressure companies to adopt their stakeholder policies. Based on its second-quarter 2020 *Global Quarterly Stewardship Report* (the "Report"),[26] it is now clear that BlackRock's investment stewardship team has ramped up its shareholder activism. On a global basis, again utilizing only around 45 professionals, the team accomplished the following in the second quarter of 2020:

- **Voting:** Globally, voted at more than 9,200 shareholder meetings (9,540 meetings) on more than 100,000 proposals (103,169). Voted *against* at least one management proposal at 43% of shareholder meetings globally and against management's recommendation on 9% of all proposals.[27]

  Specific to North America, BlackRock voted at 3,085 shareholder meetings, voted on 27,126 proposals, voted against at least one management proposal at 30% of the meetings, and voted

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[23] Barzuza, Curtis, and Webber, *supra* note 17.
[24] Author unknown, *BlackRock, Vanguard Face Shareholder Rebuke over Climate Votes*, PENSIONS & INVESTMENTS (Dec. 13, 2019), https://www.pionline.com/governance/blackrock-vanguard-face-shareholder-rebuke-over-climate-votes.
[25] *Blackrock and JP Morgan Spared ESG Voting Proposals Following Sustainability Pushes*, RESPONSIBLE INVESTOR (Mar. 10, 2020), https://www.bostontrustwalden.com/wp-content/uploads/2020/03/Blackrock-and-JP-Morgan-spared-ESG-voting-proposals-following-sustainability-pushes_.pdf.
[26] BlackRock, Inc., *BlackRock Investment Stewardship Global Quarterly Stewardship Report* (2Q:2020; July 2020), https://www.blackrock.com/corporate/literature/publication/blk-qrtly-stewardship-report-q2-2020.pdf.
[27] *Id.* at 4.

against management's recommendation on 7% of all proposals.[28] Moreover, as what appears to be the primary way of enforcing their engagement objectives, they voted against board-nominated directors approximately 9% of the time (1,751 votes against out of 19,459 total votes).[29]

- **Engagement:** Globally, a 22% increase in total company engagements (974) compared with 2Q:2019. The team engaged in direct dialogue with 812 companies, interacting numerous times with 13% of them.[30] These engagements were divided into three themes: governance, environmental, and social.[31]

  Under the governance theme, the top engagement topics were board composition and effectiveness (discussed 504 times), corporate strategy (long-term strategic direction; how strategy, purpose, and culture are aligned; and corporate milestones against which to assess management; discussed 383 times), and executive compensation (discussed 379 times).[32]

  Under the environmental theme, the top engagement topics were climate risk management (discussed 272 times) and operational sustainability (waste and water management, packaging, product life-cycle management, product offerings, and energy efficiency; discussed 245 times).[33]

  Under the social theme, the top engagement topics were human capital management (discussed 236 times; a threefold rise).[34]

- **Voting and Engagement:** Identified 244 companies that it believed were making insufficient progress integrating *climate risk* into their business models or disclosures.[35] Of these companies, it took voting action against 53, or 22%, and put the remaining 191 companies "on watch."[36] Those companies that do not make significant progress on integrating *climate risk* into their business models or disclosures risk voting action against management in 2021.[37] In addition, when it came to shareholder proposals on the environment, out of 30 votes, they voted with shareholders 20% of the time.[38]

It should be expected that BlackRock will add to its focus the impact on a company's various stakeholders resulting from COVID-19 and Black Lives Matter:

> We have learned from our engagements that companies are finding it challenging to balance the short-term actions needed to mitigate the professional and personal effects of COVID-19 on their employees, customers, and other stakeholders. Companies are having to transition their

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[28] *Id.* at 6.
[29] *Id.*
[30] *Id.* at 4.
[31] *Id.* at 5.
[32] *Id.* at 6.
[33] *Id.*
[34] *Id.* at 4.
[35] *Id.*
[36] *Id.*
[37] *Id.*
[38] *Id.* at 7.

> business models to allow employees to work from home or in a safe, socially distanced environment. This transition also includes companies re-designing their supply chains and operations due to impacts caused by COVID-19.
>
> BIS remains focused on companies' progress with respect to diversity. The movement for racial equity and justice underscores the need for companies to do better to ensure representation at all levels of the workforce, alongside an inclusive culture in which a diverse workforce can employ skills and expertise to full effect in driving a company's strategic objectives and long-term shareholder value.[39]

III. ERISA'S FIDUCIARY DUTIES

BlackRock's use of its delegated voting authority and associated shareholder activism needs to be viewed through the lens of a plan manager's fiduciary duties. For purposes of this paper, those fiduciary duties are what is required under ERISA.

A. Duty of Loyalty

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."[40] Fiduciaries include trustees[41] who retain management control over plan assets and investment managers[42] who, because of their financial expertise, are commonly delegated such authority by the trustees ("plan managers"). These fiduciaries must go about their work under the guidance of very strict fiduciary duties of loyalty and care.[43] These duties are very similar to what is found under the common law of trusts.[44]

Under ERISA's duty of loyalty, a plan manager 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."[45] This *sole interest rule* is a codification of what is found in the common law of trusts.[46] It creates a very specific and narrow path for a plan manager when considering an investment strategy or providing mutual-fund or ETF selections for self-directed individual accounts.

According to Max Schanzenbach and Robert Sitkoff, "the trustee [plan manager] has a duty to the beneficiaries [and participants] not to be influenced by the interest of any third person or by motives

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[39] *Id.* at 3.
[40] *See* 29 U.S.C. § 1002(21)(A).
[41] *See id.* § 1105(c)(3).
[42] *See id.* § 1102(c)(3).
[43] Cent. States, Southeast & Southwest Areas Pension Fund v. Cent. Transp., Inc., 472 U.S. 559, 570–71 (1985).
[44] Tibble v. Edison International, 135 S. Ct. 1823, 1828 (2015) ("We have often noted that an ERISA fiduciary's duty is derived from the common law of trusts. In determining the contours of an ERISA fiduciary's duty, courts often must look to the law of trusts").
[45] *See* 29 U.S.C. § 1104(a)(1)(A)(i).
[46] Max M. Schanzenbach and Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381, 403 (2020).

other than the accomplishment of the purposes of the trust [ERISA plan]."[47] Moreover, a "trustee [plan manager] who is influenced by his own or a third party's interests is disloyal, because the trustee [plan manager] is no longer acting *solely* in the interest of the beneficiaries."[48]

In addition, based on the U.S. Supreme Court's interpretation of the statutory language, "providing benefits to participants and their beneficiaries," a fiduciary's duty of loyalty requires an exclusive focus on the pursuit of *financial benefits*:

> "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.[49]

As further stated by the Court, "[t]he term ['benefits'] does not cover nonpecuniary benefits."[50] Therefore, ERISA's fiduciary duties incorporate a mandatory *common investor purpose*,[51] the pursuit of *financial* benefits for the plan beneficiaries, that does not allow for the pursuit of nonfinancial or nonmonetary benefits even if participants and beneficiaries approve. In sum, plan managers are to be constantly guided by the fiduciary principles of "*solely* in the interest of the participants and beneficiaries" and for the *exclusive purpose* of providing financial benefits to them.

B. ERISA's Duty of Loyalty in Practical Terms

What this duty of loyalty means in terms of plan management is discussed in the DOL's recent proposed rule, *Financial Factors in Selecting Plan Investments*.[52] The proposed rule deals with the issue of plan managers investing in what Schanzenbach and Sitkoff would call "collateral benefits ESG,"[53] i.e., a plan manager investing ERISA plan assets based on nonfinancial objectives, including moral or ethical reasons, or to benefit a third party (non-beneficiary or non-participant in a pension fund), such as one or more non-shareholder stakeholders in a public company or the plan manager itself.[54]

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[47] *Id.* (citing Restatement (Third) of Trusts § 78(1) cmt. f. (Am. Law Inst. 2007)).
[48] *Id*.
[49] Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409, 420–21 (2014).
[50] *Id.* at 421.
[51] This term is used in Sean J. Griffith's new article, *Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority*, 98 TEX. L. REV. 983 (2020).
[52] 85 Fed. Reg. 39113 (June 30, 2020).
[53] Schanzenbach and Sitkoff, *supra* note 46. By comparison, there is also what is referred to as "risk-return ESG. This is investing by utilizing ESG factors only as a means to enhance the manager's evaluation of the risk-adjusted returns of an investment without regard to collateral benefits." *See id.* at 390. This is the kind of ESG investing that is allowed under ERISA. *See* Letter from Bernard S. Sharfman to Office of Regulations and Interpretations, Employee Benefits Security Administration, *RE: Financial Factors in Selecting Plan Investments Proposed Regulation (RIN 1210-AB95)* (July 22, 2020), https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB95/00147.pdf [hereinafter Letter from Sharfman to DOL, July 22, 2020]. Please note that Sharfman's letter will form the foundation for a forthcoming law review article in the YALE JOURNAL ON REGULATION BULLETIN, the online companion to the print version of the YALE JOURNAL ON REGULATION.
[54] Letter from Sharfman to DOL (July 22, 2020), *supra* note 53.

In the proposed rule, the DOL stated that "ERISA requires plan fiduciaries to select investments and investment courses of action based *solely* on financial considerations relevant to the *risk-adjusted economic value* of a particular investment or investment course of action,"[55] "plan assets may not be enlisted in pursuit of other social or environmental objectives,"[56] and "ERISA plan fiduciaries may not invest in ESG vehicles when they understand an underlying investment strategy of the vehicle is to subordinate return or increase risk for the purpose of *non-pecuniary objectives*."[57]

1. *Screening Based on Non-Pecuniary Factors*[58]

For example, a plan manager cannot invest in, or provide as selections for self-directed individual accounts, mutual funds, or ETFs that use portfolio screening based on non-pecuniary objectives. As defined in my recent comment letter to the DOL, portfolio screening is "*a process by which a plan manager reduces its universe of eligible investments based on non-pecuniary factors*."[59] A plan manager may not invest in funds that use screening criteria based on environmental factors, use of dual class shares, ESG ratings, alcohol- or tobacco-related, diversity, executive compensation, workforce compensation or working conditions, unionization, etc.[60]

Moreover, if screening criteria based on non-pecuniary factors are used in the creation of an index, this should create a presumption that those investment funds that use such an index are collateral benefits ESG.[61] For example, consider the selection criteria utilized in the MSCI KLD 400 Social Index, the index used by BlackRock's iShares MSCI KLD 400 Social ETF, an ESG ETF with approximately $2 billion in assets as of July 7, 2020:[62]

> The MSCI KLD 400 Social Index is maintained in two stages. First, securities of companies involved in Nuclear Power, Tobacco, Alcohol, Gambling, Military Weapons, Civilian Firearms, GMOs and Adult Entertainment are excluded. Then additions are made from the list of eligible companies based on considerations of ESG performance, sector alignment and size representation. The MSCI KLD 400 Social Index is designed to maintain similar sector weights as the MSCI USA Index and targets a minimum of 200 large and mid-cap constituents. Companies that are not existing constituents of The MSCI KLD 400 Social Index must have an MSCI ESG Rating above "BB" and the MSCI ESG Controversies Score greater than 2 to be eligible. At each quarterly Index Review, constituents are deleted if they are deleted from the MSCI USA IMI Index, fail the exclusion screens, or if their ESG ratings or scores fall below minimum standards. Additions are made to restore the number of constituents to 400. All eligible securities of each issuer are included in the index, so the index may have more than 400 securities. The selection universe for the MSCI KLD 400 Social Index are large, mid and small cap companies in the MSCI USA IMI Index.[63]

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[55] 85 Fed. Reg. 39113, 39113.
[56] *Id.* at 39116.
[57] *Id.*
[58] Subsections 1–3 of Section III.B borrow heavily from Sharfman's recent comment letter to the DOL. *See* Letter from Sharfman to the DOL (July 22, 2020), *supra* note 53.
[59] *Id.*
[60] *Id.*
[61] *Id.*
[62] BlackRock, iShares MSCI KLD 400 Social ETF (July 7, 2020), https://www.ishares.com/us/products/239667/ishares-msci-kld-400-social-etf.
[63] MSCI, *MSCI KLD 400 Social Index (USD)* (June 30, 2020),

Investment funds that use this index will have a significantly reduced number of stocks held in portfolio. First, there is an up-front screen to exclude a large number of investments based on moral and ethical reasons (negative screen).[64] Second, another round of exclusions is based on an investment not having a minimum ESG rating or score. However, additions are made from the list of eligible companies based on considerations of ESG performance, sector alignment, and size representation (positive screen). All qualified securities are included in the index. Even so, the result is a relatively small portfolio of roughly 400 stocks out of a universe of 2,344 stocks that make up the MSCI USA IMI Index.[65]

2. *Portfolio Screening and Positive Skewness*

Screening techniques based on non-pecuniary factors lead to a reduced number of stocks in a portfolio and therefore an increased probability that the big winners in the stock market will be excluded from or underweighted in an investment portfolio. The result will be reduced expected returns versus a comparable benchmark. This is a very important point for plan managers when selecting mutual funds or ETFs to invest in or making them available to plan participants and beneficiaries in self-directed accounts.

In Hendrik Bessembinder's recent pathbreaking article *Do Stocks Outperform Treasury Bills?*,[66] he observed that there is a significant amount of positive skewness in the returns of individual public companies (common stock) that made up the stock market from July 1926 to December 2016. He found that "in terms of lifetime dollar wealth creation" ("accumulated December 2016 value in *excess of* the outcome that would have been obtained if the invested capital had earned one-month Treasury bill returns"),[67] "the best-performing 4% of listed companies explain the net gain for the entire US stock market since 1926, as other stocks collectively matched Treasury bills."[68] His results also showed that the sum of the individual contributions to lifetime dollar wealth creation provided by the top 50 companies represented almost 40 percent of total lifetime dollar wealth creation.[69] Thus, the returns earned by a relatively small number of best-performing companies were critical to the stock market earning returns above short-term Treasuries.

The understanding that positive skewness exists in stock-market returns means that investors are best served if those select few firms that are *expected* to be the best performers are given the maximum

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https://www.msci.com/documents/10199/904492e6-527e-4d64-9904-c710bf1533c6. This index has as its foundation the MSCI USA Investable Market Index.

[64] BlackRock reported that it currently manages $481 billion of assets that are selected based on exclusionary screens. *See* Letter from Barbara Novick, Anne Ackerley, Brian Deese, and Nicole Rosser, BlackRock, Inc. to Office of Regulations and Interpretations, Employee Benefits Security Administration, *RE: Financial Factors in Selecting Plan Investments Proposed Regulation (RIN 1210-AB95)* at 5 n. 8 (July 30, 2020), https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB95/00701.pdf.

[65] The MSCI USA Investable Market Index is "designed to measure the performance of the large, mid and small cap segments of the US market. With 2,344 constituents, the index covers approximately 99% of the free float-adjusted market capitalization in the US." *See* MSCI, *MSCI USA IMI (USD)* (June 30, 2020), https://www.msci.com/documents/10199/3c4c8412-5d81-4aa9-a9c8-4490f9f5e04a.

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

[67] *Id.* at 454 tbl. 5.

[68] *Id.* at 440.

[69] *Id.* at 454 tbl. 5.

opportunity to show up in an investment fund's portfolio. If investment funds want to maximize risk-adjusted returns, weeding out investments based on non-pecuniary factors is not the way to accomplish this objective. It is simply an additional constraint on the ability to maximize. As stated by prominent finance professors Bradford Cornell and Aswath Damodaran, "[A] constrained optimum can, at best, match an unconstrained one, and most of the time, the constraint will create a cost."[70]

3. *Portfolio Screening and Overweighting*

The use of portfolio screening based on non-pecuniary factors may also result in the *overweighting* of certain industries. This lack of portfolio diversification adds extra unsystematic risk to the ex-ante risk-adjusted return calculation. This extra risk cannot be ignored when an ESG fund is being evaluated for its risk-adjusted return.

Overweighting in certain sectors can also give the appearance that a portfolio's stocks, such as many ESG funds, are performing much better than they appear, relative to their peers. As Vincent Deluard observed, ESG funds are currently overweighted in the health-care and technology industries, the two best-performing sectors in the first part of 2020.[71] As pointed out by Mitch Goldberg, "there are two likely reasons why a fund could outperform its benchmark. Either by overweighting the outperforming sector, or by lowering the expense ratio. In the case of the recent strong run for some ESG funds, it looks like the answer is an overweight to the technology sector."[72]

The result of this recent overweighting in the health-care and technology industries in ESG funds has led some to claim that ESG is an "equity vaccine" in times of declining share prices.[73] However, this is not correct. As stated by James Mackintosh:

> Even where an ESG index did beat the market, it had little to do with environmental, social or governance issues. Instead, it came down to luck; did they happen to pick the stocks that best rode out coronavirus lockdowns? It is better to be lucky than right; but having, as some did, less exposure to cruise liners or long-haul airlines because of their carbon footprint was luck, not a well-thought-out way to avoid the stocks hurt most by Covid-19. There are several reasons

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[70] Bradford Cornell and Aswath Damodaran, *Valuing ESG: Doing Good or Sounding Good?* (Mar. 20, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3557432.

[71] Vincent Deluard, *ESG Investors Are Winning Their Unintended War on People*, StoneX Group Inc. (client memo; May 2020), https://www-test.intlfcstone.com/globalassets/featured-insights/v_deluard_0520_06302020.pdf. While outside the scope of this article, Deluard makes a very insightful observation about the unintended consequences of ESG investing:

> [T]he single most salient characteristics of these [ESG] funds is that they favor machines and intangible assets over humans. The average company in the ESG basket has 20% fewer employees than the median Russell 3,000 company. This tilt explains their success in a year which has rewarded biotech firms and tech platforms and punished employee-heavy sectors, such as airlines, retailers, and cruise lines. Companies with no employees do not have strikes or labor disputes. There is no gender pay gap when production is completed by robots and algorithms. Financial networks have no carbon footprint.

Despite its noble goal, ESG investing unintendedly spreads the greatest illnesses of postindustrial economies: winner-take-all capitalism, monopolistic concentration, and the disappearance of jobs for normal people. *Id.*

[72] Mitch Goldberg, *ESG Index Funds Are Hot: That May Be a Risky Thing for Investors*, cnbc.com (Nov. 17, 2019), https://www.cnbc.com/2019/11/17/esg-index-funds-are-hot-that-may-be-a-risky-thing-for-investors.html.

[73] Elizabeth Demers, Philip Joos, Jurian Hendrikse, and Baruch Lev, *ESG Didn't Immunize Stocks Against the COVID-19 Market Crash* (Aug. 27, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3675920.

> why Microsoft tends to score well on ESG, but its cloud services being in demand because everyone is working from home isn't among them.[74]

Moreover, Elizabeth Demers, Philip Joos, Jurian Hendrikse, and Baruch Lev, in their recent empirical study *ESG Didn't Immunize Stocks Against the COVID-19 Market Crash*, demonstrated that ESG did not serve as an equity vaccine during the COVID-19 market crash. They found that "ESG is insignificant in fully specified returns regressions for the first quarter of 2020 COVID crisis period, and it is *negatively* associated with returns during the market's 'recovery' period in the second quarter of 2020."[75] Moreover, ESG scores provide very little (1% in the first quarter of 2020 and 3% in the second quarter of 2020) in the way of explanatory power.[76] Instead, they found that "industry affiliation, market-based measures of risk, and accounting-based variables that capture the firm's financial flexibility (liquidity and leverage) and their investments in internally-developed intangible assets together dominate the explanatory power of the COVID returns models."[77] Importantly, the use of an extensive menu of control variables, including these and others, is what distinguishes their work from other research reports:

> Contrary to the findings of contemporaneous studies that do not include such a full set of controls …, as well as to the widespread claims by fund managers [e.g., claims made by BlackRock, Inc.],[78] ESG data purveyors, and the financial press who seem to arrive at their conclusions on the basis of simple pairwise correlations, our results provide robust evidence that ESG is not significantly associated with stock market performance during the first quarter of 2020 once the full array of other expected determinants of returns have been controlled for.[79]

In sum, portfolio overweighting that results from the use of non-pecuniary factors is a risk factor, not an enhancement to the expected financial performance of a fund, no matter how well the fund appears to perform in the short term.

C. ERISA's Duty of Loyalty and Shareholder Voting/Engagement

Since 1988, when first presented in a formal Opinion Letter now commonly referred to as the "Avon Letter,"[80] 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,[81] stated: "In general, the *fiduciary* act of managing plan

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[74] James Mackintosh, "ESG Investing in the Pandemic Shows Power of Luck," *Wall Street Journal*, https://www-wsj-com.cdn.ampproject.org/c/s/www.wsj.com/amp/articles/esg-investing-in-the-pandemic-shows-power-of-luck-11594810802 (July 15, 2020).
[75] Demers et al., *supra* note 73.
[76] *Id.*
[77] *Id.*
[78] *Id.,* citing *BlackRock, Sustainable Investing: Resilience amid Uncertainty* (2020), https://www.blackrock.com/corporate/literature/investor-education/sustainable-investing-resilience.pdf.
[79] Demers et al., *supra* note 73.
[80] U.S. Dep't of Labor, Pension & Welfare Benefit Admin., Opinion Letter on Avon Products, Inc. Employees' Retirement Plan (Feb. 23, 1988) [hereinafter Avon Letter].
[81] *History of EBSA and ERISA*, U.S. Dep't of Labor, 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]").

assets which are shares of corporate stock would include the voting of proxies *appurtenant* to those shares of stock."[82] This policy has been explicitly affirmed by the DOL in 1990,[83] 1994,[84] 2008,[85] 2016,[86] and 2018.[87] Such a policy presumes that significant, not *de minimis*, financial value will accrue to beneficiaries and participants if a plan manager, in accordance with its fiduciary duties, properly manages the shareholder voting rights associated with their plan's equity holdings.[88]

How shareholder voting is to be approached by a plan manager consistent with its fiduciary duties was summarized in footnote 4 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*.[89]

Accordingly, when a plan manager votes on behalf of an ERISA pension plan, it must do so within the strict and narrow boundaries of what the fiduciary duties of ERISA require. Moreover, according to the DOL's Field Assistance Bulletin No. 2018-01, a bulletin intended to provide guidance on how to properly understand Bulletins 2016-01 and 2015-01, it stated: "The Department has a similarly longstanding position that ERISA fiduciaries may not sacrifice investment returns or assume greater investment risks as a means of promoting collateral social policy goals."[90] Finally, the DOL's recently proposed rule, *Fiduciary Duties Regarding Proxy Voting and Shareholder Rights*, is very clear on the

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[82] Avon Letter, *supra* note 80, at 7 (emphasis added).
[83] 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").
[84] 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").
[85] 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").
[86] 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").
[87] 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.
[88] Bernard S. Sharfman, *Now Is the Time to Designate Proxy Advisors as Fiduciaries under ERISA*, 25 STAN. J.L. BUS. & FIN. 1 (2020).
[89] Avon Letter, *supra* note 80, at 11 n. 4.
[90] 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].

purpose of shareholder voting: "ERISA mandates that fiduciaries manage voting rights prudently and for the 'exclusive purpose' of securing economic benefits for plan participants and beneficiaries—which may or may not require a proxy vote to be cast."[91] These combined statements make DOL guidance on shareholder voting clear and unambiguous: voting for purposes of collateral benefits ESG is not allowed.

DOL guidance on shareholder engagement is also clear and unambiguous. Not surprisingly, engagement is allowed as long as it resides within the confines of a plan manager's fiduciary duties. According to the DOL's recently proposed rule on shareholder voting, "ERISA does not permit fiduciaries, in voting proxies or *exercising other shareholder rights*, to subordinate the economic interests of participants and beneficiaries to unrelated objectives."[92] Moreover, the DOL "has rejected a construction of ERISA … that would permit plan fiduciaries to expend trust assets to promote myriad public policy preferences, *including through shareholder engagement activities*, voting proxies, or other investment policies."[93]

The key point is that a plan manager is allowed to engage with the management of a portfolio company but only if the engagement conforms to its fiduciary duties. This means that engagement must only be utilized if there is "a reasonable expectation that such activities are likely to enhance the [economic] value of the plan's investments after taking into account the costs involved."[94] This does not include when a plan manager, similar to what is described in Part IV, tries to interfere in the stakeholder relationships of a portfolio company, even though the plan manager has no expertise and is engaging in such activities for purposes of collateral benefits ESG.

In sum, under the duty of loyalty, a plan manager can enter into both voting and engagement. However, voting and engagement must be constantly guided by the fiduciary principles of "*solely* in the interest of the participants and beneficiaries" and for the *exclusive purpose* of providing financial benefits to them. "Unrelated objectives" must not interfere with a plan manager's voting and engagement duties. As a result, neither voting nor engagement can be entered into for purposes of collateral benefits ESG.

D. Duty of Prudence (Care) and Shareholder Voting/Engagement

Under ERISA, the duty of prudence (care) 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."[95] Critical to determining whether a plan manager has met this duty is a finding that the "fiduciary has conducted a 'thorough, impartial investigation' of the contemplated transaction and made a decision that the fiduciary has reasonably concluded is the best for the beneficiaries."[96] This

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[91] U.S. Dep't of Labor, Emp. Benefits Sec. Admin., *Fiduciary Duties Regarding Proxy Voting and Shareholder Rights* (proposed Aug. 31, 2020), 85 Fed. Reg. 55219, 55223 (Sept. 4, 2020).
[92] *Id.* at 55220.
[93] *Id.* at 55221.
[94] Field Assistance Bulletin No. 2018-01, *supra* note 90.
[95] *See* 29 U.S.C. § 1104(a)(1)(B); ERISA § 404(a)(1)(B).
[96] Craig C. Martin, Michael A. Doornweerd, Amanda S. Amert, and Douglas A. Sondgeroth, Jenner & Block, ERISA LITIGATION HANDBOOK (2012), citing Flanigan v. GE, 242 F.3d 78, 86 (2d Cir. 2001); quoting Bussian v. RJR Nabisco, Inc., 223 F.3d 286, 300 (5th Cir. 2000), https://jenner.com/system/assets/publications/11324/original/ERISA_Litigation_Handbook.pdf?1353351675.

requires plan managers to conduct an investigation that is both adequate and reasonable "in light of the beneficiaries interests."[97] In the context of shareholder voting:

> [F]iduciaries must perform *reasonable investigations*, understanding that certain proposals may require a more detailed or particularized voting analysis. Information that will better enable fiduciaries to determine whether or how to vote proxies on particular matters includes the cost of voting, including opportunity costs; the type of proposal (e.g., those relating to social or public policy agendas versus those dealing with issues that have a direct economic impact on the investment); voting recommendations of management; and an analysis of the particular shareholder proponents. In the Department's view, fiduciaries must be prepared to articulate the anticipated economic benefit of proxy-vote decisions in the event they decide to vote.[98]

In the context of engagement, the duty of prudence will require a reasonable investigation into the costs and benefits of any engagement activity. This investigation must be done in order to conclude that there is "a reasonable expectation that such activities are likely to enhance the [economic] value of the plan's investments after taking into account the costs involved."[99]

IV. VIEWING BLACKROCK'S ACTIVISM THROUGH THE LENS OF A PLAN MANAGER'S FIDUCIARY DUTIES

In the Avon Letter, the DOL was referring "to the voting of proxies on plan owned stock."[100] Back in 1988, when the letter was written, the DOL was undoubtedly referring to the right to vote the proxies associated with the common stock of public companies held in portfolio. As the letter says: "In 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."[101] However, over time, the nature of shareholder voting has changed dramatically.[102] When a plan manager utilizes mutual funds or ETFs for its portfolio or offers them as selections in the self-directed individual accounts of its participants and beneficiaries, the plan still has voting authority but now only in the shares of the mutual funds or ETFs that it owns. It no longer has direct ownership of the common stock of public companies and therefore no longer has direct voting authority in the public companies that reside in a fund's portfolio. In turn, those funds will typically turn over their voting authority to its investment adviser. That is why BlackRock has so much shareholder voting authority.

While the voting authority of an investment adviser to a mutual fund or ETF does not come under the fiduciary duties of ERISA,[103] it is doubtful that the intent of the Avon Letter and all subsequent

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[97] *Id.* at 57.
[98] 85 Fed. Reg. 55224.
[99] Field Assistance Bulletin No. 2018-01, *supra* note 99.
[100] Avon Letter, *supra* note 80, at 1.
[101] *Id.*
[102] 85 Fed. Reg. 55221.
[103] ERISA 3(21)(B) states:

> If any money or other property of an employee benefit plan is invested in securities issued by an investment company registered under the Investment Company Act of 1940 [(15 U.S.C. 80a-1 et seq.)], such investment shall not by itself cause such investment company or such investment company's investment adviser or principal underwriter to be deemed to be a fiduciary or a party in interest as those

guidance in this regard was meant to absolve a plan manager of any fiduciary duty associated with the shareholder voting of shares that it now owns indirectly through its share ownership in mutual funds and ETFs. If so, then the question becomes: Is the use of delegated shareholder voting power consistent with a plan manager's fiduciary duties? That is, is it "*solely* in the interest of the participants and beneficiaries" and for the *exclusive purpose* of providing financial benefits to them?

To answer this question, it is incumbent on the plan manager to *investigate* how this shareholder voting power will be used prior to making the decision[104] to invest in those funds (funds where the investment adviser has delegated voting authority) or making those funds available for self-directed individual accounts. This may be a newly recognized aspect of the *duty of prudence* but one that is now required when the investment adviser to the identified funds has a large amount of delegated voting power or enough that can be used as a tool for behavior that is not within the bounds of a plan manager's duty of loyalty.

The following investigates how BlackRock utilizes its delegated voting authority. It focuses on BlackRock's marketing objectives, as identified in its rhetoric, and the stakeholder strategy that underlies its shareholder activism.

A. Marketing Objective

We first look at the two objectives of BlackRock's shareholder activism. First, as disclosed in its rhetoric, one objective is to increase the marketing of its investment products to millennials. From the perspective of BlackRock, the successful achievement of such a marketing objective would be a great financial win for the company and its own shareholders. It is no secret that the index-fund business, of which BlackRock is a leader, has become cutthroat and does not appear to be generating fees for anyone, including BlackRock. One way to increase fees is to convince investors, such as millennials, that the world would be a better place if they would just invest in collateral benefits ESG funds. For example, mutual funds and ETFs that track the MSCI's KLD 400 Social Index[105] will typically charge

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> terms are defined in this title, except insofar as such investment company or its investment adviser or principal underwriter acts in connection with an employee benefit plan covering employees of the investment company, the investment adviser, or its principal underwriter. Nothing contained in this subparagraph shall limit the duties imposed on such investment company, investment adviser, or principal underwriter by any other law.

See also U.S. Dep't of Labor, Emp. Benefits Sec. Admin., *Fiduciary Duties Regarding Proxy Voting and Shareholder Rights*, *supra* note 91, at 60 (ERISA does not govern the management of the portfolio internal to a fund registered with the SEC, including such fund's exercise of its shareholder rights appurtenant to the portfolio of stocks it holds).

[104] As a DOL advisory opinion stated, "Section 3(21)(B) provides that a plan's investment in a registered investment company 'shall not by itself cause such investment company or such investment company's investment adviser or principal underwriter to be deemed to be a fiduciary or a party in interest as those terms are defined in [Title I of ERISA], except insofar as such investment company or its investment adviser or principal underwriter acts in connection with an employee benefit plan covering employees of the investment company, the investment adviser, or its principal underwriter.' " However, "ERISA's exclusion for mutual funds is not absolute. It does not apply to a plan fiduciary's decision to invest plan assets in a mutual fund." *See* Department of Labor, Advisor Opinion 2009-04a (Dec. 4, 2009), https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/advisory-opinions/2009-04a.

[105] BlackRock's iShares MSCI KLD 400 Social ETF, Fact Sheet (Mar. 31, 2020) (identifying an expense ratio of 0.25%), https://www.ishares.com/us/literature/fact-sheet/dsi-ishares-msci-kld-400-social-etf-fund-fact-sheet-en-us.pdf.

significantly higher fees than funds and ETFs that track the more standardized and broadly based CRSP U.S. Total Market Index[106] or Fidelity U.S. Total Investable Market Index.[107] Therefore, the offering of ESG funds may be significantly more profitable for the investment adviser than lower-cost funds that use standardized indexes.[108]

But there is a big problem with this objective. Shareholder voting and engagement is not being executed *solely* in the interest of its beneficial investors, including those beneficial investors who are participants and beneficiaries of an ERISA plan. BlackRock's voting and engagement behavior is being skewed in the direction of a particular subset of beneficial and potential beneficial investors—those who fit BlackRock's marketing profile of a *millennial*—so as to enhance BlackRock's profitability. Therefore, a plan manager, after complying with its duty of prudence to investigate the marketing objective of BlackRock's shareholder activism, would be required to exclude those BlackRock funds that were associated with this kind of activity.

B. The Objective of Appeasing Shareholder Activists

BlackRock's second objective is to appease shareholder activists who threaten to attack the business decisions, procedures, and objectives of its own corporate management. As previously discussed, in response to the activism of Boston Trust Walden and Mercy Investment Services targeting the voting practices of BlackRock's investment stewardship team, it was required to increase its shareholder activism in the area of climate change. This was reflected in the team's second-quarter 2020 voting and engagement statistics. Again, the focus is on BlackRock's own interests. Shareholder voting and engagement is not being executed *solely* in the interest of its beneficial investors, including those beneficial investors who are participants and beneficiaries of an ERISA plan. Therefore, a plan manager, after complying with its duty of prudence to investigate and identify this second objective, would be required to exclude those BlackRock funds that were associated with this kind of activity.

C. Stakeholder Strategy and Exclusive Purpose of Providing Financial Benefits

In order for BlackRock to attract millennial investors, its shareholder activism must focus on "improving society" for various stakeholders and not just "generating profit" for its shareholders. This commingling of strategies can be understood as implementing a collateral benefits ESG voting and engagement approach. This activism is not being done for the *exclusive purpose* of providing financial benefits to plan participants and beneficiaries. Therefore, a plan manager, after complying with its duty of prudence to investigate and identify this mix of strategies, would be required to exclude those BlackRock funds that were associated with this kind of activity.

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[106] Vanguard Total Stock Market ETF (identifying an expense ratio of 0.03%), https://investor.vanguard.com/etf/profile/fees/vti.
[107] Fidelity's ZERO℠ Total Market Index Fund, Fact Sheet (July 3, 2020) (identifying an expense ratio of 0.00%), https://fundresearch.fidelity.com/mutual-funds/fundfactsheet/31635T708.
[108] Letter from Bernard S. Sharfman to the Department of Labor on the DOL's proposed rule on ESG investing under ERISA, https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB95/00147.pdf.

D. The Inefficiency of BlackRock's Stakeholder Strategy

Moreover, a strong argument can be made that BlackRock's shareholder activism strategy of focusing on the stakeholder relationships of its portfolio companies will not result in providing financial benefits for its beneficial investors, even if it were its exclusive purpose.

The management of stakeholder relationships is complex and is usually placed in the hands of those who have the knowledge and expertise to manage them: the company's management team, up and down the line.[109] Moreover, stakeholder relationships can change on a daily basis: consumers who have ever-changing tastes or are becoming increasingly sensitive to the negative externalities that the company may create; competitors that introduce new products; changing technologies; threats to global and domestic supply chains for key components and raw materials; credit and equity markets that require ever-changing terms; and competitive labor markets for skilled talent. A failure to deal with these stakeholder relationship issues in an integrated manner can lead a company to report mediocre financial results and eventual failure.[110]

The following quote by Emily Winston gets to the heart of how complex stakeholder relationships are and why it is very unusual for shareholders to be involved in their management:

> Public shareholders are not perfectly informed. Corporate managers have access to information about their firms to which public shareholders do not have access. Prominent in this category of private information is information about the corporation's relationships with its non-shareholder stakeholders. Corporations' relationships with their stakeholders are governed by agreements that are, to varying degrees, *incomplete*. At-will employees and customers, in particular, have very incomplete agreements with corporations, meaning most, if not all, terms of agreement are not explicitly specified. Even the more specific contracts, such as those with suppliers and creditors, will still have unspecified terms and *will need to be negotiated repeatedly over the course of the corporation's life*. Stakeholder agreements are therefore the subject of ongoing negotiations between firm managers and the relevant stakeholders. Managing these relationships is the role of a corporate manager, and it exposes managers to vital information about those stakeholder relationships to which shareholders are not privy. *This information is not reducible to metrics that can be effectively transferred to shareholders*, and public shareholders, by their nature, are not positioned, nor do they have the expertise, to be intimately involved in the management of other stakeholder relationships. Thus, information asymmetries will prevent shareholders from being effective monitors of other stakeholder interests.[111]

This understanding has led Professor Winston to conclude: "Even when shareholders are financially incentivized to use their power to promote the interests of other stakeholders, they will lack

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[109] Bernard S. Sharfman, *Why BlackRock's Stakeholder Approach Won't Work*, REALCLEARMARKETS (May 18, 2020), https://www.realclearmarkets.com/articles/2020/05/18/why_blackrocks_stakeholder_approach_wont_work_491618.html.
[110] *Id.*
[111] Emily Winston, *Managerial Fixation and the Limitations of Shareholder Oversight*, 71 HASTINGS L.J. 699, 705 (2020).

the information about stakeholder relationships necessary to do so effectively. This asymmetry of information means that shareholders cannot incorporate stakeholder information into their assessment of firm value, so managing to shareholder expectations will not maximize the value created by stakeholder relationships."[112] In sum, "while corporate attention to non-shareholder stakeholders can improve firm value, shareholder oversight of these stakeholder relationships will not succeed in having this effect."[113]

Moreover, *all* shareholders suffer from a collective action problem when it comes to shareholder voting and engagement.[114] This results in shareholders not being adequately informed when voting or participating in engagement. According to Frank Easterbrook and Daniel Fischel, "When many are entitled to vote, none of the voters expects his votes to decide the contest. Consequently none of the voters has the appropriate incentive at the margin to study the firm's affairs and vote intelligently."[115]

But BlackRock is no ordinary shareholder. From an informational perspective, BlackRock and its passive index-fund competitors such as Vanguard and State Street Global Advisors are in the worst possible position for getting involved in the management of a public company's stakeholder relationships. According to law professor Charles Korsmo:

> A large and growing share of institutional investment is in the form of "passive" index funds…. They seek to offer a market return and compete by offering the lowest possible fees to individual investors. As a result, they expend little or no effort seeking to value the firms they invest in. While these index funds are certainly "sophisticated" investors in the sense that they understand the central lesson of modern portfolio theory [it is more efficient to have a properly diversified investment portfolio than to try to pick stock winners using only publicly available information] … *they are not "sophisticated" in the sense of knowing anything about the firms they invest in.* The whole philosophy of index investing is that it is unnecessary to know anything about the firms you invest in.[116]

According to Lucian Bebchuk and Scott Hirst, when investment stewardship teams from the Big Three engage with their portfolio companies, they show zero interest in financial underperformance: "We reviewed all of the examples of behind-the-scenes engagements described in the Big Three Stewardship Reports. *We found zero cases where engagement was described as being motivated by financial underperformance*."[117] In the specific case of BlackRock's investment stewardship team, given the extremely limited resources it has to work with, why should we expect anything more?

Think about this in terms of BlackRock's recent focus on global supply chains and how the coronavirus exposed their weaknesses.[118] Where does BlackRock's expertise come from when it

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[112] *Id.* at 699.
[113] *Id.*
[114] *See* Bernard S. Sharfman, *The Risks and Rewards of Shareholder Voting*, SMU L. REV. (forthcoming, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3550077.
[115] Frank H. Easterbrook and Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 402 (1983).
[116] Charles R. Korsmo, *Delaware's Retreat from Judicial Scrutiny of Mergers*, 10 U.C. IRVINE L. REV. 55, 99 (2019).
[117] Lucian A. Bebchuk and Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2096 (2019).
[118] BlackRock, Inc., *BlackRock Investment Stewardship Global Quarterly Stewardship Report*, supra note 26, at 3.

weighs in on how supply chains need to be restructured? This type of inquiry may sound good to millennials who would like to see supply chains and their associated job offerings become more domestic, but with BlackRock being uninformed and not focused on the financial performance of its portfolio companies, one must conclude that BlackRock's investment stewardship team will not be able to add anything of real value to this kind of decision-making.

Finally, it must be noted that BlackRock's investment-management team may actually reduce firm value if its shareholder activism is successful. If BlackRock tries to pressure a company to make changes to its stakeholder relationships that management knows are value-reducing, management may counterpropose and agree to a less suboptimal, non-wealth-maximizing alternative in order to avoid the uncertain outcome of BlackRock going public with its concerns. This is an argument similar to the one made by John Matsusaka and Oguzhan Ozbas in a recent paper on shareholder proposals submitted by activists:

> Managers have an incentive to deter proposals from activist shareholders by adjusting corporate policy; one might conjecture that external pressure leads them to choose policies more appealing to other shareholders in order to reduce the electoral prospects of activist proposals. However, we show that when deterrence occurs, it is always by moving policy toward the position favored by the activist, even if this reduces shareholder wealth. Our analysis stresses the central role of *voting uncertainty* in determining the value consequences of shareholder rights and proxy access.[119]

The recent work of Nickolay Gantchev and Mariassunta Giannetti supports the idea that corporate boards would simply be acting rationally to reduce uncertainty if they were to privately agree to a less wealth-reducing alternative. Gantchev and Giannetti found that value-destroying shareholder proposals, typically submitted by high-volume submitters of proposals, may actually go to a vote, receive majority support, and be implemented by management.[120] Therefore, the risk that management may have to fully implement BlackRock's uninformed recommendations, if BlackRock were to go public and receive support from other uninformed and opportunistic shareholders, may lead them to privately agree to less harmful arrangements.

E. Summary of Stakeholder Strategy

The focus on stakeholder relationships as a strategy underlying BlackRock's shareholder activism is arguably not appropriate for enhancing the financial benefits of its beneficial investors, including those who are ERISA plan participants and beneficiaries. However, this focus is consistent with the use of shareholder activism for opportunistic purposes, i.e., supporting BlackRock's marketing efforts to attract new millennial investors and to minimize the impact of shareholder activism on its own management. If BlackRock's investment stewardship team were truly interested in enhancing the financial benefits provided to ERISA plan participants and beneficiaries, it is extremely doubtful that it would do so by becoming a third-party monitor of its portfolio companies' stakeholder relationships. Therefore, a plan manager's duty of prudence requires it to investigate the value of this strategy. If it

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[119] John G. Matsusaka and Oguzhan Ozbas, *A Theory of Shareholder Approval and Proposal Rights*, 33 J. L. ECON. & ORG. 377, 377 (2017).
[120] Nickolay Gantchev and Mariassunta Giannetti, *The Costs and Benefits of Shareholder Democracy* (Nov. 2019), http://ssrn.com/abstract_id=3269378.

finds it be to be harmful to the financial interests of its participants and beneficiaries, its duty of loyalty would require it to exclude those BlackRock funds that are associated with this strategy.

V. Conclusion

An ERISA plan manager cannot delegate away its fiduciary duties when delegating its shareholder voting authority to investment advisers of the mutual funds and ETFs that it invests in or makes available as selections to its participants and beneficiaries. The plan manager's duty of prudence requires it to investigate whether the shareholder activism of a fund's investment adviser is consistent with its obligation to act "*solely* in the interest of the participants and beneficiaries" and for the *exclusive purpose* of providing financial benefits to them.

This white paper argues that BlackRock's shareholder activism is not consistent with a plan manager's fiduciary duties. Therefore, BlackRock's investment funds that are associated with its shareholder activism should not be included in an ERISA plan. For the funds to once again become eligible for inclusion, it would appear that BlackRock needs to create a firewall between funds that are to be included in ERISA plans and those that are not. The former would somehow not be associated with the activism implemented by its investment stewardship team. Or, BlackRock could simply shut down its shareholder activism until it could implement a strategy of shareholder activism that would not violate ERISA's fiduciary duties.

The analysis found in this white paper is not meant to apply only to funds managed by BlackRock. It needs to be applied to any and all investment advisers who opportunistically attempt to leverage their delegated voting authority for purposes outside the bounds of ERISA's fiduciary duties. Finally, the DOL should provide guidance on how plan managers should make the determination to exclude investment products offered by investment advisers who engage in shareholder activism.