MI

Statement to the Senate Committee on Banking, Housing, and Urban Affairs

Hearing:

The Application of Environmental, Social, and Governance Principles in Investing and the Role of Asset Managers, Proxy Advisors, and Other Intermediaries

April 2, 2019
10:00 a.m.
Dirksen Senate Office Building, Room 2128

Who's Monitoring the Monitors?

The Rise of Intermediaries and the Threat to Capital Markets

James R. Copland
Senior Fellow and Director, Legal Policy
Manhattan Institute for Policy Research
52 Vanderbilt Avenue
New York, NY 10017

About Mr. Copland

James R. Copland is a senior fellow at the Manhattan Institute, where he has served as director of legal policy since 2003.[1] He has authored many policy briefs; book chapters; articles in journals including the *Harvard Business Law Review* and *Yale Journal on Regulation*; and opinion pieces in periodicals including the *Wall Street Journal*, *National Law Journal*, and *USA Today*. He has testified before Congress, government agencies, state and municipal legislatures, and international bodies. He is frequently cited in news articles in outlets including the *New York Times*, the *Washington Post*, *The Economist*, and *Forbes*; and has made hundreds of media appearances on networks including PBS, Fox News, MSNBC, CNBC, Fox Business, Bloomberg, C-Span, and NPR.

Mr. Copland has authored scores of reports on the shareholder-proposal process, as well as writing on the subject in popular[2] and academic[3] journals. On multiple occasions, Mr. Copland has been named to the National Association of Corporate Directors "Directorship 100" list, which designates the individuals most influential over U.S. corporate governance.[4]

Prior to joining the Manhattan Institute, Mr. Copland served as a management consultant with McKinsey and Company in New York and as a law clerk for Ralph K. Winter on the U.S. Court of Appeals for the Second Circuit. Mr. Copland has served as a fiduciary, director, or trustee on many corporate, nonprofit, and government boards. He holds a J.D. and an M.B.A. from Yale University, where he was an Olin Fellow in Law and Economics and a Teaching Fellow in Macroeconomics and Game Theory; an M.Sc. in Politics of the World Economy from the London School of Economics and Political Science; and a B.A. in Economics, with highest distinction and highest honors, from the University of North Carolina at Chapel Hill, where he was a Morehead Scholar and was awarded the Honors Prize in Economics.

The Manhattan Institute for Policy Research does not take institutional positions on legislation, rules, or regulations. Although my comments draw upon my long-running research on shareholder proposals and corporate governance as an Institute scholar, my statement before the subcommittee is solely my own, not my employer's.

---

[1] *See* James R. Copland, https://www.manhattan-institute.org/expert/james-r-copland. The Manhattan Institute is a non-profit, non-partisan think tank developing ideas that foster economic choice and individual responsibility. *See* About MI, https://www.manhattan-institute.org/about.

[2] *See, e.g.*, James R. Copland, *Another Shareholder Proposal? McDonald's Deserves a Break Today*, WALL ST. J., Jul. 7, 2017, *available at* https://www.wsj.com/articles/another-shareholder-proposal-mcdonalds-deserves-a-break-today-1499381801; *Getting The Politics out of Proxy Season*, WALL ST. J., Apr. 23, 2015, *available at* https://www.manhattan-institute.org/html/getting-politics-out-proxy-season-5461.html; *Politicized Proxy Advisers vs. Individual Investors*, WALL ST. J., Oct. 7, 2012, *available at* https://www.manhattan- institute.org/html/politicized-proxy-advisers-vs-individual-investors-3863.html.

[3] *See* James R. Copland, *Against an SEC-Mandated Rule on Political Spending Disclosure: A Reply to Bebchuk and Jackson*, 3 HARV. BUS. L. REV. 381 (2013).

[4] *See* NACD 2012 Honorees, https://www.nacdonline.org/directorship100/2012honorees.cfm ("Each year, NACD Directorship identifies the most influential people in the boardroom community, including directors, corporate governance experts, journalists, regulators, academics and counselors.").

Written Statement

Chairman Crapo, Ranking Member Brown, and members of the Committee, I would like to thank you for the invitation to testify today. My name is James R. Copland. Since 2003, I have been a senior fellow with and director of legal policy for the Manhattan Institute for Policy Research, a public-policy think tank in New York City. Although my comments draw upon my research conducted for the Manhattan Institute,[5] my statement before the Committee is solely my own, not my employer's.

Today's topic has been a significant focus of my research.

U.S. capital markets continue to lead the world. But changes in those markets potentially imperil that leadership place. These changes should prompt careful scrutiny from Congress and regulators at administrative agencies including the Securities and Exchange Commission. I want to focus my testimony on three central points:

1. Shareholder voting today is dominated by institutional investors.
2. Many of these institutional investors, and other intermediaries, are subject to capture by interest groups with values misaligned from those of the ordinary diversified investor and in tension with efficient markets and capital formation.
3. American corporate law and securities regulation, to date, have not been equipped to address this problem.

Institutional Investors

Institutional investors—such as mutual funds, index funds, pensions, and hedge funds—own 70% of the outstanding shares of publicly traded corporations in the United States.[6] The percentage of corporate shares held by institutional investors has increased over time.[7] That's not surprising. Institutional investors have much to offer the ordinary investor, who can outsource investment decisions to knowledgeable professionals and diversify holdings even with limited assets.

But this outsourcing of capital also has risks. Ordinary investors generally lack the capacity to oversee those to whom they entrust their investment resources. The costs of the principal (in this case, the investor) monitoring the agent (in this case, the institution managing the investor's funds) are called "agency costs" in the economic literature.

Federal law attempts to protect ordinary investors who entrust others with their capital. Mutual funds serving general investors must comply with the Investment Company Act of 1940. Retirement funds, except those managed by state and local governments or religious institutions, must comply with the Employee Retirement Income Security Act of 1974.

[5] Some language in this testimony may be substantially similar to, or in some places identical, to that in my previous publications and earlier testimony before other government bodies.
[6] Broadridge and PricewaterhouseCoopers, *Proxy Pulse: 2017 Proxy Season Review*, Sept. 2017, *available at* https://www.pwc.com/us/en/services/governance-insights-center/library.html.
[7] *See* Matteo Tonello & Stephan R. Rabimov, The 2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition, The Conference Board Research Report, No. R-1468-10-RR, 27, 2010, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1707512.

The Fink Letter

Yet the law has little to say about how such institutional investors exercise their voting rights as shareholders.[8] In a winter 2018 letter to shareholders, BlackRock chief executive officer Laurence Fink suggested "a social purpose" for corporations benefitting all "stakeholders," not merely corporate shareholders:

> 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.

BlackRock manages more assets than any other institutional investor in the world. To some degree, Fink's evoked a truism. But his letter nevertheless provoked controversy because it weighed in on one side of a debate that has raged on for a century—and, in one reading, embraced what has generally been the minority view, at least in terms of legal responsibilities.[9]

---

[8] In the late 1980s, the U.S. Department of Labor issued a guidance letter instructing retirement benefit funds governed by ERISA to vote their shares according to a "prudent man" standard. *See* Letter from U.S. Department of Labor to Helmuth Fandl, chairman of Retirement Board, Avon Products, Inc. (Feb. 23, 1988); *see also* 73 Fed. Reg. 61731 (Oct. 17, 2008). In 2003, the SEC clarified that similar fiduciary duties attach to mutual funds and other registered investment companies. *See* 68 Fed. Reg. 6585 (Feb. 7, 2003) ("The duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies. To satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interest of its client and must not subrogate client interests to its own" (internal citations omitted)).

[9] Shareholder primacy—the notion that corporate managers have a near-exclusive fiduciary obligation to shareholders rather than other corporate "stakeholders"—is deeply rooted in American law. It traces at least as far back as *Dodge v. Ford Motor Company*, in which the Michigan Supreme Court ruled that Henry Ford had a fiduciary duty to manage Ford Motor Company for the benefit of shareholders rather than employees or the broader community. 170 N.W. 668. (Mich. 1919).

In the academic literature, Adoph Berle and Gardiner Means were early defenders of the primacy of shareholders' interests in governing corporate managers' fiduciary duties. *See* ADOLPH A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) (the classic exploration of agency costs in the American corporation). Shareholder primacy was buttressed by later law and economics articles conceiving of the corporate form as a nexus of contracts. *See, e.g.,* Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

Notwithstanding the more modern push for "corporate social responsibility," *cf.* CHRISTOPHER STONE, WHERE THE LAW ENDS (1975); RALPH NADER, MARK GREEN & JOEL SELIGMAN, TAMING THE GIANT CORPORATION (1976); *but see* David L. Engel, *An Approach to Corporate Social Responsibility*, 32 STAN. L. REV. 1, 1 (1979) ("Any mandatory governance reforms intended to spur more corporate altruism are almost sure to have general institutional costs within the corporate system itself. . . . But the proponents of 'more' corporate social responsibility have never bothered to analyze or examine, from any clearly defined starting point, even just the benefits they anticipate from reform . . . ."), the legal duties of corporate managers have remained essentially shareholder-focused. *Cf.* Elizabeth Warren, *Companies Shouldn't Be Accountable Only to Shareholders*, WALL ST. J., Aug. 15, 2018 (implicitly acknowledging shareholder primacy as the operative legal norm in pushing a reorienting of legal duties through the Accountable Capitalism Act); James R. Copland, *Senator Warren's Bizarro Corporate Governance*, ECONOMICS21.ORG, Aug. 16, 2018, *available at* https://economics21.org/warren-backwards-corporate-governance (criticizing Senator Warren's proposal as inconsistent with three pillars of U.S. corporate law—corporate federalism, shareholder primacy, and director independence).

Equity Ownership and Agency Costs

Just as institutional investment vehicles provide enormous value to individuals who wish to invest their assets, equity ownership is central to financing innovation and productive investment. By raising capital with equity rather than debt, entrepreneurs can finance their ventures from dispersed sources without placing any obligation to pay funders an immediate or regular cash flow. It is hardly by accident that common-stock ownership structures, which emerged in the early seventeenth century in Holland and Britain, remain the principal form of ownership for large, complex profit-making institutions today. I fully concur with Senator Gramm that our unparalleled economic success is closely linked to these ownership structures.

But just as outsourcing investments has risks, so does equity ownership. Equity investors, unlike other corporate stakeholders, are unable to protect their interests by contract. The agency costs of equity ownership, like those of institutional investing, are very real.[10]

American corporate law has been oriented chiefly around managing equity owners' agency costs. Common law "fiduciary duties," enforceable in court, prohibit management self-dealing. Moreover, shareholders are protected by their voting rights—chiefly, the ability to elect directors who oversee management. And in companies whose shares are traded on public stock exchanges—the regulation of which has been the province of the federal government since the 1930s—equity investors are able to exit their investments easily, by selling their shares. Federal securities law aims to require sufficient disclosures to permit equity owners to exercise such exit rights with good information.

Who's Monitoring the Monitors?

The central question before the Committee today involves the intersection of institutional investing and shareholder voting rights.

In general, shareholder voting rights have been thought of as a tool—complementary to legal fiduciary duties and market exit rights—to mitigate agency costs between corporate managers and equity owners. But such voting rights today are dominated by institutional investors. And most of these institutional investors themselves have substantial agency costs, between fund managers and individual investors.[11] Institutional investors—either directly or through other

---

[10] As a general matter, equity ownership has substantially *higher* agency costs than alternative forms of ownership. *See generally* HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 35–49 (1996). Equity ownership has long been the dominant form of organization for complex profit-making businesses because its *other* costs of ownership—costs of collective decision-making and costs of risk-bearing—are substantially *lower* than alternative ownership forms'. *See id.* Efforts to turn homogeneous fiduciary duties (centered on shareholder wealth maximization) into heterogeneous fiduciary duties (responsive to various "stakeholder" interests) directly undercut the low costs of collective decision-making that have made equity ownership a preferred structure for large business organizations. *See* Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601 (2006) (arguing that increasing the power of shareholders to hold managers accountable, including through increased disclosure, imposes significant costs in reduced managerial authority). *See generally* KENNETH J. ARROW, SOCIAL CHOICE AND INDIVIDUAL VALUES (1963) (articulating Arrow's Impossibility Theorem, which holds that, given certain fairness criteria, voters facing three or more ranked alternatives cannot convert their preferences into a consistent, community-wide ranked order of preferences).

[11] There are exceptions. Some institutional investors, such as hedge funds, are substantially owned by their managers. These funds' agency costs are limited precisely because the fund managers have a large ownership stake—and thus a substantial interest in the funds' performance. Of course, such funds may pursue the idiosyncratic interests of their

intermediaries, such as proxy advisory funds—are monitoring corporate boards and managers. But who's monitoring the monitors?

The answer is decidedly not the ordinary, average investor. Individual investors delegate their investment decisions to intermediaries precisely to avoid complexities like the minutiae of proxy voting. Individuals may shift their assets from one fund manager to another; but such moves will be prompted by relative portfolio performance, or fee structure, or public controversy—not by shareholder voting.

To be sure, some investors will prefer various social-investing goals for their assets. That's why social-investing vehicles like Mr. Streur's have been able to raise significant amounts of capital. Nothing in my comments should be taken to disparage the appropriateness of such investment vehicles for investors who prefer them. But recognizing that an institutional fund manager's social-investing goal may be appropriate for the informed investor who embraces that goal does not imply that such a social-investing goal is appropriate for institutional asset managers that do not clearly announce to investors their social purpose. And it does not imply that such a social-investing goal should be imported more generally into our investment, securities, and corporate laws, nor that such laws should enable actors pursuing such goals to impose them on corporate managers.

Shareholder Voting and Special Interests

Unfortunately, our current body of federal securities laws, as interpreted and enforced by the Securities and Exchange Commission, have very much been enabling special interests. Under current SEC rules, any shareholder in a publicly traded corporation that has held at least $2,000 in stock for at least a year may place a proposal on the company's proxy ballot.[12] A shareholder

---

owner-managers.

[12] *See* 17 C.F.R. § 240.14a-8 (2007).

The SEC determines the procedural appropriateness of a shareholder proposal for inclusion on a corporation's proxy ballot, pursuant to the Securities Exchange Act of 1934, Pub. L. No. 73-291, Ch. 404, 48 Stat. 881 (1934) (codified at 15 U.S.C. §§ 78a–78oo (2006 & Supp. II 2009)), at §§ 78m, 78n & 78u; 15 U.S.C. §§ 80a-1 to 80a64 (2000) (pursuant to Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 841 (1940)); but the substantive rights governing such measures and how they can force boards to act remain largely a question of state corporate law: as the Supreme Court emphasized in its 1987 decision in *CTS Corp. v. Dynamics Corp.*, "[n]o principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders." 481 U.S. 69, 89.

The section of the Securities Exchange Act upon which Rule 14a-8 is promulgated, § 14(a), is principally designed to ensure corporate disclosures to shareholders to afford investment information and prevent deception. *See* J.I. Case Co. v. Borak, 377 U.S. 426, 431 (1964) ("The purpose of § 14(a) is to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation."). In its 1990 *Business Roundtable* decision, the D.C. Circuit Court of Appeals explained further:

> That proxy regulation bears almost exclusively on disclosure stems as a matter of necessity from the nature of proxies. Proxy solicitations are, after all, only communications with potential absentee voters. The goal of federal proxy regulation was to improve those communications and thereby to enable proxy voters to control the corporation as effectively as they might have by attending a shareholder meeting.

Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) ("While the House Report indeed speaks of fair corporate suffrage, it also plainly identifies Congress's target—the solicitation of proxies by well informed insiders 'without fairly informing the stockholders of the purposes for which the proxies are to be used.' " (citing H.R.Rep. No. 1383, 73d Cong., 2d Sess. 14 (1934))). *See also* S.Rep. No. 792, 73d Cong., 2d Sess. 12 (1934) (characterizing purpose of proxy protections as ensuring stockholders' "adequate knowledge" about the "financial condition of the corporation").

can introduce the same proposal year after year, even when 90% of all voting shareholders consistently oppose it.[13]

These rules have enabled special-interest shareholders to capture the attention of corporate boards and managers, at all other shareholders' expense. For example, when McDonald's stockholders gathered for the company's annual meeting in 2017, they had to vote on seven shareholder proposals. Among these were a proposal against the company's use of antibiotics in its meat supply, brought by the Benedictine Sisters of Boerne, Texas; and one by the nonprofit Holy Land Principles, which wanted the company to modify its employment practices in Israel. The Boerne Sisters owned 52 McDonald's shares. The Holy Land group owned 47. No shareholder sponsoring a proposal at the company's annual meeting that year owned more than 0.0001% of the company's stock.

This example is not anomalous. In 2016 and 2017, a majority of shareholder proposals sponsored at Fortune 250 companies involved social or policy issues largely unrelated to share value, executive compensation, or traditional board-governance concerns. Last year, many of our largest publicly traded companies faced four or more shareholder proposals on their corporate proxy ballot, including AmerisourceBergen, AT&T, Chevron, Citigroup, Dow Chemical, DuPont, Eli Lilly, Emerson Electric, ExxonMobil, Facebook, Ford, General Electric, Google, Home Depot, JPMorgan Chase, McKesson, and Starbucks.[14] In every year for the last decade, no more than 1% of these shareholder proposals were sponsored by institutional investors without a social-investing purpose or orientation, or a tie to public employees or organized labor. The SEC's lenient shareholder-proposal rules have also empowered a very small number of investors with limited investment stakes to assume an outsized role in corporate-boardroom debates; three individuals and their family members—commonly called "corporate gadflies"—have sponsored between 25% and 45% of all shareholder proposals in recent years.[15]

Today, navigating the special-interest investor is simply an expected cost of being a publicly traded corporation. In February, jeans-maker Levi Strauss filed the paperwork to become a publicly traded corporation. In March, the People for the Ethical Treatment of Animals announced it was acquiring shares in Levi's in order to propose shareholder resolutions involving the manufacturer's use of leather patches. PETA's decision was not related to investment concerns; it announced it was acquiring the minimum number of shares required to reach the SEC's $2,000 threshold.[16]

Historically, groups like PETA have been able to garner significant attention through introducing proxy ballot items but have been unable to win the support of a majority of shareholders for their precatory ballot items. But some caution is in order. Beyond institutional investors with an express social-investing purpose, many investment vehicles with large holdings are affiliated with organized labor. In 2011, the Office of the Inspector General of the Department of Labor

---

[13] *See* Amendments to Rules on Shareholder Proposals, Exchange Act Release No. 40,018; 63 Fed. Reg. 29,106, 29,108 (May 28, 1998) (codified at 17 C.F.R. pt. 240).

[14] This list of companies is underinclusive. Some other companies received multiple shareholder proposals that they ultimately excluded from their proxy ballots after asking for, and receiving, "no action" letters from the SEC.

[15] The broader problems with the SEC's Rule 14a-8 are beyond the scope of this testimony. For a deeper dive into those issues, see my House subcommittee testimony on the subject from fall 2016, referenced and linked at the end of this statement.

[16] Tanya Garcia, *PETA Takes a Stake in Levi's to Press for Vegan Leather Patches*, MARKETWATCH, Mar. 22, 2019, https://www.marketwatch.com/story/peta-takes-a-stake-in-levis-to-press-for-vegan-leather-patches-2019-03-22.

found that labor pension funds may be using "plan assets to support or pursue proxy proposals for personal, social, legislative, regulatory, or public policy agendas."[17] Pension funds managed for state and municipal public employees, which are often wholly or partly controlled by partisan elected officials, have often overtly pursued social goals in managing their investment resources, as well as in voting shares.

The Role of Proxy Advisory Firms

Proxy advisory firms can serve to amplify such special-interest advocacy. To manage their proxy voting, institutional investors rely heavily on a pair of proxy advisory firms, Institutional Shareholder Services, or ISS, which is today owned by private-equity firm Genstar Capital;[18] and Glass, Lewis & Co., a subsidiary of the Ontario Teachers' Pension Plan Board.[19] Together, these two proxy advisors control approximately 97% of the market for proxy advisory services, with ISS alone having about a 61% share.[20] By its own estimation, ISS annually helps approximately 2,000 clients execute nearly 10.2 million ballots representing more than 4.2 trillion shares.[21]

As summarized in a 2018 report I co-authored with Stanford's David Larcker and Brian Tayan, a substantial body of empirical evidence shows that proxy advisory firms' recommendations influence institutional investor voting and that publicly traded companies are influenced by proxy advisor guidelines.[22] A 2012 analysis I co-authored showed that an ISS recommendation "for" a given shareholder proposal, controlling for other factors, was associated with a 15-percentage-point increase in the shareholder vote for any given proposal.[23] As Leo Strine, a former chancellor on the Delaware Court of Chancery, observed: "Powerful CEOs come on bended knee to Rockville, Maryland, where ISS resides, to persuade the managers of ISS of the merits of their views about issues."[24]

My report with professors Larcker and Tayan also cites a substantial body of empirical evidence demonstrating that at least some proxy-advisor advice may not be in the average shareholder's interest. Notwithstanding its substantial influence over shareholder voting, ISS is a relatively small operation. Prior to its 2014 private acquisition, ISS had just over $15 million in profits on $122 million in revenues.[25] Its small size makes ISS particularly vulnerable to capture, if it is

---

[17] Dep't of Labor, Office of the Inspector General, Proxy-Voting May Not Be Solely for the Economic Benefit of Retirement Plans, (2011), *available at* http://www.oig.dol.gov/public/reports/oa/2011/09-11-001-12-121.pdf.
[18] *See* Genstar Capital: Institutional Shareholder Services, https://www.gencap.com/companies/iss/.
[19] *See* Robyn Bew & Richard Fields, Voting Decisions at US Mutual Funds: How Investors Really Use Proxy Advisers 6 (Tapestry Networks, Inc. & Investment Research Center Institute, June 2012), http://www.tapestrynetworks.com/issues/corporate-governance/upload/Voting-Decisions-at-US-Mutual-Funds-June-2012.pdf.
[20] *See* James K. Glassman & J. W. Verret, How to Fix Our Broken Proxy Advisory System 8 (Mercatus Center, George Mason Univ., 2013), *available at* http://mercatus.org/sites/default/files/Glassman_ProxyAdvisorySystem_04152013.pdf.
[21] Institutional Shareholder Services, About ISS, http://www.issgovernance.com/about/about-iss.
[22] *See* James R. Copland et al., *Proxy Advisory Firms: Empirical Evidence and the Case for Reform* (Manhattan Institute 2018), *available at* https://media4.manhattan-institute.org/sites/default/files/R-JC-0518-v2.pdf.
[23] *See* James R. Copland et al., Proxy Monitor 2012: A Report on Corporate Governance and Shareholder Activism 22–23 (Manhattan Inst. for Pol'y Res., Fall 2012), *available at* http://www.proxymonitor.org/Forms/pmr_04.aspx.
[24] Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 688 (2005).
[25] *See* MSCI 2013 Annual Report 70, "Summary of Operations," "Governance," *available at*

being managed to maximize its profits. And ISS's voting guidelines have generally shown a propensity to support various social and environmental proposals, much moreso than the median shareholder. Historically, ISS has backed some 70% of shareholder proposals related to political spending, 45% of those related to employment rights, and 35% of those related to human rights or the environment[26]—a sharp contrast to the dearth of average shareholder support for these proposal classes. In general, ISS support for these social issues has been increasing.

Institutional Investors, Agency Costs, and Shareholder Voting

With trillions of assets under management, large mutual fund families are less susceptible to capture than proxy advisors. But at least some large, diversified mutual funds have also been moving to support some social and environmental causes in discussions with corporate managers. On March 7, 2017, State Street Global Advisers, the world's third-largest institutional investor, launched a campaign to pressure companies to add more women to their boards—symbolically installing a bronze statue, "Fearless Girl," facing the iconic "Charging Bull" that has graced Wall Street since 1989. Less than a week later, BlackRock, the world's largest mutual fund company, announced that it, too, would prioritize talking with companies on "gender balance on boards," as well as "climate risk." And by the next winter, Fink issued his letter.

Had institutional investors suddenly decided that their previous reluctance to embrace social and environmental causes had been misguided—and that these issues were now key factors in maximizing share return? The answer is almost surely no, however fund families spin their efforts through public-relations releases. In the winter of 2017, Walden Asset Management and other social-investing and public-pension investors had introduced a proposal at BlackRock, scheduled for the investment firm's own May 2017 annual meeting.[27] The proposal asked BlackRock to clarify its own voting policies on social and environmental shareholder issues. Reportedly, the social investors' "move was partly motivated by frustration [that] BlackRock and some other large shareholders like Vanguard . . . declined to support a single shareholder proposal on board diversity or climate change in 2016."[28] Walden and other investors made similar pushes at JPMorgan Chase, Bank of New York Mellon, T. Rowe Price, and Vanguard.

The sponsors of the 2017 socially oriented proposals did not manage many assets relative to BlackRock. In total, the sponsoring investors managed $3.5 billion; BlackRock manages some $5 trillion. Still, the reaction of BlackRock, State Street, and other fund families may reflect economic self-interest. Such funds' fee structures tend to be a function of assets under management. Thus, such institutional investors may be sensitive to marginal investors' preferences: a sustained and successful effort to divest from a large mutual-fund family could

---

http://files.shareholder.com/downloads/MSCI/3458217323x0x739303/DAB046E7-737E-43C7-9114-040465AD560E/2013_Annual_Report.pdf. ISS was acquired by Genstar in September 2017 for a reported $720 million. *See* Nikhil Subba & Diptendu Lahiri, *Genstar Capital to Buy Proxy Advisory Firm ISS for $720 Million*, REUTERS, Sept. 7, 2017, *available at* https://www.reuters.com/article/us-institutional-shareholder-services-m/genstar-capital-to-buy-proxy-advisory-firm-iss-for-720-million-idUSKCN1BI20C. This valuation implies significant realized growth—or anticipated future growth—for ISS. But the proxy advisor's market valuation remains very small relative to its influence over stock market proxy voting.

[26] *See* Copland et al., *supra* note 23, at 22–23.

[27] *See* Emily Chasan, *BlackRock Finds Shareholder Action Goes Both Ways*, BLOOMBERG BRIEFS, Mar. 16, 2017, *available at* https://newsletters.briefs.bloomberg.com/document/ZAq33YrjbIsCER50poBT1g--_9ez25goq72ezes8vkh/front.

[28] *Id.*

cause a drop in the funds' assets under management.

To be sure, assets under management will also be highly sensitive to investment returns. But the relevant figure for investment returns is *relative to other fund managers*. A general decline in market performance over some baseline will negatively affect fund performance over the long run, but in the short run, an asset manager's earnings are likely to be much more sensitive to an asset-divestment campaign. This is particularly true if other institutional investors are making parallel choices—as a divestment-style campaign against an institutional investor would be much more likely to have an impact if a fund was an outlier among its peers. Thus, social-investing activists may be able to engender a "cascade" effect among fund managers; once one succumbs to a pressure campaign, others will follow.

Such risks are heightened by the fact that portfolio managers themselves—those who buy and sell securities for institutional investing fund families—tend not to involve themselves heavily in shareholder voting. A survey of 64 asset managers and owners with a combined $17 trillion in assets, sponsored by RR Donnelley, Equilar, and the Rock Center for Corporate Governance at Stanford University, finds that portfolio managers are only moderately involved in voting decisions. Among large institutional investors with assets under management greater than $100 billion, portfolio managers are involved in only 10% of voting decisions.[29]

Rather than portfolio managers, large institutional investors tend to have in-house corporate-governance teams to handle proxy voting matters. These in-house positions are often staffed by former employees of proxy advisors—thus sharing those proxy advisors' biases—or are otherwise at least somewhat committed to environmental- or social-investing causes. State Street, the world's third-largest institutional investor, delegates oversight of these issues to Rakhi Kumar, head of ESG investments and asset stewardship. Ms. Kumar has no apparent experience trading in securities,[30] but she envisions for herself a broad role in overseeing aspects of corporate management both broad and granular: at the SEC's proxy process roundtable in November 2018, Ms. Kumar talked about how she was working with corporate executives to change terms of maternity leave and to manage hog farms in North Carolina. It is hard to see what specialized expertise Ms. Kumar has over hog farming. But when shares are concentrated in large fund families' hands—and proxy advisors like ISS threaten to withhold support for corporate directors who fail to act upon any shareholder proposal that receives majority shareholder support[31]—it's little wonder that company leaders pay attention.

Such sweeping policy oversight by institutional investors is far afield from the agency costs shareholder voting rights are intended to mitigate. It is particularly strange when employed by index funds. The premise of such funds is to leverage capital-market efficiency and minimize active management costs—in essence, to follow the stock market. Yet in shareholder-voting decisions, such fund families are actively supporting efforts to modify corporate behavior. There is no clear investment-based rationale for this obvious tension in strategy.

[29] *See* David F. Larcker et al., *2015 Investor Survey: Deconstructing Proxies—What Matters to Investors*, Feb. 2015, https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-survyey-2015-deconstructing-proxy-statements_0.pdf.
[30] *See* State Street Global Advisors—Who We Are: Rakhi Kumar, https://www.ssga.com/global/en/about-us/who-we-are/team.bio.36520799.html.
[31] *See* ISS, United States Proxy Voting Guidelines: Benchmark Policy Recommendations, https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf, at 13.

The Costs of Socially Oriented Shareholder Activism

The aggressive sweep of shareholder influence over corporate handling of far-flung social and environmental causes can hurt shareholder value. Entrepreneurs and investors tend to opt for equity ownership notwithstanding high agency costs. Aside from the risk-bearing advantages of equity, there is good reason to believe that one reason why we tend to see shareholder ownership as the dominant form of complex business organization is that it minimizes collective decision-making costs.[32] Other forms of ownership—such as employee ownership, customer ownership, and supplier ownership—can handle risk-bearing to some significant extent but tend only to exist in limited circumstances. And in such cases, rules tend to exist to limit the costs of disparate interests in decision-making—like law firms' strong bias toward screening partners for a preference for very high work hours. Understanding that disparate voting interests along multiple factors can make collective action difficult requires no specialized understanding of public-choice theory—and should be quite evident to members of the United States Senate.

In 2015, the Manhattan Institute commissioned an econometric study of shareholder activism and firm value.[33] Tracie Woidtke, a professor at the Haslam College of Business at the University of Tennessee,[34] examined the valuation effects associated with public pension fund influence, measured through ownership, on Fortune 250 companies. Woidtke found that "public pension funds' ownership is associated with lower firm value" and, more particularly, that "social-issue shareholder-proposal activism appears to be negatively related to firm value."[35] As such, public employee pension funds' use of the shareholder-proposal process in an effort to affect corporate behavior in pursuit of social or policy goals may be harming the financial interests of plan beneficiaries—and ultimately state and local taxpayers—as well as, by inference, the average diversified investor.

Conclusion

In recent years, regulatory changes and changes in market ownership have combined to increase the shareholder voting power of institutional investors. Abetted by SEC rules and procedures, idiosyncratic "corporate gadflies" and institutional investors with labor affiliations and social-investing orientations have gained power in the boardroom. By co-opting proxy advisory firms—and, to some degree, institutional investors facing their own significant agency costs—these activists have pursued their agendas at other shareholders' expense. At least some of this social activism appears to be depressing share value.

Diagnosing the problems with the status quo is to some extent easier than proposing solutions, which is beyond the scope of this statement. I am happy to discuss ideas with members of the Committee. I am also listing below earlier writings I have written or published. Please consider these citations incorporated by reference, and please feel free to reach out to me about any of the listed writings as well as my principal testimony. Thank you for your time and consideration.

[32] *See* Hansmann, *supra* note 10.
[33] *See* Tracie Woidtke, *Public Pension Fund Activism and Firm Value* (Manhattan Institute 2015), *available at* https://www.manhattan-institute.org/html/public-pension-fund-activism-and-firm-value-7871.html.
[34] *See* The University of Tennessee Knoxville: Tracie Woidtke, http://finance.bus.utk.edu/Faculty/TWoidtke.asp.
[35] *See* Woidtke, *supra* note 33, at 16.

Further Resources

Testimony

James R. Copland, Testimony before the House Financial Services Subcommittee on SEC Rule 14a-8, Sept. 21, 2016, *available at* https://media4.manhattan-institute.org/sites/default/files/T-JC-0916.pdf.

Reports

James R. Copland et al., *Proxy Advisory Firms: Empirical Evidence and the Case for Reform* (Manhattan Institute 2018), *available at* https://media4.manhattan-institute.org/sites/default/files/R-JC-0518-v2.pdf.

James R. Copland & Margaret M. O'Keefe, *Proxy Monitor 2016: A Report on Corporate Governance and Shareholder Activism* (Manhattan Institute 2016), *available at* http://www.proxymonitor.org/pdf/pmr_13.pdf.

James R. Copland & Steven Malanga, *Safeguarding Public Pension Systems—A Governance-Based Approach* (Manhattan Institute 2016), *available at* https://media4.manhattan-institute.org/sites/default/files/R-JCSM-0316.pdf.

Tracie Woidtke, *Public Pension Fund Activism and Firm Value* (Manhattan Institute 2015), *available at* https://media4.manhattan-institute.org/sites/default/files/lpr_20.pdf.

Article

James R. Copland, "Against an SEC-Mandated Rule on Political Spending Disclosure: A Reply to Bebchuk and Jackson," 3 *Harvard Business Law Review* 381 (2013), *available at* http://www.hblr.org/wp-content/uploads/2013/10/HLB209_crop.pdf.

Columns

James R. Copland, "Senator Warren's Bizarro Corporate Governance," ECONOMICS21.ORG, Aug. 16, 2018, *available at* https://economics21.org/warren-backwards-corporate-governance.

James R. Copland, "Another Shareholder Proposal? McDonald's Deserves a Break Today," *Wall Street Journal*, Jul. 7, 2017, *available at* https://www.wsj.com/articles/another-shareholder-proposal-mcdonalds-deserves-a-break-today-1499381801.

Howard Husock & James R. Copland, "'Sustainability Standards' Open A Pandora's Box Of Politically Correct Accounting, *Investor's Business Daily*, Mar. 24, 2017, *available at* https://www.investors.com/politics/commentary/sustainability-standards-open-a-pandoras-box-of-politically-correct-accounting/.

James R. Copland, "Getting The Politics out of Proxy Season," *Wall Street Journal*, Apr. 23, 2015, *available at* https://www.manhattan-institute.org/html/getting-politics-out-proxy-season-5461.html.

James R. Copland, "Politicized Proxy Advisers vs. Individual Investors," *Wall Street Journal*, Oct. 7, 2012, *available at* https://www.manhattan- institute.org/html/politicized-proxy-advisers-vs-individual-investors-3863.html.