

**Pensions & the Companies They Own:
New Fiduciary Duties in a Changing Social Environment**

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Pensions & the Companies They Own: New Fiduciary Duties in a Changing Social Environment

Change is usually ugly, and the whole world, both physical and moral is now in a period of transition. But the serpent does not cast his skin till the new one is formed beneath the old: and because the old world is now sloughing its skin, we cannot conclude that the world of the future is to exist without one. -Charles Francis Adams, Jr. (1871)¹

This paper argues that the Securities & Exchange Commission (SEC) has altered the fiduciary duties of those holding stock on others' behalf. That redefinition will become the rule for all fiduciaries, pensions² included.

The revised standard will require fiduciaries to factor into their judgments social and corporate responsibility issues. In framing their new regulations, the SEC drew on the experience of the socially-screened mutual funds. Their experience and tools offer a framework for implementing the new responsibilities.

The new approach to fiduciary responsibility will force pensions to examine the meaning of "ownership" in the context of shares in corporations. It will compel pensions to address their dual roles as guarantors of benefits and as financial institutions, and finally to redefine their relationship to our economic and political systems.

The next 20 years promise to be interesting times for pensions.

¹ C.F. Adams, Jr., "The Railroad System," as reprinted in Charles F. Adams, Jr. & Henry Adams, *Chapters of Erie and Other Essays* [1871] (New York: Augustus M. Kelley, 1967), p. 354.

² By "pensions", I mean defined benefit plans, in particular, those sponsored by government units. Different rules apply to defined contribution plans which ease the inclusion of socially-screened options in diversified offerings. Here, I will only deal with defined benefit plans.

I. Introduction

The theory of representation, whether in politics or in business, is of the essence of modern development. Our whole system rests upon the sanctity of the fiduciary relations. Whoever betrays them, a director of a railroad no less than a member of Congress or the trustee of an orphans' asylum, is the common enemy of every man, woman, and child who lives under representative government. -Charles Francis Adams, Jr. (1869)³

Law students learn that the Securities Acts of 1933 and 1934 work because they rely on corporate disclosure enforced, primarily, by private actions. They do not, typically, learn that disclosure also shored up the legitimacy of the securities industry and, indeed, the American capitalist system itself⁴ which the 1929 Crash and the subsequent Great Depression had called into question.

For pensions in 2004, similar lessons apply. The word *du jour*, “transparency”⁵, applies both to their actions and those of the companies they own. Their legitimacy – the pensions’ and the companies’ – and that of our financial system are at stake.

In today’s context, the financial transparency of the Securities Acts marks only a starting point for pension and corporate reporting. Corporate activities and, therefore, pension-fund investments have social and environmental effects that do not yield to ready quantification. Still, they may affect investment performance – especially over the long term – as profoundly as currently quantifiable and measurable criteria.

Pensions have, as a rule, ignored non-quantifiable factors, such as social and corporate responsibility issues. That will change; perhaps it has already changed with the evolution of the concept of fiduciary duties.

³ C.F. Adams, Jr., "A Chapter of Erie," (1869) as reprinted in Charles F. Adams, Jr. & Henry Adams, *op. cit.*, p. 8.

⁴ Thomas K. McCraw, *Prophets of Regulation* (Cambridge, Mass.: Belknap/Harvard Univ. Press, 1984), p. 166.

⁵ “Transparency” is the “word that the big shots use when they mean ‘honesty’ but just can't get it out of their mouths.” Nicholas von Hoffman, "Flimflam Finances Spell Trouble for Pitt," *New York Observer*, June 24, 2002, p. 4. In this paper, I will use the circumlocution.

Socially responsible investing (SRI) offers pensions a vital tool for meeting this new obligation. The framework, research and benchmarks developed over the last 35 years provide a structure and a context for monitoring corporate activities which both corporations and the institutional investors have accepted.

In part because of their experience during the South Africa years, pensions have avoided social investing. They can no longer do so. They are an integral part of the fiduciary relationships that bind together the American economic system. As such, they not only represent the interests of their beneficiaries but of a much broader group of stakeholders. The legitimacy of the system is at risk.

II. The SEC's New Fiduciary Standard

Where stock is held by a great number, what is anybody's business is nobody's business. -Andrew Carnegie (1900)⁶

One hundred and seventy-four years ago, the Supreme Judicial Court of Massachusetts stated what is now called “the prudent investor rule” for trustees. Trustees should model their stewardship on

how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.⁷

Not the least reason for this rule's durability lies in its flexibility, in its assumption that trustees would apply their “prudence, discretion, and intelligence” to the facts available about an investment. So as with the concept of fiduciary duty itself, the rule has endured as the nature and scope of such information evolved and expanded.

The question before the court in *Harvard College v. Amory* was whether trustees could invest in what was then a relative novelty: common stock. Could the trustees know enough about the ventures to make them appropriate for a trust to benefit a widow and the residuary beneficiaries?

Pensions now confront similar questions about issues of governance, social effects and sustainability posed by the companies they own. They must address those questions with tens of thousands of other shareholders about corporations vastly larger than any imaginable in 1830.

⁶ John Micklethwait & Adrian Wooldridge, *The Company: A Short History of a Revolutionary Idea* (London: Weidenfeld & Nicolson, 2003), p. 74.

⁷ *Harvard College v. Amory*, 9 Pick. (26 Mass.) 446, 461 (1830). The Reporter for the *Restatement (Third) of Trusts* characterizes the rule as “dicta”. *Restatement (Third) of Trusts* §227 Gen. Notes, p. 58 (1991). If so (and the point is arguable), it is another example of a judge's aside outstripping the importance of the case itself. Virtually no one today knows what “the prudent man case” was about, much less its outcome. (And, it was very important.) That lesson should be kept in mind when considering the importance to trustees of the SEC's rationale for its proxy voting regulations, discussed below.

And, they must now gauge their fiduciary duties in a new context, one set out by the SEC in 2003. For in answer to Andrew Carnegie, the SEC has decided that what is anybody's business is everybody's business.

The 2003 Proxy Regulations

On January 23, 2003, the U.S. Securities & Exchange Commission (SEC) adopted regulations on proxy voting by mutual funds and investment advisers based on a new concept of fiduciary duty.⁸

Responding to a petition by Domini Social Investments, LLC, the AFL-CIO and the Teamsters Union, the Commission now requires mutual funds and investment advisers to

- Disclose their policies and procedures for voting in corporate elections; and
- Report how they actually voted on each issue at each company.

Until then, only some social mutual funds⁹ and the California Public Employee Retirement System (CalPERS) had done this.

The new rules were in full effect for the first time during the 2004 proxy season.

Affected Corporate Constituents. The SEC regulations apply to approximately 3,700 mutual funds and 6,200 investment advisers who have the power to vote in corporate elections shares they hold on behalf of clients. Therefore, the new rules

⁸ Securities & Exchange Commission, "Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies" (Jan. 31, 2003), 17 CFR Parts 239, 249, 270, and 274 [Release Nos. 33-8188, 34-47304, IC-25922; File No. S7-36-02], RIN 3235-AI64 <http://www.sec.gov/rules/final/33-8188.htm> (hereafter "Adviser Regulations"). And, Securities & Exchange Commission, "Proxy Voting by Investment Advisers" (Jan. 31, 2003), 17 CFR Part 275 [Release No. IA-2106; File No. S7-38-02], RIN 3235-AI65 <http://www.sec.gov/rules/final/ia-2106.htm> (hereafter "Mutual Fund Regulations"). For a discussion of the regulations and their importance, see "KLD Newslines", April 2003. <http://www.kld.com/newsletter/archive/april092003.htm>

⁹ The Domini Social Equity Fund was the first to publish (in 1994) its proxy voting guidelines and the second to report its votes. KLD prepared the first set of guidelines and has remained involved in their annual iterations ever since. <http://www.domini.com/shareholder-advocacy/Proxy-Voting/index.htm>

affect tens of millions of mutual fund shareholders and investment management clients.

More importantly, the new rules open corporate elections to stakeholders – persons who may or may not own shares in a company but who have a distinct, definable interest in how the company operates. Stakeholders will now be able to see how mutual funds vote and why.

Making proxy voting a public matter will transform the governance of corporations. For the first time it will be possible to learn how mutual funds and investment advisers plan to vote, so clients and others can try to affect their votes.

Effect on Pensions. Pension schemes are not subject to SEC jurisdiction. So why should their trustees attend to the SEC’s new rules?

Simply put, the SEC’s redefinition of fiduciary duties as to equities will become the general rule. Trust lawyers, a notably conservative lot, will default to the most stringent statement of fiduciary duty. Its simplicity will also appeal to them, as will its incorporation of important features of the *Restatement (Third) of Trusts* “prudent investor rule”.¹⁰

As a practical matter, however, what will drive the rule’s general adoption are the expectations of constituents. If the funds in their 401(k) or 403(b) or 457 plans must disclose, why shouldn’t their defined benefit plan? If those funds and their advisers are engaging corporations on social, environmental or governance issues, shouldn’t their defined benefit plan?

A Unitary Fiduciary Duty. The SEC has now categorized proxy voting as a fiduciary duty. Hence, a trustee must exercise the same degree of care as s/he does in managing money.

¹⁰ *Restatement (Third) of Trusts (Prudent Investor Rule)* § 227 (Washington, D.C.: American Law Institute, 1992). The rule itself does not mention social investing. However, comment c. (pp. 8-9) approves of the practice. See also 3 A. Scott, *The Law of Trusts* (W. Fratcher 4th ed. 1988) § 227.17 which endorses application of social criteria in investment decision-making by trustees under particular conditions. Scott was until his death the Reporter for the *Restatement of Trusts*.

That summary of the SEC's rationale for its proxy rules may misstate what the Commission intended. An adviser or a mutual fund, the SEC may be saying, is a fiduciary as to all aspects of ownership embodied in a share of stock. The prudent fiduciary will assume the existence of a single standard.

A New View of Shareholder Rights

The SEC's new rules on proxy voting ended the era when advisers and mutual funds and pensions could ignore proxies or just vote with management.¹¹ By defending their regulations in terms of fiduciary responsibilities, the Commission foreclosed the possibility of resuming that practice.

More importantly, the SEC extended share voters' and stakeholders' ability to exercise supervisory control over publicly traded corporations. And most importantly of all, the Commission has required advisers and mutual fund companies to look at publicly traded corporations in all their aspects, not just their financials.

To grasp the full implications of what the Commission has done, one has to read together the SEC's rationales for the two sets of regulations.¹²

Advisers Act Rules. "Under the Advisers Act, ... an adviser is a fiduciary that owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting."¹³

The Commission might have limited the duty to those aspects of proxy voting that affected financial performance – something, arguably, the Department of Labor

¹¹ *But see* Chuck Jaffe, Voting with your money: Proxy disclosure rules present a dilemma", CBSMarketWatch.com, April 25, 2004. The Muhlenkamp Fund, in response to the regulations, had adopted an explicit voting policy of always voting with management. Since this policy was widely reported in the trade press, it presents a direct challenge to the Commission to define its policy in practice.

¹² The rationales for administrative regulations state the agency's case for their adoption. They are best thought of as anticipatory briefs for a federal Court of Appeals reviewing the agency's authority to adopt the rules. They describe for the court what the agency intended and the legal basis on which its assertion of jurisdiction rests. The SEC's rationales for the two sets of proxy regulations are models of their kind.

¹³ Adviser Regulations rationale, *op. cit.*

has done.¹⁴ But the SEC's formulation applies to anything that can appear on a proxy ballot, from the election of directors to social issues.

“Duty to Monitor”. As noted earlier, the advisor and mutual fund regulations are not identical.¹⁵ The adviser rules are more vague on what an advisor must do than are the mutual fund rules: “The duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies.”¹⁶

“To monitor corporate events”: What does that mean for an adviser? The Commission's rationale for its mutual fund regulations may answer that question:

The following are examples of specific types of issues that are covered by some funds' [*i.e.*, the social funds'] proxy voting policies and procedures and with respect to which disclosure would be appropriate:

- Corporate governance matters, including changes in the state of incorporation ... and anti-takeover provisions such as staggered boards...;
- Changes to capital structure...;
- Stock option plans and other management compensation issues; and
- Social and corporate responsibility issues.¹⁷

The funds whose guidelines the Commission adopted are all social funds. So in my view, all advisers must now monitor the same types of events as KLD has reported on for 13 years. The SEC has adopted social investors' view of what fundamental analysis should include.

¹⁴ The Department of Labor's “Avon Letter” (1988) states, in part: “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.” ERISA issued the letter in the midst of the takeover mania from which the pension fund variety of shareholder activism emerged. (See discussion below.) Not surprisingly, Labor did not detail the nature of the fiduciary relationship, nor did it specify what or how trustees should consider and report. Nothing in the Avon letter would prevent a general policy of voting with management, for instance. <http://www.lens-library.com/info/dolavon.html>

¹⁵ The SEC adopted the respective regulations under different statutes, but that is not the reason for the differences in rationale and approach.

¹⁶ Adviser Regulations rationale, *op. cit.*

¹⁷ Mutual Funds Regulations rationale, *op. cit.*

“Corporate Governance”: A New Substance

In the Mutual Fund regulations, the SEC swept away the old distinction between social and governance issues.

As a class of “corporate events”, “corporate governance” takes on a different meaning than it has had. “Corporate governance” originally referred to the structures and procedures used to organize a corporation – directors’ terms, board committees, senior executives’ lines of authority, and the like. Now as indicated by the list of examples of activities mutual funds must monitor, “corporate governance” refers to how a company is being run: corporate *governing*.

That meaning may signal increasing power for shareholders and stakeholders, but a significant barrier – of the SEC’s creation – exists.

The issues that shareholders may raise are limited by the SEC’s “ordinary business” rule. This exemption keeps off the ballot matters relating to the company’s day-to-day operations. It has also kept off issues such as an option plan for officers and discrimination in hiring against gays. Former SEC Chair, Harvey L. Pitt, suggested in a September 2003 speech that the exemption be dropped. But, no proposed rules have appeared.¹⁸

How much control the redefined fiduciary duty as to proxy voting may shift to shareholders is unclear. Nonetheless the only remaining question is: how much farther will this ownership revolution go?

¹⁸ “It is my hope that we can eliminate this exception, making shareholder suffrage a reality, and sparing our Staff from trying to resolve what is, or isn't, within the purview of ordinary business issues facing public companies.” Harvey L. Pitt, “Remarks Before the Council of Institutional Investors’ Fall Conference”, Sept. 23, 2002. <http://www.sec.gov/news/speech/spch582.htm>

III. “Owning” and “Governing”: The SRI Template

It has often been said that the owner of a horse is responsible. If the horse lives he must feed it. If the horse dies he must bury it. No such responsibility attaches to a share of stock. The owner is practically powerless through his own efforts to affect the underlying property. -Adolf A. Berle & Gardiner C. Means (1932)¹⁹

For pensions, the SEC’s new standard of fiduciary duty presents a knot of conceptual problems which today lack black-letter-law solutions.

On the one hand, pensions’ primary duty is to fund their obligations to beneficiaries.²⁰ On the other, as major factors in our financial and corporate systems, pensions have an obligation to advance integrity and legitimacy²¹ if for no other reason than that their ability to meet their financial obligations depends on the health of those interrelated systems.

Put differently, in my view the pensions’ ability to meet their primary duty – to meet their obligations to their beneficiaries – depends on their positive roles as part of our financial system and as owners of our corporations.

In defining these roles, socially responsible investing (SRI) offers a ready-made template. For SRI has focused for the 35 years on what it means to own a publicly-traded company and to govern it – the issues on which the legitimacy of the American corporate-financial system depends..

¹⁹ Adolf A. Berle & Gardiner C. Means, *The Modern Corporation and Private Property* [1932] (New Brunswick, N.J.: Transaction Publishers, 1990), p. 64 (hereafter “Berle & Means”).

²⁰ By using “primary” I do not ignore the statutes which make this duty the sole one of pension schemes. I simply mean it is the first, the main duty of all pensions regardless of governing legislation.

²¹ Robert A.G. Monks and Nell Minow, of course, made this point a decade and a half ago in their book, *Power & Accountability* (New York: HarperCollins, 1991). Now out of print, the book is available in full on line: <http://www.thecorporatelibrary.com/power/index.html>

Taking Responsibility for Ownership

“Socially responsible investing” – an ungainly phrase – has the virtue of turning on “responsibility”. Properly understood, a “responsibility” is an obligation one imposes on one’s self. Unlike a duty, neither cultural expectations nor the law imposes it.

Nothing in the American financial system requires shareholders to act as owners in anything vaguely resembling the way in which partners would relate to their business. In fact, the opposite is true, as Adam Smith in 1776 pointed out:

[Shareholders] seldom pretend to understand anything of the business of the company; and when the spirit of faction happens not to prevail among them, give themselves no trouble about it, but receive contentedly such half yearly or yearly dividend, as the directors think proper to make to them. This total exemption from trouble and from risk, beyond a limited sum, encourages many people to become adventurers in joint stock companies, who would, upon no account, hazard their fortunes in any private copartnery.²²

The lack of responsibility the joint stock company (the modern “corporation”)²³ encouraged by their very nature amongst their putative owners made these business organizations noxious to Smith.

Smith’s theme has recurred in Anglo-American political life for 230 years. In 1967, the economist Gardiner C. Means could write:

At the same time that economic power has built up in the hands of corporate management, the separation of ownership and control has released management from the overriding requirement that it serve stockholders. Profits are an essential part of the corporate system. But the use of corporate power solely to serve the stockholders is no longer likely to serve

²² Adam Smith, *The Wealth of Nations* [5th ed. 1789 (Glasgow ed.)] (Indianapolis, Ind.: Liberty Press, 1981), p. 741 [V.i.e.18].

²³ When Smith uses “corporation”, he refers to organizations such as the medieval guilds, municipal corporations and universities which received grants of monopolies and/or the control of aspects of trade from the Crown. The historical relationship between “corporations” and “joint stock companies” is obscure and it is best to think of them as distinct types of entities. *See generally* John P. Davis, *Corporations* [1905] (Washington: Beard Books, 2000).

the public interest. Yet no criteria of good corporate performance have yet been worked out.²⁴

Within five years of when Means wrote, a new concept of ownership and a new framework for judging corporate performance had emerged from the turmoil that was the late 1960s and early 1970s. They took the form of socially responsible investing.

Activism & Screening: SRI's Parents

Socially responsible investing as it now exists emerged in the US in the late 1960s. It had two parents – shareholder activism and social screening – who quickly joined.

Shareholder activism, here defined as the use of the right to vote conferred by share ownership to raise social, environmental or corporate governance issues with a corporation, began in the mid-1960s with actions at Kodak. By the time of Campaign GM and the founding of the Interfaith Center for Corporate Responsibility in the early 1970s, shareholder activism looked much as it does today.²⁵

The other SRI parent is social screening, the inclusion of social, environmental or ethical criteria in the investment decision-making process usually with the purpose of making the investments one owns as consistent as possible with one's ethics or mission. It has a much longer history than shareholder activism, perhaps dating to the 17th century.²⁶

Historically, social screening has been – and continues to be – a statement about what are appropriate products and business practices. So, 18th century Quakers refused to participate in the weapons or slave trades, and evangelical Christians declined to own alcohol or tobacco stocks in the 20th century. In 1969, a group of Methodist ministers founded the Pax World Fund, the first mutual fund that held itself out as screening on issues beyond alcohol or tobacco.

²⁴ Gardiner C. Means, "Implications of the Corporate Revolution in Economic Theory," (1967), in Berle & Means, *op. cit.*, p. xlvii.

²⁵ See generally David Vogel, *Lobbying the Corporation* (New York: Basic Books, 1978).

²⁶ Peter D. Kinder, *et al.*, *Investing for Good* (New York: HarperCollins, 1993), pp. 12-15.

SRI's Concept of Responsibility. So, by 1970 two distinct SRI approaches to share ownership had emerged: shareholder activism which focused on particular issues at specific companies and social screening which focused on issues affecting industries or lines of business.

Both shared a common basis: an assertion of responsibility for the actions of the companies they owned. In short order, a broader range of people – stakeholders – came to realize that pools of assets of which they were direct or indirect beneficiaries invested in companies whose activities they regarded as unacceptable.

The issue that aroused that awareness was South Africa.²⁷ And, it was in that context US pensions first encountered social investing.

Pensions & South Africa. In its relationships with institutions, South Africa transformed SRI.²⁸ That transformation led to an approach to ownership pensions should adopt.

For more than a decade, the Sullivan Principles provided a focal point and a series of lenses for SRI on South Africa. The Principles amounted to an aspirational code for companies doing business in South Africa. A respected consulting firm devised a set of graduated rankings representing evaluations of corporate performance against the standards.

The most important effect of the Sullivan Principles and the corporate rankings was that they forced shareholders and activists to recognize nuances and differences in corporate performance. That recognition led to changes in approach to corpora-

²⁷ Here is not the place – or the space – to look at the history of SRI and South Africa. Two points, however, require noting. First, shareholder activists played a critical role in publicizing and organizing around the issue. As engagement evolved into divestiture, they also advanced the legislative agenda. But, SRI's role was in support of a larger movement made up of many organizations with different strategies toward the same end. Second, South Africa has received the same revisionist treatment that *Brown v. Board* has gotten on this its 50th anniversary: Change was inevitable and clearly on its way, so the trauma caused by those in a hurry was unnecessary. As one who lived for a time in rural Florida in 1966, I find the argument obscene in the case of *Brown* and contrary to all evidence in the case of South Africa. *See generally* Robert Kinloch Massie, *Loosing the Bonds* (New York: Nan A. Talese/Doubleday, 1997).

²⁸ South Africa, however, was not a catalyzing issue for most individual investors which is why SRI survived the end of sanctions and the race away from any form of social screening by pensions and endowments.

tions. One size did not fit all. But dialogue – via shareholder activism – and incremental progress became SRI’s lodestones.

Research & Divestment Decisions. The data developed for the Sullivan rankings, the South Africa reports the companies issued and the evaluations of proxy resolutions produced by the Investor Responsibility Research Center set standards for what information companies could generate on social issues and for how it social investors should evaluate it.

Some issues – tobacco most notably – would remain as categorical exclusions, but South Africa established the principle that an in-out approach would not apply to complicated issues such as the environment, labor relations and the like. There, nuanced judgments had to be made.

Starting in 1988, KLD began systematizing SRI screens in the context of developing the Domini 400 Social Index.²⁹ Today, KLD reports on nearly 100 screens under the following headings:

Qualitative Screening Areas

Exclusionary Screening Areas

Community

Alcohol

Corporate Governance

Firearms

Diversity

Gambling

Employee Relations

Military Weapons

Environment

Nuclear Power

Human Rights

Product Safety

Taken together, these screens amount to the most comprehensive and widely accepted statement of the social and environmental characteristics against which

²⁹ KLD maintains five benchmark indexes of which the Domini is the oldest. They were originally intended to gauge the costs of social investing.

investors and, indeed, the public evaluate US corporations. This framework has many limitations and the last sentence many qualifications. Not the least of these are that the screens must be of general applicability to American corporations and that data exists on which to base KLD's decisions.³⁰

Screening & Pensions: A Final Note. In the end, South Africa proved that pressure of many different types on corporations, pensions and endowments could effect the course of social change.³¹ The broad range of companies in South Africa responded to one degree or another to the urges of institutional shareholders. And, US institutions – pensions included – responded to shareholder activists and legislatures.

But while the interaction with institutions may have transformed SRI, it did not transform the pensions.

At the same time that the pensions were being forced to divest, Modern Portfolio Theory began its rise to dominance. Its mantras on diversification and risk merged with hoary arguments against social screening.³²

It has now become received doctrine that pensions “can’t” screen on social, environmental or governance issues – even amongst those that pursue active or sectoral investment strategies which inherently require screening. How a social investment mandate might be different from an active or style mandate rarely enters the screening opponent’s invocation of financial probity. Outside of passive market-basket approaches, the argument against social and environmental screening – regardless of the benefits they might bring – is visceral, not reasoned.

³⁰ A complete statement of KLD's screens will be found in “Sustainable & Socially Responsible Investing” (KLD Research & Analytics, Inc., 2004) and at <http://www.kld.com/research/ratings.html>

³¹ See Massie, *op. cit.*, pp. 620-71.

³² By far the most important intellectual support for this argument comes from John H. Langbein & Richard A. Posner, "Social Investing and the Law of Trusts," 79 *Mich. L. Rev.* 72 (1980). Uninhibited – as often in their writings – by the utter absence of supporting data, Langbein and Posner asserted pension trustees violated their fiduciary duties by applying social screens. The best gauge of the article is their definition of social investing: “excluding the securities of certain otherwise attractive companies ... because the companies are judged to be socially irresponsible, and including the securities of certain otherwise unattractive companies because they are judged to be behaving in a socially laudable way. By ‘attractive’ and ‘unattractive’ we refer to the conventional objective of investment, which is to make money ... for the investment beneficiary.” At 73.

A trustee told me at a conference in 1994, “I had South Africa shoved a mile up my ***, and it’ll never happen again.” For ten years, he has been right. Corporate governance and a new way of looking at fiduciary duties on proxy voting may prove him wrong ultimately.

Activism & Engagement

It is no small irony that “shareholder activists” have become identified with pensions, especially CalPERS, rather than nuns. It is a still larger irony that “corporate governance” rather than “social and environmental justice” is the descriptor of choice for the issues raised in the proxy arena.

2004 Successes. As noted earlier, the SEC has suggested a range of concerns broader than governance that should go into trustees’ evaluations of the companies whose stock they hold.³³

Signs have appeared amongst the news from this year’s annual meetings that institutional shareholders are responding to the SEC’s nudging. The agreement of American Electric Power and Southern Company to report on climate change issues is the clearest of these.³⁴

Activism’s Limitations. Shareholder activism has real limitations for effecting change. For one thing, it targets particular issues at particular companies. A diversity issue at ExxonMobil or Cracker Barrel may have little or no application to companies at large.

Also, shareholder activists almost never leave the Russell 1000 for their targets. And their efforts are little felt beyond that range. A limited focus, no matter how large the targets, means a limited effect. So, a limited focus does not reflect “ownership” of companies so much as “ownership” of shares, of fungible pieces of paper.

³³ Mutual Fund Regulations rationale, *supra*.

³⁴ See Joe Truini, “A Growing Minority”, *Waste News*, Feb. 2, 2004; Chris Stadelman, “Utilities to release cost information for future environment rules”, *Akron Beacon Journal*, Feb. 19, 2004; “Power giants agree to report climate emissions to shareholders”, *Environmental News Network*, Mar. 10, 2004.

http://www.enn.com/news/2004-03-10/s_13807.asp

Perhaps the greatest weakness afflicting activism is its lack of a comprehensive framework of standards. Its approach is fundamentally *ad hoc* in comparison with screening³⁵ or the combination of screening and activism used by many socially-screened mutual funds. Without a framework, it is difficult to justify an ultimate sanction: divestiture. If a dispute involves a principle and the company defeats moves to make it change, are shareholders simply to accept and go on?

It may be that “social screens” should become “standards”.

³⁵ ISIS Asset Management (UK) has developed what it calls a Responsible Engagement Overlay for its clients. This impressive effort may yield a comprehensive framework for activism. *See e.g.* “Quarterly REO Report (London: ISIS Asset Management, 1st quarter 2004).

IV. Pensions & Their Companies in the Future

An investment firm is set up to be responsible to a limited group of stakeholders -- usually just the investors who are in it for a maximum return over time. Harvard is responsible to a much bigger group of stakeholders -- its faculty, students, staff, and alumni. -Brian C.W. Palmer (2003)³⁶

Are pensions owners of companies or speculators in shares? Do pensions have fiduciary duties to stakeholders beyond their beneficiaries? Much rides on the answers to those questions.

The New “Maximizing of Shareholder Value”

Shareholder activism as presently practiced by pensions reveals its bastard heritage. It is the product of the paroxysm of corporate acquisitions in the 1980s.³⁷ Raiders and pensions alike justified their actions by invoking “the maximization of shareholder value”.³⁸

This co-operation had fatal consequences for the legitimacy of the American corporate system. Writing at the time, Monks & Minow rightly argued:

The ultimate death of the corporate myth, the theory under which management owed shareholders a greater duty than they owed themselves, came with the widespread acquiescence to the so-called management buyout....³⁹

³⁶ Garrett M. Graff, "Social Investing." *Harvard Magazine*, July 2003, p. 76. Palmer is a Harvard lecturer on the study of religion and serves on the University's SRI committee.. Prof. Palmer omitted from his list of stakeholders the public to which Harvard owes its tax exempt status as an educational institution.

³⁷ See “The Avon Letter”, *supra*. It bears noting that the only two practical examples of issues the ERISA administrator cited were anti-takeover maneuvers.

³⁸ The focus of shareholder activists on abolishing the “staggered board” is a continuing example of this heritage. Its only rationale is making it easier to flip control. It is directly contrary to every notion of what actually constitutes good governance in administrative agencies – entities often with far less impact on society. Continuity in oversight and management are positives, not negatives, except where control is at issue. It also mitigates toward long-term thinking, rather than quarter-by-quarter management.

³⁹ Monks & Minow, *op. cit.*, pp. 47-48.

It may be that the pensions' abetting of corporate restructuring well served their beneficiaries in at least the short run. But it will be sometime before a verdict is rendered on the 80s consolidation from a social and economic perspective.

Speculators and Owners. "Maximization of shareholder value" in this context was consistent with the interests of a speculator but not an "owner". There was little or no concern for the well-being of the juridical person, for the enterprise that by law has a life independent of its shareholders. There was certainly no regard for the interests of other stakeholders in the enterprise.

The SEC's proxy voting regulations take a different – albeit not distinct – view. They explicitly contemplate a concept of ownership that takes in considerations traditionally regarded as "non-financial" – "social and corporate responsibility issues".⁴⁰

What then will the prudent investors who manage and supervise pensions do?

SRI's Lenses for Corporate Evaluation. Socially responsible investors offer pensions a model of ownership. They are long-term investors by choice rather than by size and necessity. They tend to be conservative investors and to be people concerned about the legitimacy and viability of our economic and political systems.

The circumstances in which today's prudent investors find themselves dictate a close attention to corporate governing, how a company is run across their full dimensions. Imperfect as it is, the framework developed by social investors over the last 30 years provides a systematic means for dealing with the large numbers of companies whose stock the typical pension holds.

In 1991, the redoubtable Robert Monks and Nell Minow wrote:

All of the ingredients now exist for the re-establishment of a traditional system of trust on which an ongoing and productive system of corporate governance can be

⁴⁰ Again, as discussed above pensions are not subject to the SEC's 2003 proxy voting regulations.

built. The essential elements are a stable base of permanent shareholders represented by trustees who exercise care and loyalty.⁴¹

Sadly, they were wrong then. There is little reason to think that they are right today. But the stakes are much higher for pensions today, and they must act like owners if they are to carry out their mission “not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.”⁴²

By returning to the concept of prudence, pensions can redefine the maximization of shareholder value.

⁴¹ Monks & Minow, *op. cit.*, p. 244.

⁴² *Harvard College v. Amory*, 9 Pick. (26 Mass.) 446, 461 (1830).