

Corporate Governance, Social Responsibility, and Obligations of Ownership

Background Paper for State Treasurers and Legislators

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Executive Summary

As major institutional owners of corporate equities, pension funds have a responsibility to communicate clearly with their participants and speak out on vital issues relating to the governance and direction of companies whose shares they own. As owners of equity in these companies, pension funds vote on hundreds of management-sponsored and shareholder-sponsored resolutions appearing on corporate proxy statements each year. These resolutions address vital issues of corporate governance and social and environmental responsibility. Pension funds have an obligation to vote clearly and consistently on these resolutions in the best long-term interests of their participants. Communication with participants on these votes and with corporate management on these issues is part and parcel of this voting process. This paper recommends that pension funds take three steps in this regard:

- Develop comprehensive formal voting guidelines for the corporate governance, social and environmental issues appearing on the annual proxy statements of those corporations held in pension fund portfolios.
- Disclose votes cast on corporate governance, social and environmental issues appearing on the annual proxy statements of those corporations held in pension fund portfolios.
- Enter into direct dialogue as circumstances appropriately dictate on corporate governance and social and environmental issues with corporations whose stock is held in pension fund portfolios.

Recent corporate scandals have brought to the public's attention systematic abuses within the financial and corporate worlds. To help assure that such abuses do not recur and that faith in our financial systems and corporate management can be restored, a series of reforms have been proposed and adopted by legislators (including the U.S. Congress), financial industry regulators (including the U.S. Securities and Exchange Commission), and stock exchanges (including the New York Stock Exchange). State legislators, regulators, or other public officials may want to consider further steps that could appropriately be taken. Among the possible step identified in this paper are:

- Impose additional corporate governance requirements for publicly traded corporations.

- Encourage appropriate disclosure of social and environmental data by publicly traded corporations.
- Impose appropriate limitations or restrictions on executive compensation for publicly traded corporations.
- Make “social choice” investment options available to public employee participants in public pension plans as part of their savings options.
- Change state chartering provisions to encourage due consideration of the broad public interest by managers of corporations.

Introduction

The purpose of this background paper is to provide guidance to state and local public officials, including treasurers and comptrollers, who have an interest in public policies regarding corporate governance and corporate social responsibility.¹

State treasurers, pension fund boards and trustees, state legislators, municipal officials and others responsible for the management of public pension fund assets will, we hope, find this guidebook helpful. In addition, public officials generally interested in corporate responsibility, including the impact of corporate conduct on investors, employees, communities and the environment, will find valuable information and references herein.

In recent years, financial markets have taken a volatile roller-coaster ride. An extraordinary technology boom was followed by an equally dramatic market reversal. In the midst of this downturn, a wave of corporate scandals further shook confidence in financial markets. We now see what can happen to corporations and markets when CEOs, corporate directors, auditors, analysts and government regulators fail to do their jobs or abuse the public trust. We now better understand the risk to investors inherent in poor corporate governance and the neglect of corporate responsibility. We also realize that institutional investors, as major stockowners, have a special opportunity to make their voices heard in promoting sound corporate management.

A central theme of this paper is that state and local governments can take responsible steps to protect investors within their jurisdictions – including those in public pension funds – by carefully considering corporate governance and corporate social responsibility in public policy formulation, in keeping with long-established fiduciary principles. In addition, public officials help serve a larger public good by encouraging corporate efforts to act in society’s interests and by promoting public debate on issues of corporate social responsibility.

¹ For the purposes of the paper, “corporate governance” refers to the range of structural issues that govern the operation of publicly traded companies, focusing specifically on those that address the relationship between management and stockowners. “Corporate social responsibility” refers to the integration of stakeholder issues into the management and policy direction of publicly traded corporations, in an attempt to balance these interests with profitability in a mutually satisfactory manner. “Shareholders” are defined employees, customers, suppliers, and communities.

In Part One of this paper, we have focused on what state, county and municipal governments can do to assure that public pension funds are exercising their responsibilities as shareholders of the corporations whose equity shares they own. We do this in the context of risk, and specifically the risk that public pension funds and their fiduciaries are exposed to when abuses of corporate governance and corporate malfeasance undermine equity performance. We examine the various strategies that public pension funds are pursuing to become engaged, responsible shareholders that seek, through the exercise of fiduciary responsibilities, to mitigate risk, improve long-term performance and promote the public good through the pursuit of strong corporate governance and improved corporate social responsibility.

In Part Two, we focus on what actions state legislators can take to assure that corporations chartered in their jurisdictions take seriously their responsibilities to stockowners, other stakeholders, and the general public. We do so in the context of the extensive reforms recently imposed at the federal level by the Sarbanes-Oxley Act and the New York and NASDAQ Stock Exchanges through new listing requirements. Although these substantial efforts have made major strides in restoring confidence in our financial markets, additional measures are arguably needed to address still unresolved issues undermining the public's faith that corporations will act fairly and in society's best interests.

We have prepared this background paper in the belief that public officials have an opportunity to continue to build trust in our financial markets. The time to tackle these challenges is now, building upon progress already made. Completing the job at hand today will help assure that other such crises do not occur tomorrow.

Part One: Pension Funds and Responsible Investing

Background

Pension funds in the United States control approximately \$7.4 trillion in financial assets, a substantial portion of which is invested in corporate equities.² With total capitalization of the US equity markets approximating \$14 trillion, this means that pension funds – professionally managed retirement funds of private and public employees – account for roughly half of US securities. State, county and municipal governments control most of these pension funds.³

State and local governments, through their pension funds, are among the nation’s most important institutional investors. Both singly and collectively, pension funds are frequently the most important shareholders a corporation has. They are consequently in a unique position to influence corporate policies and financial markets. As long-term investors, they can play a powerful role in shaping the policies, practices and direction of America’s corporations as they affect our society and environment.⁴

As fiduciaries of public pension funds, public officials, pension oversight boards, and their money managers have great responsibilities. They must discharge these responsibilities prudently and take care to mitigate risk wherever possible. Like other institutional investors and their fiduciaries, state and local pension funds essentially have dual responsibilities. First, as *fiduciaries*, they have a duty to act prudently and in the best interests of their plan participants and beneficiaries. Second, as *shareowners*, they have an opportunity and duty to speak out on the strategy, direction, and governance of the corporations whose shares they own. The prudent discharge of these duties is what this paper refers to as “responsible investing.”

² U.S. Federal Reserve System, *Flow of Funds Accounts of the United States: Annual Flows and Outstandings*. Washington, DC. General Printing Office, 1999. See also, Fung, A., Hebb, T. and Rogers, J., *Working Capital – The Power of Labor’s Pensions*. Cornell University, 2001.

³ The remaining assets are in employer-sponsored defined benefit and defined contribution (e.g., 401K) plans in the private sector.

⁴ See, Monks, Robert A. G., *The New Global Investors*, Capstone Publishing, 2001.

Shareowner Responsibilities. As shareowners, state and local pension funds have an opportunity to speak out on vital issues relating to the governance and direction of companies whose shares they own. Corporate directors, of course, have the primary responsibility for overseeing the affairs of a corporation, including corporate governance. Their duties include establishing company strategy and direction, monitoring company management, assuring the integrity and truthfulness of company financial reporting and protecting the long-term assets of company shareholders. In carrying out these duties, however, corporate directors are acting as agents of the shareholders who elect them, and must act in the interests and for the benefit of those shareholders. Ultimate responsibility for corporate conduct rests with the shareowners themselves.

In light of recent corporate governance scandals, public pension fund fiduciaries are likely to be under increased pressure and scrutiny to assure that they closely monitor the governance, ethics, and corporate responsibility of the companies they invest in. We have seen what can happen to companies, employees, investors, shareholder value, and the financial markets when corporate managers and directors fail to do their jobs. Institutional investors – particularly public pension fund fiduciaries – can be particularly influential in preventing such failures. In fact, responsible share ownership can play an important role in assuring that corporations are perceived as responding to societal concerns, and in restoring a measure of trust in financial markets.

It is also important to note that a growing body of research suggests that companies with good corporate governance practices and high standards of corporate social responsibility may outperform their peers and can make for better long-term investments.⁵ In addition, a growing number of institutional investors are actively voting their proxies as part of a strategy for influencing corporate behavior and thereby enhancing portfolio performance.⁶

A 1994 study of the CalPERS shareowner process, for example, found that engagement with company management, including proxy voting, could yield positive results to a portfolio.⁷

Many public pension funds invest a significant portion of their assets in index funds. Because index funds are passively managed, trading activity cannot be used

⁵ See Post, J., Preston, L. and Sachs, S., *Redefining The Corporation*, Stanford University Press, 2002, pp. 26-28; Camejo, P., *The SRI Advantage*, New Society Publishers, 2002; Zadek, S., *Conversations With Disbelievers*; Verschoor, C. “The Strong Direct Link Between CSR and Profitability: The Best Corporate Citizens Do Outperform The Remaining S & P 500 Companies”

⁶ See Palmiter, Alan R., *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?*, 23 *Cardozo L. Rev.* 1419, note 1.

⁷ Nesbitt, Steven L. “Long-Term Rewards from Shareholder Activism: A Study of the CalPERS Effect,” *Journal of Applied Corporate Finance*, Winter 1994.

to enhance performance. Voice, that is voting and governance activity, rather than exit (divestment), may constitute an important means – if not the only means – of exercising influence and enhancing fund value. It can be argued, therefore, that index investors – because they are committed not to sell companies’ stock – have a special responsibility to exercise their rights as shareholders. They have no other way to communicate to corporate management either their pleasure or displeasure with actions it is taking on their behalf.

Thus, it is clear that public pension funds should faithfully exercise their shareowner responsibilities and that failure to do so may increase risk and compromise long-term performance.

Fiduciary Responsibilities. Federal laws such as ERISA generally do not apply to state and local pension funds, which are governed by state and local regulatory structures that vary from jurisdiction to jurisdiction. In every jurisdiction, however, those who control state and local pension funds – state treasurers, pension boards and trustees, etc. – are considered fiduciaries and held to a fiduciary’s standard of care.

The fiduciary of a pension fund is under a duty to act in good faith and for the exclusive benefit of plan participants and beneficiaries. In general, fiduciaries are held to a standard of prudence, meaning that they must discharge their duties with the care, skill, and diligence that a prudent investor would exercise on his or her own behalf under like circumstances. To meet this standard, state and local pension fund fiduciaries need to demonstrate that the investment practices and policies they adopt on behalf of plan participants and beneficiaries are fundamentally sound.

In the aftermath of recent corporate scandals, pension funds will be under increased pressure to demonstrate that they are meeting their fiduciary obligations to participants and beneficiaries, *i.e.*, that their investment strategies are prudent and sound. To do so, pension fund fiduciaries will need to monitor and evaluate increasingly important metrics such as corporate governance, environmental risk, employee morale, customer loyalty, company reputation and other “intangible” assets of the companies they invest in.⁸ Up to 80% of the market value of companies in today’s marketplace can be accounted for by these intangibles, up from only 20% two decades ago.⁹

⁸ One study found that non-financial performance criteria account for as much as 35% of investors’ buy-side decisions, confirming that share price is affected by – and shareowners place a value – upon such non-financial criteria. Ernst & Young Center for Business Innovation. *Measures That Matter*. 1998

⁹Robert G. Eccles and Samuel A. DiPiazza *Building Public Trust: The Future of Corporate Reporting*. John Wiley & Co., New York, 2002 p. 36.

Thus, it is increasingly clear that pension fund fiduciaries can consider issues of corporate governance and corporate social responsibility – in conjunction with traditional financial factors – when making decisions to buy or hold investments or vote proxies. At the same time, once invested, pension fund fiduciaries can – and are arguably obligated to – attempt to mitigate risk and enhance share price through efforts to influence the corporate governance and social and environmental responsibility of the companies whose shares they own.

Fiduciary responsibility, in other words, requires that pension funds actively exercise their shareowner responsibilities. The two are inextricably linked.

Responsible Investing. With the ownership of stock in publicly traded corporations come certain basic responsibilities. The obligation to communicate with management on important issues of governance and widespread social concern is one. Gone are the days when the so-called “Wall Street Walk” ruled – if investors disagreed with company management, they sold their stock and walked away. Now, as long-term stockowners, it is investors’ duty to let management know their views on important issues of corporate governance and social and environmental responsibility.¹⁰

Below are three examples of actions institutional investors such as pension funds can take to meet their fiduciary and shareowner obligations to communicate with corporate management.

Potential Action One: Vote Proxies According to Guidelines

Each year, approximately three to four weeks prior to a corporation’s annual meeting, shareholders receive a proxy statement in the mail. This proxy statement contains valuable information about the company’s ownership structure, board of directors, management and governance. Shareholders before the annual meeting are offered the opportunity to vote on key issues by filling out and sending in this special ballot or “proxy.” They are always asked to elect members of the Board of Directors, often asked to approve the company’s choice of auditors, and frequently asked to weigh in on other issues as well. Other issues include proposals by corporate management for shareholder approval as well as shareholder proposals submitted by investors.

Management typically submits for approval issues such as major mergers or acquisitions, compensation plans for top management, broad-based stock option

¹⁰ See James Pl. Hawley and Andrew T. Williams *The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic*. University of Pennsylvania Press, Philadelphia 2002.

plans, “poison pill” changes in the corporation’s structure intended to prevent hostile takeovers, or other corporate governance measures.

Shareholder resolutions often concern issues of corporate governance, such as annual elections of directors, board independence, mandatory stock ownership by directors, separation of the CEO and Chair position, and confidential balloting. They can also involve social and environmental issues, such as greater board and management diversity, disclosure of environmental liabilities, endorsement of environmental principles, nondiscrimination policies, or adoption of strengthened overseas labor standards.

In a typical year, hundreds of non-management shareholder proposals are filed on corporate governance, as well as social and environmental, issues. Historically, most shareholder resolutions have been opposed by corporate management, and seldom received a significant number of votes. In recent years, however, many shareowner proposals have fared much better, climbing steadily from votes of support in the 3% to 5% range during the 1970s to votes of support now frequently in the range of 10% to 20% on social and environmental issues. For corporate governance issues, these votes now frequently top 30%. A small, but increasing number of shareowner resolutions on corporate governance issues (particularly those relating to CEO compensation and staggered boards) are receiving majority votes, despite the opposition of corporate management. (These resolutions are non-binding. If they receive a majority vote, management is obliged simply to take them under advisement.)

Several changes have prompted this strong growth in the willingness of shareholders to express their opinions to management. Among other things, the Department of Labor (DOL) and Securities and Exchange Commission (SEC) have made it clear that voting proxies is a fundamental responsibility of pension funds and mutual fund managers¹¹. In 1988, the Department of Labor affirmed the fiduciary obligation of officials of ERISA-regulated pension funds to vote their proxies on behalf of their participants. In early 2002, the Securities and Exchange Commission acknowledged the fiduciary obligation of money managers to vote proxies on behalf of their clients. Then in January 2003, the SEC took an additional strong step, adopting new rules requiring all mutual fund managers and registered investment advisers to develop formal proxy voting guidelines for their portfolios, and to disclose their actual proxy votes each year.

It is clear that federal regulators view the voting of proxies as a basic duty of stockownership – and the voting of proxies by investment advisers, mutual funds

¹¹ Although the fiduciary implications for non-ERISA pension funds, universities, foundations and other institutional investors are less explicit, implicit in these rulings is an expansion of some of the general concepts of fiduciary responsibility.

and other institutional investors as a fundamental fiduciary obligation. Although not subject to ERISA standards governing private pension funds or SEC regulations governing the mutual fund industry, public pension funds are also fiduciaries, and as such should carefully consider development of appropriate proxy voting guidelines on corporate governance, social and environmental issues. Indeed, their prominent public positions and large blocks of stock arguably impose a particular obligation to do so.

The development of transparent proxy voting guidelines allows public pension fund participants to better understand the power of their proxy and how it is used to influence corporate governance and other corporate policies. Failure to disclose the pension plan's basic positions on important issues for its own participants may serve to shroud the investment process in an air of mystery and potentially undermine their faith in their pension fund management and in the basic workings of the system. The States of California and Connecticut have pioneered the development of such guidelines.

***Recommendation.** Develop comprehensive formal voting guidelines for the corporate governance, social and environmental issues appearing on the annual proxy statements of those corporations held in pension fund portfolios.*

Potential Action Two: Disclose Proxy Votes

Institutional investors, including public pension funds, should also disclose their proxy votes to the public.¹² Historically, the financial community in general, including mutual funds, had avoided such disclosure. In 1999, however, the Domini Social Equity Fund became the first mutual fund in America to publicly disclose its proxy votes, publishing them on its website, together with the guidelines it follows when voting proxies. A number of socially responsible mutual funds and money managers, including Pax World and Calvert Group, have subsequently adopted the same approach.

In 2001 and 2002, Domini Social Investments, the AFL-CIO, and the International Brotherhood of Teamsters filed petitions for rulemaking with the SEC asking that all U.S. mutual funds be required to disclose their proxy votes. Domini pointed out that mandating proxy voting, but not requiring disclosure of these votes, undermines the credibility of the system. "If proxy voting is a fiduciary responsibility of fund management, why is disclosure not mandated?" Domini asked, pointing out that it could "think of no other instance where the Commission

¹² For the purposes of this paper, it is assumed that most institutional investors' proxies are voted, even if this takes place by outside managers without the guidance or oversight of investors themselves.

countenances opacity rather than transparency in the discharge of fiduciary obligations.”¹³ In January 2003, the SEC (after receiving a record number of favorable public comments) adopted new rules that would require all mutual funds not only to vote proxies according to specific guidelines, but also to report all votes and to annually compile a report on these proxy votes that will be available to investors.

Public pension funds should seriously consider adopting similar disclosure standards¹⁴. Simply put, proxy-voting disclosure and transparency are good governance practices.

The disclosure of proxy votes by pension funds serves several important purposes. Such disclosure:

- Informs pension fund participants how their fiduciary rights are being exercised in practice
- Puts companies on notice that major institutional investors are voicing their support for certain policies and procedures
- Provides valuable information to financial analysts, bond raters and other members of the mainstream financial community who daily assess the prospects of publicly traded firms
- Alerts other institutional investors to specific positions being taken by their peers

Equally important, such disclosure promotes public debate and discussion. Debate on these issues should be embraced, not avoided. All pension fund proxies are voted, whether participants agree with the specific positions or not. Voting in secrecy, although it may avoid occasional complaints, is injurious to the credibility of fiduciaries and the process itself in the longer term. Public pension funds have a unique opportunity to promote openness and discussion regarding the practices and policies of corporations.

¹³ Letter to SEC Chairman Harvey L Pitt, December 12, 2001.

¹⁴ For the purposes of this discussion, we have separated the issue of confidential voting of proxies from that of disclosure. Confidential voting means that stockowners are entitled, if they so desire, to cast their ballots without corporate management knowing their position on a specific issue. This sound principle protects institutional and other investors from inappropriate pressures from corporate management on their votes. Many corporations do not currently have confidential voting provisions. It should be noted in this context that the SEC has required annual disclosure of a fund’s votes only after a corporation’s annual meeting has taken place, thereby preserving the beneficial effects of confidential voting.

In 1999, the California Public Employees Retirement System (CalPERS) became the first public pension fund in the U.S. to voluntarily disclose its proxy votes. More recently, at the urging of California State Treasurer Phil Angelides, the California State Teachers' Retirement System (CalSTRS) adopted a new policy aimed at pressuring mutual funds and other investment managers to disclose their proxy votes. CalSTRS also decided to make its own proxy policies and votes available to the public on its web site.¹⁵

***Recommendation.** Disclose votes made on corporate governance, social and environmental issues appearing on the annual proxy statements of those corporations held in pension fund portfolios.*

Potential Action Three: Communicate Directly with Corporate Management

Whether the issue is global warming, equal opportunity for women and minorities, executive compensation, or overseas labor standards, managers need to be reminded of what society expects from the corporate community.

Institutional investors, including pension funds, are particularly well suited for such communications. Because they represent participants who hope to retire into a world with breathable air, drinkable water, safe streets, equal opportunity for all, reduced levels of poverty and vital communities, pension funds have an opportunity to speak out for long-term wealth creation that is consistent with the goal of building a just and livable society. Because they are among the largest and most important stockowners in most corporations, pension funds also have the opportunity to attract the undivided attention of top corporate management.

Over the last two decades, a growing number of concerned shareholders – including religious groups, environmentalists, community activists and unions – have engaged in dialogue with corporate management. These communications can urge action as varied as adoption of strengthened environmental policies, increased representation of women and minorities on boards of directors, opposition to corporate plans to reincorporate off shore, assessment of the financial risks of climate change exposure, and greater independence within boards of directors.

These communications can be informal, involving behind-the-scenes, in-person dialogue with top-level managers. Or, they can publicly put management on notice that the issue is one deserving of increased public attention. If management responds, great progress can often be made in a relatively short

¹⁵ See, "CalSTRS Adopts Angelides Proposal Seeking Mutual Fund Accountability to Investors," News Release, California State treasurer's Office, October 2, 2002.

period of time. If management does not respond, the shareholder always has the option of filing a proxy resolution in order to communicate concerns to fellow investors.

In recent years, for example, the Office of the Treasurer of the State of Connecticut has communicated with Disney's management on the issue of executive compensation, with Stanley Works on its plans to reincorporate in Bermuda, and with American Electric Power concerning its environmental policies, among other issues.

Recommendation. *Enter into direct dialogue as circumstances appropriately dictate on corporate governance and social and environmental issues with corporations whose stock is held in pension fund portfolios.*

Part Two: Promoting Corporate Governance and Social Responsibility

Background

In the aftermath of Enron and other corporate scandals, there has been a renewed interest in corporate governance on the part of regulators and throughout the financial community. The Sarbanes-Oxley Act, signed into law by President Bush in 2002 and the proposed new listing requirements for the New York Stock Exchange (NYSE) and NASDAQ are two indications of how serious this interest is.

The Sarbanes-Oxley Act included the following specific reforms:

- Corporate CEOs and chief financial officers will now be required to sign company financial statements. If those statements turn out to be fraudulent, company officials must bear responsibility.
- A majority of the board of directors of all publicly traded companies will have to be independent directors.
- Audit, compensation, and nominating committees must consist exclusively of independent directors.
- Companies will be prohibited from making loans to their executives.
- A new oversight board will now regulate the accounting industry, with power to independently verify company audits and financial statements.

The revised NYSE listing requirements, also proposed in 2002, include the following additional reforms:

- Director “independence” will be defined to mean that directors do not have any material relationship with the company outside of their board service, and do not directly or indirectly receive any benefit from the company beyond their director’s fee.
- Accounting firms may be prohibited from providing certain consulting services to companies they audit.
- All exchange-traded companies will be required to adopt a business code of conduct and ethics.

The corporate governance reforms achieved through Sarbanes-Oxley and the new NYSE listing requirements address some of the most egregious conduct at the heart of corporate scandals that have plagued the U.S. economy in recent years.

Many investors would argue that they are not enough – that in order to further strengthen corporate governance, promote corporate responsibility and protect investors in state and local pension funds, public policy makers at both the state and federal levels will need to consider further reforms.

Some of the reforms that have been suggested – and may be appropriate for policy makers at the state level to consider – fall into the following four categories.

Potential Action One: Consider Improvements in Corporate Governance Guidelines

Building upon Sarbanes-Oxley and the NYSE reforms, regulators, legislators or other public officers might support initiatives that promote further reform¹⁶. Among those corporate governance reforms currently receiving wide attention are the following.

- Director “independence” could be strictly defined, including a detailed definition of what constitutes a "material relationship" to the company, and detailed guidance concerning the nature and duration of such relationships. (For example, states could adopt the definitions utilized by the Council of Institutional Investors or Institutional Shareholder Services).
- Corporations could be required to adopt policies and report on progress in facilitating the election of directors that are representative of diverse stakeholder constituencies, including women, people of color, employees, customers and the public.¹⁷
- Directors of corporate Boards of Directors could be required to take certain minimal levels of training or certify that they are minimally familiar with basic issues necessary to adequately fulfill their responsibilities.
- In addition to audit, compensation and nominating committees, corporate boards could be required to have “corporate responsibility” or “business practices” committees to oversee corporate ethics, corporate governance and corporate social responsibility.
- Access to the nomination process for corporate boards of directors could be required for shareholders of a certain size, in line with the proposals currently under consideration by the SEC. Similarly, shareholders could be

¹⁶ Please note that in various circumstances states’ ability to impose legislative or regulatory reforms is superseded by federal authorities. Careful consideration should be given to the form and substance of all reforms advocated in this regard.

¹⁷ In January 2003, The Conference Board’s *Commission on Public Trust and Private Enterprise: Findings and Recommendations* recommended “Boards of directors should develop procedures to receive and to consider shareowners’ nominations for the board of directors....” P. 26.

- granted the right to vote individually on nominees for corporate boards of directors, and no longer be required to vote for nominees as a slate.
- Annual in-person shareholder meetings could be mandated, thereby resisting efforts by some corporations to replace in-person shareholder meetings with remote, online annual meetings. The annual in-person shareholder meeting is the only forum that allows shareowners to directly communicate with corporate management. It is an essential component of corporate democracy and efforts to substitute remote, online annual meetings for in-person gatherings will undermine this important feature of our system of checks and balances.
 - States could also mandate disclosure of the amount and purpose of lobbying expenditures by corporations at the state, county and municipal levels.

Recommendation. *Impose additional corporate governance requirements for publicly traded corporations.*

Potential Action Two: Encourage Appropriate Social and Environmental Disclosure

Much attention is currently focused on corporate governance reforms as a means of restoring public confidence in the financial markets. Increased attention to social and environmental issues could also be of great value. In particular, disclosure of corporate goals and actual records in these areas is of increasing importance on at least two levels.

From a financial perspective, this disclosure is important because a growing portion of a company's stock market value is accounted for by intangibles, which – along with such items as intellectual property and patents – included brand name, reputation, and quality of management. A company's record on social and environmental issues – including employee relations, product quality, customer service, environmental policies and practices, community affairs, and work/family matters – can be a crucial factor in evaluating these intangibles. Needless to say, these intangibles can have a significant impact on risk and on a company's future financial prospects. Moreover, how corporations deal with the risks and opportunities implicit in the handling of social and environmental issues can be an indicator of the quality of management.

From a broader social perspective, disclosure of social and environmental data can help regulators, communities, employees, and consumers to ascertain whether corporations are doing a particularly good (or bad) job of meeting society's expectations.

Among the reforms that state legislators, regulators or other public officials might adopt to strengthen disclosure in these areas are the following.¹⁸

- Corporate Codes of Ethics and Business Conduct could be required to include the companies' values on social and environmental issues. These statements of social and environmental values could then be measured against actual performance. The Code of Business Conduct could also be required to identify and outline the process by which Boards and executives will manage social and environmental risks. Already, the NYSE listing requirements require corporations to address employee and consumer issues in their Codes of Business Conduct.
- States could also, through various means, encourage companies to disclose basic information about their social and environmental performance, including material risks, liabilities, and impairments, as well as investments and achievements in these areas – keeping in mind that such “intangibles” are increasingly a key factor in stock market performance.¹⁹
- Public pension funds could be required to disclose whether and to what degree social and environmental criteria are taken into account in making specific investment decisions.

Recommendation. *Require appropriate disclosure of social and environmental data by publicly traded corporations.*

Potential Action Three: Consider Executive Compensation Issues

Excessive executive compensation has perhaps been more responsible than any other single issue for undermining the public's confidence in corporations' willingness and ability to act fairly and in society's best interests. Twenty years ago, CEOs made 40 times the average employee; today they are paid 600 times

¹⁸ Please note that the SEC has sole authority over disclosures required in corporate public filings, such as reports to shareholders.

¹⁹ In this regard, states might give careful consideration of the reporting requirements of the Global Reporting Initiative (GRI). The GRI is in a pilot phase and earning respect from the business community, the United Nations, and even the Johannesburg Stock Exchange, which recently embraced it. GRI provides a uniform disclosure policy and extends the reach of corporate social responsibility to economically, environmentally and socially sustainable business practices. In addition, the GRI is being developed through a multilateral, transparent process that lends the ultimate report substantial credibility. Careful consideration could also be given to the disclosure guidelines contained in the American Society for Testing and Materials 2001 Standard Guide for Disclosure of Environmental Liabilities.

more, earning on average \$15.5 million per year. Recent reforms have only begun to address this issue. Greater shareowner and regulatory scrutiny over executive compensation and severance packages – including scrutiny by public pension funds – is much needed, and could have a salutary effect on corporate behavior.

Whereas some reforms are more properly addressed at the federal level – *e.g.*, expensing stock options or modifying the “reasonable business expense” deduction – many actions to curb excessive executive compensation can be taken at the state level, including changes to state corporation laws.

- States could require that stock options paid to top executives be submitted to a company’s shareholders for approval – New York Stock Exchange listing requirements now include such a provision – as should executive severance agreements (so-called “golden parachutes”).
- Guidelines could be established for determining a reasonable ratio of highest- to lowest-paid workers (or CEO to median salary), and the linking of executive compensation to certain indicia of social and environmental success.
- Restrictions on the sale of company stock applicable to non-management company employees could be made equally applicable to top executives and members of the company’s board of directors.

Recommendation. *Impose appropriate limitations or restrictions on executive compensation for publicly traded corporations.*

Potential Action Four: Offer “Social Choice” Investments

Public pension funds could consider adding one or more “social choice” investments to their portfolio of investments. One of the nation’s largest retirement plans, TIAA-CREF, makes available a “social choice” account to its participants, so that those who wish to do so can invest in portfolios applying social, environmental and corporate governance screens. Public pension funds at the state and local level can similarly make “social choice” accounts available to their participants among the savings option in their defined contributions accounts. Among public pension funds already including such options are the cities of New York (New York), Chicago (Illinois), San Francisco (California), King County (Washington), the States of Alaska, California, Colorado, Illinois, Indiana, Tennessee, Vermont, Wisconsin, and the Commonwealth of Massachusetts.

Recommendation. *Make “social choice” investment options available to public employees participants in public pension plans as part of their savings options.*

Potential Action Five: Further Reform State Corporation Laws to Promote Corporate Social Responsibility

Finally, it should be remembered that corporations are creatures of state law and are subject to state charters. Corporations are man-made creations and they exist to serve a definite social purpose: wealth creation. This process of wealth creation that is the underlying rationale for the corporate form should not be at the expense of other important social values such as employee health and safety and protection of the environment.

Some have therefore urged that state legislators – who created and chartered these corporations in the first place – should take their oversight responsibilities more seriously and renew efforts to promote corporate behavior that is consistent with community expectations and social objectives. Specifically, they can take action to ensure that a state’s corporation laws promote creation of wealth in a *responsible* manner by minimizing the externalization of social costs, and that corporations should not create such wealth *at the expense of* their various stakeholders or the public interest itself. Therefore, state corporation laws could be amended to clarify that corporations owe a duty not only to satisfy the short-term interests of their shareowners, but the long-term interests of all their stakeholders, including the communities and states where they do business.

Model legislation incorporating these changes to state corporation law has been drafted and filed in Minnesota²⁰. (See an example of draft legislation in Appendix C.)

Recommendation. *Change state chartering provisions to encourage due consideration of the broad public interest by managers of corporations.*

²⁰ See Kelly, Marjorie *The Divine Right of Capital: Dethroning the Corporate Aristocracy*. Berrett-Koehler 2001 p. 138.

Conclusion

This paper suggests that public officials, pension fund fiduciaries, legislators, and regulators can take responsible steps to promote communications with investors and corporations that can lead to greater openness and transparency in the financial sectors, while keeping within long-established fiduciary guidelines. In addition, public officials help serve a larger public good by encouraging corporate efforts to act in society's interests and by promoting public debate on issues of corporate governance and corporate social responsibility. As recent corporate scandals have demonstrated, fundamental reform at this time can play an important role in restoring trust in the corporate world and financial markets, and in assuring that this trust is not systematically abused in the years to come.

Appendix A -- Resources

A. Examples of Proxy Voting Guidelines

Mutual Funds

Calvert Group publishes its proxy voting guidelines for social and environmental issues, as well as corporate governance issues. See its website www.calvertgroup.com, specifically http://www.calvertgroup.com/sri_648.html

Domini Social Investments publishes its proxy voting guidelines for social and environmental issues, as well as corporate governance issues. See its website www.domini.com, specifically <http://www.domini.com/shareholder-advocacy/proxy-voting/index.htm>

Pax World Fund publishes its proxy voting guidelines for social and environmental issues, as well as corporate governance issues. See its website www.paxworld.com, specifically <http://www.paxfund.com/proxyvote4.htm>

Money Managers and Financial Planners

First Affirmative Financial Network publishes its proxy voting guidelines for social and environmental issues, as well as corporate governance issues. See its website <http://www.firstaffirmative.com/pdf/ProxyVoting/SRIProxyVotingPolicy-ExSum.pdf>.

Trillium Asset Management publishes its proxy voting guidelines for social and environmental issues, as well as corporate governance issues. See its website www.trilliuminvest.com, specifically http://www.trilliuminvest.com/pages/activism/activism_voting_social.asp

Walden Asset Management publishes its proxy voting guidelines for social and environmental issues, as well as corporate governance issues. See its website www.waldenassetmgmt.com, specifically <http://www.waldenassetmgmt.com/social/proxyvoting.html>

Pension Funds

California Public Employees Retirement System (CalPERS) publishes its proxy voting guidelines on social and environmental issues, as well as corporate governance matters. Go to <http://www.calpers.ca.gov>, and search on “proxy voting guidelines.”

Connecticut Office of the Treasurer publishes its domestic and global proxy voting guidelines on social and environmental issues, as well as on corporate governance matters. Go to <http://www.state.ct.us/ott/>, then click on “corporate governance and proxy voting guidelines” in the box labeled “Corporate Responsibility” for a pdf version of these guidelines.

TIAA-CREF publishes a summary of basic principles underlying its proxy voting guidelines. See its website www.tiaa-cref.org, specifically <http://www.tiaa-cref.org/libra/governance/index.html>

B. Examples of Disclosure of Proxy Voting

Mutual Funds

Domini Social Investments publicly reports its annual proxy votes on social and environmental issues, as well as corporate governance issues. See its website www.domini.com, specifically <http://www.domini.com/shareholder-advocacy/Proxy-Voting/index.htm>

MMA Praxis Mutual Funds publicly reports its annual proxy votes on social and environmental issues, as well as corporate governance issues. See its website www.mmapraxis.com/mmapraxis/index.html, specifically http://www.mmapraxis.com/corporate/proxy_voting_set.html.

Pax World Funds publishes annual proxy votes on social and environmental issues, as well as corporate governance issues. See its website www.paxworld.com, specifically <http://www.paxfund.com/bfproxy/setup.htm>

Money Managers

Walden Asset Management publicly reports its annual proxy votes on social and environmental issues, as well as corporate governance issues. See its website

www.waldenassetmgmt.com, specifically
<http://www.waldenassetmgmt.com/social/proxyvoting.html>

Pension Funds

Universities Superannuation Scheme, one of the largest pension funds in the United Kingdom, posts its voting on its website. See www.usshq.co.uk, specifically <http://www.usshq.co.uk/srsi/voting/VOTEFRAM.HTM>.

For a complete list of members of the U.S. Social Investment Forum that disclose proxy voting and have proxy voting guidelines publicly available, see the Social Investment Forum's website at www.socialinvest.org, specifically <http://www.socialinvest.org/areas/sriguide/mfsc.cfm>.

C. Example of Consulting Firms Assisting Institutional Investors in the Developing of Social and Environmental Proxy Voting Guidelines and the Voting of Proxies According to Such Guidelines

First Affirmative Financial Network provides consulting services to institutional investors wishing to develop proxy voting guidelines. See its website <http://www.firstaffirmative.com/services.jsp>.

Investor Responsibility Research Center provides consulting services to institutional investors wishing to develop proxy-voting guidelines. See its website <http://www.irrc.org> specifically <http://www.irrc.org/products/advisory.html>.

Institutional Shareholder Services, through its **Social Investment Research Service** subsidiary, provides assistance to institutional investors in voting proxies according to social and environmental guidelines. See its website www.issproxy.com, specifically <http://www.issproxy.com/products/sirs/index.html>.

KLD Research and Analytics provides consulting services to institutional investors wishing to develop proxy voting guidelines. See its website www.kld.com, specifically <http://www.kld.com/consulting/index.html>.

SRI WorldGroup, through its **iShareowner** subsidiary, provides consulting services to institutional investors wishing to develop proxy-voting guidelines. See its website www.ishareowner.com, specifically <http://www.ishareowner.com/consulting.html>.

D. Background on the Responsibility of Stockowners to Vote Proxies According to Guidelines and Report Such Votes Publicly

Securities and Exchange Commission. In September 2002, the SEC issued a proposed rule change relating to the voting of proxies and disclosure of these votes by Registered Investment Advisors. This Release No.: 34-46518, IC-25739; File No.: S7-36-02 is available on the SEC's website www.sec.gov, specifically <http://www.sec.gov/rules/proposed.shtml>.

Domini Social Investments. On November 27, 2001, Domini Social Investments wrote the SEC urging that it require all mutual funds to adopt a policy of disclosing votes on social and environmental issues. This letter contains background rationale as to why such disclosure is important. It is available on the Domini Social Investments website at www.domini.com, specifically at http://www.domini.com/about-domini/News/Press-Release-Archive/Proxy-Voting-Ltr-to-SEC-12-01.doc_cvt.htm.

SRI World Group. SRI World Group's *Sustainable & Responsible Investment Strategies: A Guide for Fiduciaries and Institutional Investors* contains substantial background on proxy voting and includes the 1988 letter from the Department of Labor to Avon Products including its finding that under ERISA "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." See SRI World Group's website at www.sriworld.com, specifically <http://www.ishareowner.com/reports.html>.

E. Background on the Importance of Public Pension Funds Exercising their Fiduciary Duties with Regard to Social and Environmental Issues

CERES' (Coalition for Environmentally Responsible Economies) Sustainable Governance Project ties the fiduciary responsibilities of institutional fund management to issues of environmental sustainability. In March 2002, it published *Value at Risk: Climate Change and the Future of Governance*, which examines questions of environmental risk and fiduciary obligations. The study is available on the CERES website at www.ceres.org, specifically at <http://www.ceres.org/reports/main.htm>.

Robert A.G. Monks' book *The New Global Investors: How Shareowners Can Unlock Sustainable Prosperity Worldwide* provides an excellent exposition of the

arguments for increase attention by public pension funds to the social and environmental records of companies in which they invest. It is available through the website of The Corporate Library, www.thecorporatelibrary.com, specifically at <http://asp.thecorporatelibrary.net/bookstore/monksminow.asp?curpage=2>.

Universities Superannuation Scheme, one of the largest pension funds in the United Kingdom, has launched a number of “thematic engagement projects.” In these it examines the link between a number of corporate governance and social issues – including global warming, investments in Burma, executive compensation and independent directors – and financial risk and performance. See its website www.usshq.co.uk, specifically http://www.usshq.co.uk/srsi/thematic_engagement/THEMFRAM.HTM.

Additional Reading. For an excellent overview of developments relating to public and private pension funds and social investing see *Working Capital: The Power of Labor’s Pensions*. Edited by Archon Fung, Tessa Hebb and Joel Rodgers. Published by Cornell University Press (under the ILR Press imprint) in 2001.

For an authoritative discussion of the performance of socially screened mutual funds in the United States, see: “Socially Responsible Mutual Funds” by Meir Statman, *Financial Analysts Journal*, vol. 56, no. 3 (May/June 2000): 30-39. This article points out that there is apparently no financial cost to social screening. This article, published in the journal of the Association for Investment Management and Research (AIMR) is available to AIMR members at <http://www.aimrpubs.org/cgi-bin/search>.

For a well-argued case that U.S. pension funds have now become “universal owners” with a specific fiduciary duty to consider the implications of their investments for the whole economy – not simply firm-specific returns – see *The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic* by James P. Hawley and Andrew T. Williams. Published by University of Pennsylvania Press in 2000.

For an overview of arguments that socially responsible investing can add to financial performance see *The SRI Advantage: Why Socially Responsible Investing Has Outperformed Financially*, New Society Publishers, 2002. Available through New Society Publishers website at <http://www.newsociety.com/index.html>.

F. Background on Dialogue with Corporations and Filing Shareholder Resolutions on Social and Environmental Issues

Interfaith Center on Corporate Responsibility has for many years served as a clearinghouse for church groups, unions, foundations and other institutional investors conducting dialogues and filing shareholder resolutions with corporations on social and environmental issues. In particular, it publishes an annual listing of all shareholders with whom it is working on resolutions each year. See its website, www.iccr.org in general and for this publication specifically at http://www.iccr.org/products/pubs_printout.htm.

Investor Responsibility Research Center monitors shareowner resolutions filed each year and provides a background research service for institutional investors seeking support in voting on these resolutions. See its website www.irrc.org specifically <http://www.irrc.org/products/sis/sispv.html?show=products>.

Institutional Shareholder Services, monitors shareowner resolutions filed each year and provides a background research and voting service for institutional investors seeking support in voting on these resolutions. See its website www.issproxy.com, specifically <http://www.issproxy.com/services/institutional/index.html>.

Connecticut Office of the Treasurer reports on its website on its dialogue with corporations and filing of corporate governance and social issues. Go to <http://www.state.ct.us/ott/> and see 2002 and recent news releases.

G. Background on the Social and Environmental Screening of Funds

Innovest Strategic Value Advisors provides consulting services to institutional investors wishing to screen assets according to social or environmental guidelines. See its website www.innovestgroup.com.

Investor Responsibility Research Center provides consulting services to institutional investors wishing to screen assets according to social or environmental guidelines. See its website www.irrc.org, specifically [http://www.irrc.org/products/p\\$/Screener.html](http://www.irrc.org/products/p$/Screener.html).

Institutional Shareholder Services, through its **Social Investment Research Service** subsidiary, provides assistance to institutional investors wishing to screen assets according to social or environmental guidelines. See its website

www.issproxy.com, specifically
<http://www.issproxy.com/products/sirs/index.html>.

KLD Research and Analytics provides consulting services to institutional investors wishing to screen assets according to social or environmental guidelines. See its website www.kld.com, specifically <http://www.kld.com/consulting/index.html>.

SRI WorldGroup, through its **iShareowner** subsidiary, provides consulting services to institutional investors wishing to screen assets according to social or environmental guidelines. See its website www.ishareowner.com, specifically <http://www.ishareowner.com/consulting.html>.

H. Background on Recommendations to Improve Corporate Governance and Enhance Public Trust

Robert Monks and **Allen Sykes** authored *Capitalism Without Owners Will Fail: A Policymaker's Guide to Reform* published in November 2002 by the Centre for the Study of Financial Innovation. For further information, see the Centre's website at <http://www.csfi.fsnet.co.uk>.

In January 2003, **The Conference Board** published the recommendations of its *Commission on Public Trust and Private Enterprise*. The Findings and Recommendations of the Commission include corporate governance recommendations, including solicitation of stakeholder nominations to the Board of Directors.

Appendix B – Additional Initiatives for Consideration

In addition to the initiatives listed in Parts One and Two above, a number of additional initiatives might be considered by pension funds, legislators or regulators. Among these are:

Incorporation of Social and Environmental Criteria into the Management of Defined-Benefit Pension Fund Assets

A number of states and cities incorporate social and environmental criteria into the management of their defined-benefit pension fund assets. Tobacco, Northern Ireland, and human rights violations incorporated in the United States. In Europe, a number of pension fund incorporate environmental and sustainability criteria into their investment processes. Pension funds might consider the financial and social implications of adopting similar approaches.

Preferential Purchasing

This paper has focused primarily on the role of state and local governments and their pension funds as investors in raising issues of social and environmental concerns with corporations. In addition these public bodies can use their position as purchasers of goods or services to raise such issues.

A number of states and cities factor social and environmental considerations into their purchasing policies. Use of recycled materials in products and ownership of vendors by women and minorities are among the factors considered in such policies. Various branches of the federal government have guidelines limiting purchases from vendors that have a record of legal misconduct. Governmental bodies might consider adopting preferential purchasing programs for vendors with demonstrated corporate social responsibility programs.

Required CSR Disclosure by State Vendors

Because sunshine is the best disinfectant, governments often adopt disclosure regulations on issues of vital public concern. Governmental bodies might consider policies requiring vendors to disclose basic information about their social and environmental practices, and make this information publicly available.

Deposits with Community Development Financial Institutions

Because many communities in our society are still underserved when it comes to access to capital, a number of Community Development Financial Institutions (CDFIs) have grown up around the country. Governmental bodies might consider placing funds with such institutions.

Community and Economically Targeted Investing

A wide range of strategies has been adopted by various state and municipal pension funds to channel fund to local economic development or union-related projects. Generally known as economically targeted investing, these practices serve to support local economies. In addition, the Social Investment Forum and similar SRI organizations have developed a variety of strategies to promote community investing. Pension funds may wish to study the opportunities offered by these strategies.

Communications with Peers

Governmental bodies may want to consider increased dialogue among state and local officials on the implications of corporate social responsibility issues and appropriate actions to increase the ability of corporations to contribute positively to society.

Appendix C – Proposed State Code for Corporate Responsibility

The following amendments to the Minnesota state law regulating the chartering of corporations have been proposed. The proposed revisions are in *italics*.

THE MINNESOTA CODE FOR CORPORATE RESPONSIBILITY

Preamble. Whereas directors of corporations formed under the Minnesota Business Corporations Act (the "Act") have heretofore been required by law to manage their corporations in the best interests of the corporation and

Whereas this requirement has been found to restrict directors from managing corporations in a manner that fully respects the public interest and

Whereas the legislature believes that large corporations formed under the laws of Minnesota should have due respect for and safeguard the environment, human rights, the public health and safety, the welfare of communities in which such corporations operate and the dignity of employees,

Now therefore, in order to expand the duties of corporate directors to require that the pursuit profit by corporations formed under the Act no longer occurs at the expense of the environment, human rights, the public health or safety, the welfare of communities or the dignity of employees, be it enacted that the following changes shall be made to the Act:

Section 1. **Duty to Safeguard the Public Interest.**

Subdivision 1 to Section 302A.251 of the Act shall be deleted entirely and the following substituted therefore:

Subd. 1. A director shall discharge the duties of the position of director *(i)* in good faith, *(ii)* in a manner the director reasonably believes to be in the best interests of the corporation, *but not at the expense of the environment, human rights, the public health or safety, the communities in which the corporation operates or the dignity of its employees* and *(iii)* with the care an ordinarily prudent person in a like position would exercise under similar circumstances. A person who so performs those duties is not liable *to the corporation or its shareholders* by reason of being or having been a director of the corporation.

Section 2. Civil Liability for Damage Caused to the Public Interest.

The following shall be added to Section 302A.251 of the Act as Subdivision 6 thereof:

Subd. 6. In the case that any corporation formed under this Chapter causes damage to the environment, violates human rights, adversely affects the public health or safety, damages the welfare of the communities in which the corporation operates, or violates the dignity of its employees, any person damaged by such action, may either in law or in equity, in [court of competent jurisdiction], sue either

(a) the corporation or

(b) any person who was a director of the corporation either at

(i) the time the damage occurred or

(ii) the time the board of directors approved the corporate action that led directly to such damage.