

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

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Dedication

This paper is dedicated to the memory of William J. Brown, Attorney General of Ohio, 1971-1983, who believed the duties of trustees should be enforced and devoted the staff and political capital required to regulate charitable trusts. As the years pass, it becomes ever more clear what a privilege it was to work for him.

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

I would like to warn the gentlemen of the City and High Finance that if they do not listen in time to the voice of reason their days may be numbered. I speak to this great city as Jonah spoke to Nineveh.... I prophesy that unless they embrace wisdom in good time, the system upon which they live will work so very ill that they will be overwhelmed by irresistible things which they will hate much more than the mild and limited remedies offered them now. -John Maynard Keynes. (1923)¹

On the new Wall Street, everything occurs out in the open. Any financial system based on the stock market is bound to be as transparent as the old bank-based system was opaque, so that it is fitting that asset managers operate in glass skyscrapers. -Ron Chernow (1997)²

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, pensions³ included, whether or not they are subject to the SEC's jurisdiction.

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 Robert Skidelsky, *John Maynard Keynes: The Economist as Saviour* [1992], (New York: Penguin Books, 1995), p. 131.

² Ron Chernow, *The Death of the Banker* (New York: Vintage, 1997), p. 81.

³ 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)⁴

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 itself which the 1929 Crash and the subsequent Great Depression had called into question.

The Acts' proponents knew what they proposed to remedy. Future House Speaker Sam Rayburn (D. Tex.) put it perfectly when he said the 1933 Act "is not so much a response to the frauds of criminals as it is to the reticence of financiers."⁵ The U.S. Securities & Exchange Commission (SEC), better than most administrative agencies, has stuck to its founding principles. Its 2003 proxy voting regulations, requiring mutual funds and advisers to disclose their policies and votes, attack a profound reticence in the financial services industry and among pension funds.

Transparency

The time is coming when all business will have to be done with glass pockets. -J. Pierpont Morgan (1913)⁶

For pensions in 2005, the word *du jour*, "transparency", 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.

⁴ C.F. Adams, Jr., "A Chapter of Erie," (1869) as reprinted in Charles F. Adams, Jr. & Henry Adams, *Chapters of Erie and Other Essays* [1871] (New York: Augustus M. Kelley, 1967), p. 8.

⁵ Thomas K. McCraw, *Prophets of Regulation* (Cambridge, Mass.: Belknap/Harvard Univ. Press, 1984), p. 173.

⁶ Ron Chernow, *The House of Morgan*, New York: Atlantic Monthly, 1990, p. 157.

Today, the financial transparency⁷ required by the Securities Acts marks only a starting point for pension and corporate reporting. Some corporate activities and, therefore, pension-fund investments have social and environmental effects that do not yield to ready quantification.⁸ Contributions to global warming is one of these. 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-financial factors, a category to which they have consigned social and corporate responsibility issues. That will change; perhaps it has already changed with the evolution of the concept of fiduciary duties.

SRI's Contribution

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.

Their broad ownership of common stock makes the pensions an integral part of the network of 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. While their primary duties run to their beneficiaries, they also owe a duty to the entities that established them for the social good.

This paper explores how pensions may fulfill that duty.

⁷ “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.

⁸ Many social and environmental issues have quantifiable costs associated with them, as employment practices do. The standards applied in these areas evolve. Even the most forward looking employment policies of 1964 would probably be actionable today.

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)⁹

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.¹⁰

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.¹¹ The practical definitions of those terms changes over time. Because of the flexibility of these concepts, the rule has endured as the nature and scope of knowledge about particular types of investments has evolved and expanded.¹² Just as the concept of fiduciary duty itself has.

⁹ John Micklethwait & Adrian Wooldridge, *The Company: A Short History of a Revolutionary Idea* (London: Weidenfeld & Nicolson, 2003), p. 74.

¹⁰ *Harvard College v. Amory*, 9 Pick. (26 Mass.) 446, 461 (1831). *Cf.* Uniform Prudent Investor Act (1994) §2 which restates the rule, clumsily, and omits both the negative reference to speculation and the explicit admonition to manage for the long term.

¹¹ 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 judicial 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 to its time. That lesson should be kept in mind when considering the importance to trustees of the SEC's rationale for its proxy voting regulations.

¹² Prof. Charles E. Rounds, Jr., pointed out to me that *Harvard College v. Amory* had nothing to do with social investing. He is correct. My point, however, is that the court did not limit to financial data the scope of the information trustees would bring to bear on a decision as to “the permanent disposition of their funds”. As individuals, trustees would consider their own ages, the life-stages and needs of their family members, their familiarity with the subject of the potential investment and other, similar factors.

One 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 questions about issues of governance, social effects and sustainability¹³ posed by the companies they own – corporations vastly larger, far more complex than even the most far-sighted could imagine in 1831.

And, pensions 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

[The securities laws must embody] the ancient truth that those who manage banks, corporations, and other agencies handling or using other people's money are trustees acting for others. -Franklin D. Roosevelt (1933)¹⁴

On January 23, 2003, the U.S. Securities & Exchange Commission (SEC) adopted regulations on proxy voting by mutual funds and investment advisers¹⁵ based on a new elaboration of the concept of fiduciary duty.¹⁶

¹³ *But compare* Uniform Prudent Investor Act §2(c) which lists only financial criteria which a trustee should consider. However, the Comment to that section (¶6) characterizes the list as “nonexclusive.”

¹⁴ Ron Chernow, *The House of Morgan, op. cit.*, p. 378.

¹⁵ 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>

¹⁶ It is the SEC's expansion of the concept that is novel and important. At least as early as 1994, the US Department of Labor was telling ERISA and Taft-Hartley plans, “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. For example, it is the Department's position that the decision as to how proxies should be voted with regard to the issues presented by the fact pattern are fiduciary acts of plan asset management....”

(continued...)

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 funds¹⁷ and the California Public Employee Retirement System (CalPERS) had done this.¹⁸

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 advisers¹⁹ who have the power to vote shares they hold on behalf of clients. Hence, they affect tens of millions of mutual fund shareholders and investment management clients who can now make more informed decisions about investments and managers.

¹⁶(...continued)

“The Avon Letter”, Feb. 23, 1994. <http://www.lens-library.com/info/dolavon.html> To the same effect, see “Interpretive bulletin relating to written statements of investment policy, including proxy voting policy or guidelines”, 29 CFR §2509.94-2(1) (hereafter “DOL Interpretive Bulletin 94-2”) http://www.dol.gov/dol/allcfr/Title_29/Part_2509/29CFR2509.94-2.htm

¹⁷ The Domini Social Equity Fund was the first mutual fund to publish (in 1992) its proxy voting guidelines and to report its votes. In 1999, it was the only mutual fund cited as reporting proxy votes by SEC Commissioner Paul R. Carey in a speech to the leading industry trade group. Paul R. Carey, “Remarks to the Investment Company Institute Procedures Conference”, Dec. 9, 1999. <http://www.sec.gov/news/speech/speecharchive/1999/spch335.htm> 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>

¹⁸ One reviewer of this paper suggested that public pension votes would be available through a state freedom of information act-type request. For a successful example of such a request in New York, see Wayne Barrett & Emily Weinstein, “Carl McCall’s Secret Self”, *Village Voice*, Aug. 21, 2002 <http://www.villagevoice.com/issues/0234/barrett.php>

¹⁹ The two sets of regulations are not identical. The SEC was not as prescriptive in the Adviser regulations. Advisers only have to make these disclosures upon a client’s request, while the funds must publish them for their clients.

But the effect of the new rules may be far broader: For they 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. Why? Trust lawyers, a notably conservative lot, will default to the most stringent statement of fiduciary duty.²⁰ Its simplicity will also appeal to them, as will its incorporation of important features of the *Restatement (Third) of Trusts* “prudent investor rule”.²¹

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 to proxies as s/he does in managing money.

²⁰ As noted earlier, the U.S. Department of Labor has held that such a duty exists under ERISA. What Labor has not done – and why the SEC regulations will define the duty – is say how trustees will fulfill it. See p.5n.14, *supra*.

²¹ *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 the application of social criteria in investment decision-making by trustees under particular conditions. Until his death, Scott was the Reporter for the *Restatement of Trusts*. But see the Comment to the Uniform Prudent Investor Act (UPIA) (1994) §5 For a more complete discussion of the legal authorities, see the Appendix to this paper which quotes and discusses the UPIA.

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

Far more serious than these ad hoc special relationships [between institutional investors and conglomerates] is the general problem created by lodging the power and responsibility for the selection and legitimation of corporate management in the hands of people who have disclaimed any interest in the election decision. The standard line of the institutional manager is: 'We vote with the management. If we don't like the management, we sell the stock.' Since institutions now own about one-quarter of the shares of the companies listed on the New York Stock Exchange, this attitude creates a rather large vacuum in the corporate election process. -David L. Ratner (1970)²²

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.²³ By defending their regulations in terms of fiduciary responsibilities, the Commission foreclosed the possibility of resuming that practice.²⁴

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.

²² David L. Ratner, "The Government of Business Corporations: Critical Reflections on the Rule of 'One Share, One Vote'", 56 Cornell L. Rev. 1, 26 (1970).

²³ *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.

²⁴ The Department of Labor's "Avon Letter", *supra*, describes the duty as fiduciary and, by example, states it applies to resolutions proposing a change in the state of incorporation or a "poison pill". While plan sponsors or trustees may delegate the responsibility to vote proxies to a manager, they must "monitor" the votes. But the "Avon Letter" does not require public reporting of the votes and does not mention the need for public proxy voting guidelines. To the same effect, *see also* DOL Interpretive Bulletin 94-2, 29 CFR §2509.94-2 http://www.dol.gov/dol/allcfr/Title_29/Part_2509/29CFR2509.94-2.htm

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.²⁵

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.”²⁶

The Commission might have limited the duty to those aspects of proxy voting that affected financial performance – something, arguably, the Department of Labor has done.²⁷ But the SEC's formulation applies to anything that can appear on a proxy ballot, from the election of directors to social issues.

“Monitor Corporate Events”. As noted earlier, the adviser and mutual fund regulations are not identical.²⁸ 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.”²⁹

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

²⁵ 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.

²⁶ Adviser Regulations rationale, *op. cit.* See the Appendix, below, on how the duty of loyalty applies generally to socially responsible investing.

²⁷ The Department of Labor's “Avon Letter” (1994) 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> See also DOL Interpretive Bulletin 94-2, 29 CFR §2509.94-2 http://www.dol.gov/dol/allcfr/Title_29/Part_2509/29CFR2509.94-2.htm

²⁸ The SEC adopted the respective regulations under different statutes, but that is not the reason for the differences in rationale and approach.

²⁹ Adviser Regulations rationale, *op. cit.* The “Avon Letter”, *supra*, notes the duty of trustees to monitor the performance of managers to whom they have delegated voting authority.

The following are examples of specific types of issues that are covered by some 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.³⁰

The funds whose guidelines the Commission cited are all social funds.

In my view, the plain implication of this list is that advisers and mutual funds should now monitor the same types of events as KLD has reported on for 13 years.³¹ The SEC's examples indicate that it has adopted – in this context, at least – social investors' view of what fundamental analysis should include and, I would argue, what fiduciary responsibilities now rest on trustees.³²

The DoL Position. In its Interpretive Bulletin 94-2, the Department of Labor outlined the duties of trustees under the Employee Retirement Income Security Act of

³⁰ Mutual Funds Regulations rationale, *op. cit.*

³¹ *But compare* Charles E. Rounds, Jr., *Loring A Trustee's Handbook*, 2004 ed. (New York: Aspen Publishers, 2004) §3.5.3.1(e) (hereafter "Rounds, *Trustee's Handbook*") which asserts the trustee must "act solely in the economic interests of the beneficiary in light of the manifested intentions of the settlor." As discussed in the Appendix, below, Prof. Rounds is too broad in his claim. (Rounds does not address the SEC proxy regulations in this section or in §3.5.3.1(e) "The power to vote proxies", though they appeared in January 2003 and his book in 2004.) He is on more solid ground here when he adds, "One has no power as trustee to indulge one's own social and political predilections with the stockholder's franchise." It probably goes without saying that the operative word here is "indulge".

³² It is possible, as one reviewer of this paper commented, to give "corporate events" a very limited definition, encompassing only things of the magnitude of a merger, a bankruptcy, *etc.*, and therefore excluding social proxy questions and the like. This usage is common among one narrow sector of the financial services industry, benchmark index providers. The SEC's repeated use of the word "issues" in its list of examples, I think, disposes of this argument. DoL Interpretive Bulletin 94-2, quoted above, uses "issues".

1974 (ERISA) as to investment policy statements and proxy voting.³³ The first sentence of part (3) of the Bulletin, adopted in 1994, states:

An investment policy that contemplates activities intended to monitor or influence the management of corporations in which the plan owns stock is consistent with a fiduciary's obligations under ERISA where the responsible fiduciary concludes that there is a reasonable expectation that such monitoring or communication with management, by the plan alone or together with other shareholders, is likely to enhance the value of the plan's investment in the corporation, after taking into account the costs involved.

Bulletin 94-2 acknowledges that such “a reasonable expectation may exist in various circumstances....”³⁴ It then lists a number of standard governance-type issues, followed by “assuring that the [corporation’s] board has sufficient information to monitor management”.³⁵ There follows a second list of governance-type issues which concludes with:

the nature of long-term business plans, the corporation's investment in training to develop its work force, other workplace practices and financial and non-financial measures of corporate performance.³⁶

Given a broad – but not unreasonable – reading, the DoL’s Interpretive Bulletin 94-2 is roughly congruent with the SEC’s Mutual Fund regulations. The scope of what is commonly understood to be within a corporate board’s purview has changed since 1994. More importantly, so has the conception of what enhances “the value of the plan’s investment”.³⁷

“Corporate Governance”: A New Substance

In the Mutual Fund regulations, the SEC swept away the decade-old distinction between social and governance issues. “Corporate governance” has lost its earlier

³³ DOL Interpretive Bulletin 94-2, *supra*, 29 CFR §2509.94-2(3)
http://www.dol.gov/dol/allcfr/Title_29/Part_2509/29CFR2509.94-2.htm

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.*

definition and become a catch-all for subjects of administrative reforms ranging from auditor independence to directors' fees to executive compensation.

In the context of these issues and “corporate events”, the SEC has restored “corporate governance” to its old meaning: the structures and procedures used to organize a corporation – directors’ terms, board committees, senior executives’ lines of authority, and the like.

The SEC’s focus has shifted beyond “corporate governance” to how a company is being run: corporate *governing*. That is the significance of the list of examples of activities mutual funds must monitor. This interpretation may signal increasing power for shareholders and stakeholders, but a substantial barrier – of the SEC’s creation – exists.

The issues that shareholders may raise are limited by the SEC’s rules limiting access to the proxy ballot. The “ordinary business” 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 until 1999 discrimination in hiring against gays.³⁸ Former SEC Chair, Harvey L. Pitt, suggested in a September 2003 speech that the exemption be dropped. But, no proposed rules have appeared.³⁹

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?

³⁸ Securities & Exchange Com’n, “Amendments to Rules on Shareholder Proposals”, Release Nos. 34-40018, IC-232000, May 21, 1998, 1998 SEC LEXIS 1001.

³⁹ “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)⁴⁰

For pensions, the SEC’s new interpretation of an advisor or fund’s fiduciary duties 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.⁴¹ On the other, as major factors in our financial and corporate systems, pensions have an obligation to advance integrity and legitimacy⁴² 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 perform their primary duty – to meet their obligations to their beneficiaries – depends on their positive roles as part of our financial system and as owners – but not managers – of corporations. While distinct in description, the three roles intertwine and are inseparable in practice.

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.

⁴⁰ 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”).

⁴¹ By using “primary” here, I do not ignore the statutes which make this duty the sole one of pension schemes. It is the first, the main duty of all pensions regardless of governing legislation.

⁴² Robert A.G. Monks and Nell Minow made this point a decade and a half ago in their important 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 requires shareholders to assume the responsibility to act as owners of a corporation in the way partners would own their business. In fact as Adam Smith pointed out in 1776, the opposite is true:

[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.⁴³

By its legal nature, the joint stock company (the modern “corporation”)⁴⁴ freed its owners from liability for anything beyond their investment. The shareholder’s freedom from accountability made these business organizations noxious to Smith. In partnerships (Smith’s “copartnery”), the partners were liable for debts each incurred,⁴⁵ and the liability was not limited, as shareholders’ was. Bad business judgment could result in confinement in a debtors prison – which made Rikers Island look like “Club Fed” – until the debtor died or the debt was satisfied.

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

⁴³ Adam Smith, *The Wealth of Nations* [5th ed. 1789 (Glasgow ed.)] (Indianapolis, Ind.: Liberty Press, 1981), p. 741 [V.i.e.18].

⁴⁴ 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).

⁴⁵ In law, this is termed “joint and several liability”, and it explains why, next to trustees, partners have the most stringently enforced fiduciary duties.

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 the public interest. Yet no criteria of good corporate performance have yet been worked out.⁴⁶

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

Let us be clear: if the billions of dollars that companies spend on their direct operations are spent in a principled manner and fall within the skills and direct responsibilities of the company, this will have a far greater impact on world problems than any arbitrary philanthropy, even if this runs into millions.-Sir Geoffrey Chandler (2004)⁴⁷

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.⁴⁸

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

⁴⁶ Gardiner C. Means, "Implications of the Corporate Revolution in Economic Theory," (1967), in Berle & Means, *op. cit.*, p. xlvii.

⁴⁷ Sir Geoffrey Chandler, "Corporate Social Responsibility: The International Aspects", Keynote Address, Conference on Corporate Social Responsibility and the Role of the Lawyer, Amsterdam, June 25, 2004.

⁴⁸ See generally David Vogel, *Lobbying the Corporation* (New York: Basic Books, 1978).

mission. It has a much longer history than shareholder activism, perhaps dating to the 17th century.⁴⁹

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.

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.⁵⁰ And, it was in that context US pensions first encountered social investing.

⁴⁹ Peter D. Kinder, *et al.*, *Investing for Good* (New York: HarperCollins, 1993), pp. 12-15.

⁵⁰ Here is not the place 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: 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).

Pensions & South Africa. In its relationships with institutions, South Africa transformed SRI.⁵¹ 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 corporations. 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 (IRRC) 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 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.⁵² Today, KLD reports on nearly 100 screens under the following headings:

⁵¹ South Africa, however, was not a catalyzing issue for most individual investors which is why SRI survived the end of sanctions and the scurry away from social screening by pensions and endowments.

⁵² KLD maintains five benchmark indexes of which the Domini is the oldest. They were originally intended to gauge the costs of social investing.

Qualitative Screening Areas

Community
Corporate Governance
Diversity
Employee Relations
Environment
Human Rights
Product Quality & Safety

Exclusionary Screening Areas

Alcohol
Firearms
Gambling
Military Weapons
Nuclear Power
Tobacco

Taken together, these screens amount to the most comprehensive and widely accepted statement of the social and environmental characteristics against which investors and, indeed, the public evaluate US corporations.

As a gauge of corporate social responsibility and sustainability, 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.⁵³

Screening & Pensions: A Final Note. In the end, South Africa proved that pressure of many different types on corporations, pensions and endowments could affect the course of social change. US institutions – pensions included – and the corporations they owned responded to shareholder activists and, at the end, state and federal legislatures.

⁵³ 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>

But while the interaction with institutions may have transformed SRI, it did not transform the pensions.⁵⁴ For at the same time that the pensions were being forced to divest, Modern Portfolio Theory (MPT) began its rise to dominance.

MPT's mantras on diversification and risk merged with hoary arguments against social screening.⁵⁵ On that basis, 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 by their nature require screening based on industry groupings, stock characteristics or the like.

Yet, 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.

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.⁵⁶

⁵⁴ See *Bd. Of Trustees v. Mayor of Baltimore City*, 317 Md. 72, 562 A.2d 720 (1989), *cert. den. sub nom. Lubman v. Baltimore City*, 493 U.S. 1093, 107 L.Ed. 2d 1069, 110 S.Ct. 1167 (1990) which is discussed and quoted at length in the Appendix to this paper. In this, the only English-language case involving SRI to have a full trial and reach a court of last resort, the trustees failed to overturn an ordinance which would have required them, under limited circumstances to divest. Nonetheless by the end of sanctions in 1994, I am told, the trustees had never divested despite losing the case.

⁵⁵ 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) (hereafter "Langbein & Posner"). Uninhibited – as often in their writings – by the dearth of supporting data, Langbein & 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.

Activism & Engagement

To measure the effectiveness of an ethical sanction by whether it caused a country to make a U-turn makes as little sense as to describe sanctions against South Africa as futile because they have failed to destroy apartheid before now. The aim is to influence for the better. And opportunism as well as absolute values must play a part. -Financial Times editorial (1990)⁵⁷

As noted earlier, shareholder activism – now often called “engagement” – emerged at the same time as modern portfolio screening. They share common values frameworks. They have nurtured and cross-pollinated each other for more than 35 years.

It is no small irony that today “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.⁵⁸

Signs have appeared amongst the news from this year’s annual meetings that institutional shareholders responded to the SEC’s nudging with an avalanche of actions.⁵⁹ The agreement of American Electric Power and Southern Company to report on climate change issues is the clearest of these.⁶⁰

Shareholder actions almost always target large, highly visible companies. Their proponents hope that change at the top will cause other companies to follow. Hence,

⁵⁷ "The Ethical Ways to Invest," *Financial Times* (London), April 14, 1990, p. 6.

⁵⁸ Mutual Fund Regulations rationale, *supra*.

⁵⁹ See e.g., G. Jeffery MacDonald, “A Record Year for Shareholder Activism”, *Christian Science Monitor*, June 28, 2004.

⁶⁰ 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

they target Procter & Gamble, the Gap and the like. Usually the issues fall within the screening issues typically applied by social investors. In many instances – most notably with South Africa and the environment – shareholder actions have led to increased refinement in screens and screening.

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 application to companies at large. But if that is true of social and environmental resolutions, it is even more so of governance issues.

Governance activists almost never leave the Russell 1000 for their targets. And the threat of their efforts is 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.

In contrast to the social and environmental activists, the great weakness afflicting governance activism is its lack of a comprehensive framework of standards. Its approach is fundamentally *ad hoc* in comparison with social screening⁶¹ 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”.

⁶¹ ISIS Asset Management (UK) (now F&C Asset Management, PLC) 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).
Univ. of Colorado, Leeds School of Bus. -21- March 11, 2005

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)⁶²

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”

Unlike the conglomerate-builders, who buy shares largely to amass enough of the votes that are attached to them to take control of the company’s assets, the institutional investors generally want shares only for the possibility of profit or return. They do not really want the votes, which require them to make decisions for which they do not want to be held responsible. -David L. Ratner (1970)⁶³

Shareholder activism as presently practiced by pensions reveals its bastard heritage. It is the product of the paroxysm of corporate acquisitions in the 1980s.⁶⁴ Raiders and pensions alike justified their actions by invoking “the maximization of shareholder value”.⁶⁵

⁶² 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.

⁶³ David L. Ratner, *op. cit.*, p. 26.

⁶⁴ See “The Avon Letter”, *supra*. It bears noting that the only two practical examples of issues the ERISA administrator cited were anti-takeover maneuvers. Also DoL Interpretive Bulletin 94-2, *supra*, and the Uniform Prudent Investor Act, discussed in the Appendix, *infra*, were adopted within days of each other in the Summer of 1994 and within a few weeks of the end of sanctions on South Africa. Neither 94-2 nor the UPIA even implicitly refers to the controversy over how South Africa affected both proxy voting and the trustee’s duty of loyalty. Given the heat of this controversy for the preceding 15 years, this is at least odd.

⁶⁵ 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.

(continued...)

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 wide-spread acquiescence to the so-called management buyout....⁶⁶

It may be that the pensions' abetting of corporate restructuring well served their beneficiaries in 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 of 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”.⁶⁷

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

⁶⁵(...continued)

It also mitigates toward long-term thinking, rather than quarter-by-quarter management.

⁶⁶ Monks & Minow, *op. cit.*, pp. 47-48.

⁶⁷ Again, as noted at the outset, pensions are not subject to the SEC's 2003 proxy voting regulations.

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 built. The essential elements are a stable base of permanent shareholders represented by trustees who exercise care and loyalty.⁶⁸

Sadly, they were wrong then. There is little reason to think that they are right today. But the stakes are much higher for pensions now, 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.”⁶⁹

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

⁶⁸ Monks & Minow, *op. cit.*, p. 244.

⁶⁹ *Harvard College v. Amory*, 9 Pick. (26 Mass.) 446, 461 (1831).

Appendix

Notes on *Loring A Trustee's Handbook* (2004 ed.) §6.1.3

For me, the twisting of the law by lawyers is especially troubling. I have spent my life believing that the safety of this difficult, diverse country lies to a significant extent in the good faith of lawyers -- in their commitment to respect the rules. -Anthony Lewis (2004)⁷⁰

In law school legal research courses, one learns to disdain legal encyclopedias and treatises as the least valuable of legal authorities. In law practice, one finds they are indispensable for their pedantic reliability. And the young lawyer comes to rely on them as his starting point. Or rather on some of them, for others – which he describes with expletives – have misled him.

Because my first job as a lawyer was in the Charitable Trusts Section of the Ohio Attorney General's Office, I am especially aware of the value of treatises and acutely sensitive to their quality. While there, I worked on a major case which traipsed across uncharted territory. We were lost.

One of my peers discovered a Rosetta Stone: Marion Fremont-Smith, *Foundations and Government: State and Federal Law Supervision* (Russell Sage Foundation, 1965). Thirty years later, I can still feel the relief and, later, assurance her invaluable treatise provided. So, I bring a certain perspective to my examinations of treatises.

These thoughts arose while I prepared for a conference at the American Enterprise Institute in June 2004. I had looked at the treatise authored by my co-panelist, Prof. Charles E. Rounds, Jr.,⁷¹ which he had cited 13 times in his paper.⁷² This Appendix describes what I found there about socially responsible investing and what I believe to be its deficiencies.

⁷⁰ Anthony Lewis, "Making Torture Legal", *New York Review of Books*, July 15, 2004, pp. 4, 6.

⁷¹ Rounds, *Trustee's Handbook*, *op. cit.*

⁷² Charles E. Rounds, Jr., "Public Pension Funds, Charitable Fund, and the Social Security Trust Fund: When the State Gets into the Investment Business, Social Investing is Inevitable and There is Little the Law Can Do About It", paper presented at the American Enterprise Institute, June 7, 2004.

http://www.aei.org/events/eventID.832,filter.all/event_detail.asp

SRI: “Indirect Benefit” to Trustee? I focused, in particular, on a discussion in §6.1.3.4 “Indirect Benefit Accruing to the Trustee” which he did not discuss in his paper⁷³ but certainly echoed.

He begins with a classic example of a trustee usurping a trust asset for his/her benefit. He notes the temptations trust assets can pose for trustees and urges conduct like that of “Caesar’s wife”.⁷⁴ Then, Rounds identifies social investing as one of those temptations:

Social investing has been defined by Professor Langbein and Judge Posner as the “pursuit of an investment strategy that tempers the conventional objective of maximizing the investor’s financial interests by seeking to promote nonfinancial social goals as well.” A trustee who without express authority in the governing instrument voluntarily undertakes to practice social investing uses the trust estate, *i.e.*, other people’s property, to promote the trustee’s own political and social goals – a clear case of indirect self-dealing.⁷⁵

Leaving aside the question of how one can clearly deal indirectly with oneself, the loaded language yields a valid point: a trustee cannot use trust assets to “promote” his or her “goals”.⁷⁶ But, that does not mean even trustees lacking express authority are categorically barred from applying social or ethical criteria, as I will show later.

SRI: “Acting on Divided Loyalties”? Rounds goes on to argue that yielding to third-party demands to apply social criteria amounts to “acting on divided loyalties” and that trustees, by so doing, “may be subordinating the interests of the trust to the interests of the trustee.”⁷⁷ Then comes:

⁷³ *But see id.*, p. 13 where he discusses a footnote to this section but not in the context of the fiduciary issues addressed in this Appendix. Rounds does not define or give an example of an “indirect benefit”.

⁷⁴ Given the conduct of the wives of the Caesars – Augustus, Caligula and Claudius, especially – this seems an inappropriate caution.

⁷⁵ Rounds, *Trustee’s Handbook* §6.1.3 at pp. 277-78 (footnotes omitted). The Langbein-Posner SRI definition is discussed at note 36 above. In support of the propositions in his final sentence, Prof. Rounds cites a libertarian journal which criticizes Ralph Nader’s stock holdings and Rounds’s memorable law journal article on interest on lawyers’ trust accounts (IOLTA). *Id.*, p. 278nn.164, 165.

⁷⁶ Unless, of course, they happen to correspond with the trust’s – a far from uncommon situation.

⁷⁷ *Id.*, p. 278. For these propositions, Rounds cites, respectively, a *Wall Street Journal* article on the

(continued...)

If social investing has any place in the law of trusts, it is incumbent upon the courts and the legislatures to create objective standards, *i.e.*, to define away this exception to the trustee's duty of undivided loyalty in a way that establishes reasonable limits on a trustee's right to promote with the trust estate his own personal, political, and social goals, or the personal, political, and social goals of third parties.⁷⁸

In fact, the parameters of a "trustee's right to promote with the trust estate ... personal, political, and social goals" are well-established. But Prof. Rounds chose to ignore what didn't fit his viewpoint – a cardinal sin for a treatise writer.

Scott's General Rule. The late Harvard professor, A.W. Scott, stated the basic rule on trustees and SRI:

Trustees in deciding whether to invest . . . may properly consider the social performance of the corporation. They may decline to invest in, or to retain, the securities of corporations whose activities . . . are contrary to . . . ethical principles. They may consider such matters as pollution, race discrimination, fair employment, and consumer responsibility.⁷⁹

Prof. Scott did not assume, as Prof. Rounds does, that applying such criteria must necessarily reveal the trustees' improperly divided loyalties. Rather, Scott asserts the trustees' investment decisions may reflect the principles, the values of their community.

⁷⁷(...continued)

controversy over the Hershey Trust and Langbein & Posner, *op. cit.*, at pp. 278-79nn.166-168. The last footnote contains an extended discussion of the Department of Labor's interpretations of ERISA as it applies to Economically Targeted Investments (ETIs). Compare Robert A.G. Monks & Nell Minow, *Power and Accountability, op. cit.*, p. 221, who argue, "The traditional trust concept of an undivided duty of loyalty may not be possible in the context of pension funds, where both fiduciaries and beneficiaries are so divided in needs, priorities and responsibilities." Monks served as ERISA administrator during the first Reagan administration.

⁷⁸ *Id.*, p. 279. "Incumbent on the courts and legislatures": One US court of last resort has spoken on precisely these issues, but Rounds does not cite – much less discuss – its opinion which runs counter to his. Prof. Rounds cites neither Scott, nor the *Restatement (Third)* prudent investor rule, nor the ERISA administrator's Advisory Opinion 98-04a, much less *Bd. of Trustees v. Mayor of Baltimore City* – all of which are cited and discussed below. The most recent of these has a publication date six years before Rounds's treatise's

⁷⁹ 3A. Scott, *The Law of Trusts* (W. Fratcher 4th ed. 1988) § 227.17. See the discussion below of *Bd. of Trustees v. Mayor of Baltimore City*, 317 Md. 72, 562 A.2d 720 (1989), *cert. den. sub nom. Lubman v. Baltimore City*, 493 U.S. 1093, 107 L.Ed. 2d 1069, 110 S.Ct. 1167 (1990) which quotes this language approvingly. But compare Langbein & Posner, *supra*, at 99-100, who correctly note Scott's lack of supporting citations for this proposition and ERISA's contrary implications. Given their lack of supporting data and citations for their propositions, it seems a classic pot-kettle proposition.

The Restatement (Third) of Trusts. Prof. Scott was the long-time reporter for the *Restatement of Trusts*, the most influential treatise in the field. A project of the American Law Institute, the *Restatements* attempt to compile and codify the common law of America's fifty states and, as in the case of social investing, to fill in the blanks.

In 1992, the *Restatement's* "prudent investor rule" appeared. The rule itself does not address SRI but the Comments to the rule – which courts and lawyers rely upon – do.⁸⁰ Here the general rule is closer to Rounds's approach, but it is not inconsistent with Scott's:

[In] managing the investments of a trust, the trustee's decisions ordinarily must not be motivated by a purpose of advancing or expressing the trustee's personal views concerning social or political issues or causes. Such considerations may properly influence the investment decisions of the trustee to the extent permitted by the terms of the trust or by the consent of the beneficiaries.⁸¹

In the area of charitable trusts, the *Restatement* suggests trustees have considerable latitude in applying social criteria:

[S]ocial considerations may be taken into account in investing the funds of charitable trusts to the extent the charitable purposes would justify an expenditure of trust funds for the social issue . . . or to the extent the investment decision can be justified on grounds of advancing, financially or operationally, a charitable activity conducted by the trust.⁸²

So, it would seem that trustees of a charitable trust can lose on social investments an amount roughly equivalent to what they might grant to the same cause.

⁸⁰ *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. *But compare* Uniform Prudent Investor Act § 5, the comment to which says that under certain circumstances trustees can violate their duty of loyalty by implementing a social investment policy. See the discussion of this, above

⁸¹ *Id.* To the same effect, *see* *Uniform Trust Code* §802 Comment ¶2: "In the case of a charitable trust, the trustee must administer the trust solely in the interests of effectuating the trust's charitable purposes."

⁸² *Id.* The Charity Commission for England and Wales has gone as far, too. Its guidelines make sophisticated distinctions between the types of social investments trustees may properly make. *See* "Useful Guidelines – Charities and Social Investment"

<http://www.charity-commission.gov.uk/supportingcharities/casi.asp>

That is not a radical proposition. The *Restatement* recognizes the institutional imperative of, say, a Quaker institution to maintain a portfolio free of armaments manufacturers or a Catholic diocese to avoid primary-care facilities that perform abortions – even at some cost to their portfolios.

No one could argue public pension fund trustees might have the same discretion to lose money on a socially responsible investment program. Nonetheless, the *Restatement* does not reflect Prof. Rounds’s concerns about SRI leading to divided loyalties or indirect benefits.

DoL PWBA Advisory Opinion 98-04A. In 1998, the Calvert Group sought an advisory opinion from the U.S. Department of Labor on whether a defined-contribution plan subject to the Employee Retirement Income Security Act (ERISA) could include one or more socially screened mutual funds. It responded:

The Department has expressed the view that the fiduciary standards of sections 403 and 404 do not preclude consideration of collateral benefits, such as those offered by a ‘socially-responsible’ fund, in a fiduciary’s evaluation of a particular investment opportunity. However, the existence of such collateral benefits may be decisive only if the fiduciary determines that the investment offering the collateral benefits is expected to provide an investment return commensurate to alternative investments having similar risks.⁸³

The “commensurate return”/“similar risk” approach has been the Department’s since the early 1980s.⁸⁴ Again, no hint of concerns about the trustees’ divided loyalties or indirect benefits.

Bd. of Trustees v. Mayor of Baltimore City. The only case on the fiduciary duties of trustees as to social investing to reach a court of last resort in an English-speaking jurisdiction is *Bd. of Trustees v. Mayor of Baltimore City* decided by the Maryland Court of Appeals in 1989.⁸⁵

⁸³ “Calvert Letter”, US Dept. Of Labor PWBA Advisory Opinion 98-04A (May 28, 1998) <http://www.dol.gov/ebsa/programs/ori/advisory98/98-04a.htm> (footnote omitted).

⁸⁴ *Id.* p. 3n2.

⁸⁵ *Bd. of Trustees v. Mayor of Baltimore City*, 317 Md. 72, 562 A.2d 720 (1989), *cert. den. sub nom. Lubman v. Baltimore City*, 493 U.S. 1093, 107 L.Ed. 2d 1069, 110 S.Ct. 1167 (1990).

In this case, the trustees of the Baltimore City pension funds sought to void ordinances passed by the City Council which would have required them, under very limited circumstances, to divest their funds of stocks issued by companies doing business in South Africa. In the course of rejecting constitutional arguments not relevant here, the court addressed the trustees' duties of prudence and loyalty.⁸⁶

The court's opinion is quite clear and at least as good as any summary of mine might be. So, I will quote from it at length.

In a related argument, the Trustees contend that the Ordinances alter the duty of prudence by mandating the consideration of social factors unrelated to investment performance. Under the circumstances of this case, we disagree.

No less an authority than Professor Austin Wakeman Scott rejected the proposition that "trustees are rigidly bound to attempt to secure the maximum return, whether as to income or principal, consistent with safety."⁸⁷

The court then quoted Scott's general rule on SRI which is quoted at p. 25, above.⁸⁸

For this position, Scott relied in part on an analogy to the corporate fiduciary's limited right to make charitable contributions; just as the directors may conclude that charitable contributions are in the corporation's long-term interests, so too a trustee "may well believe that a corporation that has a proper sense of social obligation is more likely to be successful in the long run than those that are bent on obtaining the maximum amount of profits." "But," he continued, "even if this were not so, the investor, though a trustee of funds for others, is entitled to consider the welfare of the community, and refrain from allowing the use of funds in a manner detrimental to society."⁸⁹

⁸⁶ It might be argued that the court's treatment of the trustees' duties of prudence and loyalty is *dicta*. Given the court's elaborate response to the issues and its context, that seems unlikely. *See id.*, 562 A.2d at 736-38.

⁸⁷*Id.*, 562 A.2d at 736.

⁸⁸ 3A *Scott on Trusts, op. cit.*, §227.17.

⁸⁹ *Bd. of Trustees, supra*, 562 A.2d at 736-37 (citations and footnotes omitted). I have heard it argued that corporate charitable contributions amounted to what Prof. Rounds terms an "indirect benefit", since executives and directors receive kudos – some distinctly tangible – for what the company has conferred. This argument seems much less far fetched than Rounds's about trustees and SRI.

These views are consistent with the position that a trustee's duty is not necessarily to maximize the return on investments but rather to secure a "just" or "reasonable" return while avoiding undue risk. [Citations omitted.]⁹⁰ As one commentator stated, a "trustee is under no duty to open a brothel in Nevada, where prostitution is legal, in order to maximize return to beneficiaries." [Citation omitted.] Thus, if, as in this case, social investment yields economically competitive returns at a comparable level of risk, the investment should not be deemed imprudent.⁹¹

The court then turned to the trustees' argument that the ordinances affected their ability to fulfill their duty of loyalty to the beneficiaries.

Moreover, as with the duty of prudence, the Baltimore City Code incorporates ERISA's formulation of the trustee's duty of loyalty (Art. 22, §§ 7(h), 35(h)):

"The Board of Trustees shall discharge its duties ... solely in the interest of the members and beneficiaries and:
(1) For the exclusive purpose of:
(i) providing benefits to members and beneficiaries...."

The Trustees urge that, by requiring them to consider the interests of persons other than the beneficiaries and by requiring them to manage the systems for purposes other than providing benefits, the ordinances change this duty.

It is clear that the trustee's duty of loyalty extends beyond a prohibition against self-dealing and conflict of interest, two wrongs that are not present in this case. Even if the trustee has no personal stake in a transaction, the duty of loyalty bars him from acting in the interest of third parties at the expense of the beneficiaries. [Citations omitted.]

Nevertheless, we do not believe that a trustee necessarily violates the duty of loyalty by considering the social consequences of investment decisions. If, as in this case, the costs of considering such consequences are *de minimis*, the trustee ordinarily will not have transgressed that duty.

Although Professor Scott termed the trustee's duty of loyalty "[t]he most fundamental duty owed by the trustee to the beneficiaries," IIA *Scott on Trusts, supra*, §170, he clearly believed that the obligation could be reconciled with considering the ethical implications of the trust's investments. See III *Scott on Trusts, supra*, §227.17.

⁹⁰ The court cited eight law journal articles and treatises in support of its statement. It then explicitly acknowledged Langbein & Posner, *op. cit.* as taking a contrary view. With that treatment compare Rounds, *Trustee's Handbook* §6.1.3 at pp. 277-80nn.163-70.

⁹¹ *Bd. of Trustees, supra*, 562 A.2d at 737. The court quoted J.C. Dobris, "Arguments in Favor of Fiduciary Divestment of 'South African' Securities", 65 Neb. L. Rev. 209, 232 (1986).

Our conclusion is consistent with that belief. Moreover, our opinion in this case is broadly consistent with the requirement, embodied in the Baltimore City Code, that the trustees act “solely in the interest of the beneficiaries,” and “for the exclusive purpose ... of providing benefits.” As Professor Scott recognized, under some circumstances trustees may well believe that, by investing in businesses with “a proper sense of social obligation,” they will in the long run best serve the beneficiaries’ interests and most effectively secure the provision of future benefits. *Ibid.*

Consequently, the Ordinances do not change the Trustees’ duties of prudence and loyalty, which are implicit in the pension contracts.⁹²

The Uniform Prudent Investor Act §5 Comment. Lest the sins of omission already noted seem unprecedented, a glance is in order at something which supports Rounds but is buried in a footnote to §6.1.3.⁹³

The Uniform Prudent Investor Act is an extremely important statute which has been adopted in about 45 US jurisdictions since its promulgation by the American Bar Association in 1994.⁹⁴ Section 5 states the duty of loyalty in one terse sentence: “A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries.”⁹⁵

As is common in treatises and Uniform State Laws, the drafters accompanied the “black letter law” with a “comment” explaining the text and citing authority for it. As here, the gloss is usually many times longer than the statement it discusses.⁹⁶ And

⁹² *Bd. of Trustees, supra*, 562 A.2d at 738. It might be argued that the Uniform Prudent Investor Act § 5 would alter the court’s holding on the duty of loyalty. As discussed above, the comment to that section takes a categorical approach to any social investments that would sacrifice the interests of the beneficiaries. Here, the plaintiffs could not show a loss to the pensioners through a diminution of their promised benefits. They could only show what *might* have been a nominal cost to the pension funds.

⁹³ Rounds, *op. cit.*, p. 278n.168.

⁹⁴ See Uniform Law Commissioners, Fact Sheet - Uniform Prudent Investor Act. http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-upria.asp The Act was drafted by a committee of the National Conference of Commissioners of Uniform State Laws. The notes that follow discuss that committee and its membership.

⁹⁵ The Uniform Prudent Investor Act §5 and the Comment to it are to be found at: <http://www.law.upenn.edu/bl/ulc/fnact99/1990s/upia94.htm> One reaches that site via the NCCUSL site, <http://www.nccusl.org>

⁹⁶ The Comment to §5 consists of four paragraphs. The last paragraph – which is 14 times longer (continued...)

for courts and lawyers, the drafters' interpretation is as important as the text itself. The last paragraph of the Comment to §5 begins,

No form of so-called "social investing" is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries - for example, by accepting below-market returns - in favor of the interests of the persons supposedly benefitted by pursuing the particular social cause.

In support of this proposition the Comment then cites the Langbein & Posner article, discussed above, which in 1994 was 14 years old. As with Rounds, not one of the authorities discussed above in this appendix is cited in the Comment, including the Maryland Court of Appeals decision. Not one – and the Maryland case was then five years old!

There follows, “Commentators supporting social investing tend to concede the overriding force of the duty of loyalty. They argue instead that particular schemes of social investing may not result in below-market returns.”⁹⁷ The Comment cites a couple of law journal articles in support of what the Reporter wishes the reader to believe are reluctant acceptances of the duty of loyalty – something the articles themselves don't question, just as the Maryland Court of Appeals doesn't.

The Comment to §5 ends with this discussion:

In 1994 the Department of Labor issued an Interpretive Bulletin reviewing its prior analysis of social investing questions and reiterating that pension trust fiduciaries may invest only in conformity with the prudence and loyalty standards of ERISA §§ 403-404. Interpretive Bulletin 94-1, 59 Fed. Regis. 32606 (Jun. 22, 1994), to be codified as 29 CFR §2509.94-1. The Bulletin reminds fiduciary investors that they are prohibited from "subordinat[ing] the interests of participants and beneficiaries in their retirement income to unrelated objectives."

⁹⁶(...continued)

than §5, itself, and contains as many words as the first three paragraphs combined – is the one under discussion here.

⁹⁷ Assuming, as I do, that John Langbein had something to do with the drafting of this comment (*see* p. 34, below), it is worth contrasting the treatment of data on SRI performance here and in his article with Richard Posner, discussed above. When the 1980 article appeared, there was virtually no performance data available. Then, Langbein & Posner simply made assumptions about how SRI portfolios must perform, and based their criticism on those assumptions. In 1994, mutual fund performance data existed for at least 20 funds and KLD's Domini 400 Social Index had reported data for four years. These data were ignored, presumably because they did not fit the Comment's implication that screened portfolios underperform.

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It is sufficient to note that the phrase “social investing” does not appear in the cited DOL bulletin and that it does not review DOL’s “prior analysis” of anything.⁹⁸

How did this misrepresentation of the outstanding authorities come to be in the Comment? I have found no “smoking gun”. But, here are two intriguing facts.

- The American Bar Association adopted the UPIA in the summer of 1994, the same summer in which South Africa sanctions ended.
- John Langbein, whose longstanding opposition to social investing I’ve noted, was the Reporter for the UPIA⁹⁹ which it may safely be assumed gave him a strong voice in the drafting of the Comment.

Whatever the explanation, the misrepresentation to bench and bar of the authorities cannot be justified.

The Treatise Author’s Obligation. The point of this lengthy appendix is not that Prof. Rounds’s *Trustee’s Handbook* is wrong in its position that trustees violate their duty of loyalty when they apply social investment criteria. One state supreme court, the US Department of Labor, the Securities & Exchange Commission (probably) and a couple of treatises disagree with him.¹⁰⁰ The point cannot be said to be settled absolutely against him.

I have described the contrary opinions because, I believe, Prof. Rounds violated his duty to acknowledge authorities who disagreed with him. The writer of legal treatises bears a special obligation to his readers to guide them to all authorities on point.

⁹⁸ Interpretive bulletin relating to the fiduciary standard under ERISA in considering economically targeted investments, 29 CFR §2509.94-1.
http://www.dol.gov/dol/allcfr/Title_29/Part_2509/29CFR2509.94-1.htm

⁹⁹ He is so designated in the list of UPIA committee members.
<http://www.law.upenn.edu/bll/ulc/fnact99/1990s/upia94.htm>

¹⁰⁰ I have omitted a summary of the many law journal articles on the subject of SRI and fiduciary duties, since they rely mainly on the sources discussed above. A fairly complete collection of citations – both pro and con – will be found on KLD’s website: <http://www.kld.com/resources/intro.html>

Is Prof. Rounds right on what the law should be? In the end, that matters far less than the fact that he is wrong on the processes by which law should be researched and debated.