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Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Attention: File Number S7-11-21: Enhanced Reporting of Proxy Votes by Registered Management Investment Companies; Reporting of Executive Compensation Votes by Institutional Investment Managers

To Whom It May Concern:

We are writing with respect to the Proposed Rule (the "Proposed Rule") and the accompanying supplementary information (the "Proposing Release") regarding enhanced reporting of proxy votes by registered management investment companies and reporting of executive compensation votes by institutional investment managers.

The Shareholder Commons (TSC) is a nonprofit organization focused on ensuring that companies act in a manner that promotes the best interests of their investors and that asset owners and managers act in the best interests of their beneficiaries, in each case by protecting the social and environmental systems upon which diversified shareholders rely. B Lab USA/CAN is a nonprofit that serves a movement of people using business as a force for good.

A. Introduction

1. Statement of support for the Proposed Rule

We support the Proposed Rule because it makes more information available in more accessible form to the ultimate beneficiaries ("Beneficial Owners") of Registered Management Investment Companies ("RMICs") and Institutional Investment Managers ("IIMs," and together with RMICs, "Covered Fiduciaries"), providing vital insight for these ultimate investors regarding the exercise of a valuable right being managed on their behalf. Proxy votes can have significant influence on the manner in which companies in the portfolios of Covered Fiduciaries perform on environmental, social, and governance issues ("ESG"). ESG performance can, in turn, have significant effects on the performance of the portfolios held by and for the benefit of Beneficial Owners. Information regarding proxy voting on ESG matters is no less important to investors than is the composition of the portfolios managed by RMICs and IIMs, which is already made available to these investors.

Proxy voting information allows for enhanced accountability to Beneficial Owners and thus more efficient use of capital. As an example, an individual may benefit from a defined benefit retirement plan, a spouse's defined contribution retirement plan and foundations and endowments that benefit the community and fund education. These entities are IIMs that are likely served by RMICs. Without more transparency as to proxy voting, there is no way for that individual to determine whether the votes cast on her behalf are being voted to protect all the investments that benefit her.

2. *Request to expand Proposed Rule to provide greater ESG voting transparency*

The interests of Covered Fiduciaries in a portfolio company's ESG performance can differ from the interest the Beneficial Owners on whose behalf they are making proxy voting decisions. This is particularly true with respect to the effect that such ESG performance can have on critical social and environmental systems. The importance of these proxy votes to the ultimate beneficial owners of securities, combined with the potential divergent interests of the Covered Fiduciaries legally entitled to exercise those votes, makes full, timely and simple access to voting records critical to the efficient functioning of the capital markets.

Accordingly, we urge the Commission to expand the Proposed Rule to require more timely disclosure of votes on Covered Fiduciary websites and to require that IIMs disclose all of their proxy votes, and not just those relating to say-on-pay ("SOP") questions. This enhancement will provide Beneficial Owners with the information necessary to understand if and how the proxy votes controlled on their behalves are being used to protect their economic interests.

Specifically, we recommend that all votes by Covered Fiduciaries be reported and that Covered Fiduciaries should promptly update their websites after votes are taken at annual meetings. The need for this expansion is discussed below in detail.

B. System Stewardship Is Necessary to Protect the Interests of Beneficial Owners

1. *Three forms of shareholder ESG activity*

Many shareholder votes address ESG issues. For example, in the 2021 proxy season, 56 social and environmental shareholder proposals were voted on at US-traded companies.[1] SOP votes can involve the interaction of ESG issues and management compensation, and the annual vote on directors can also address critical ESG issues when management nominees are opposed by some shareholders due to a company's ESG performance. For example, one of the most celebrated proxy contests in recent years involved the question whether Exxon-Mobil's directors were adequately addressing climate change--the quintessential "E" issue.[2]

Shareholders may engage with companies—and vote their proxies—in an effort to improve their ESG performance by reducing negative impacts and increasing positive impacts on social and environmental systems. Potential investor ESG activism can be separated into three categories: (1) **ESG integration**, undertaken to improve an individual company's financial performance (its "alpha") by improving its ESG performance; (2) **system stewardship**, undertaken to improve the social, environmental and economic systems that support the overall corporate performance in the financial markets (the market's "beta"[3]);

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[1] Georgeson's 2021 Annual Corporate Governance Review.

[2] Matt Levine, *Exxon Lost a Climate Proxy Fight,* Money Stuff (May 27, 2021) available at https://www.bloomberg.com/opinion/articles/2021-05-27/exxon-lost-a-climate-proxy-fight?sref=oAmKviWU.

[3] This colloquial use of the term "beta" differs from its technical meaning in finance, where it represents the difference between overall market volatility and the volatility of an individual security (just as alpha means the difference between the return of the

and (3) **ends activism**, undertaken to improve social and environmental systems as an end itself, rather than for the purpose of improving corporate financial performance.

Proxy voting on an ESG integration basis does not contemplate any trade-offs, because shareholders are voting to improve company ESG performance when it will also improve company financial performance; it is often described as "doing well by doing good." In contrast, proxy voting on a system stewardship basis might involve asking a company to forgo an activity that would improve the company's financial performance, but that would also damage the environment. In this case, the shareholder would be seeking to trade the value of the individual company in exchange for better portfolio performance (by preserving the environment that supports the financial performance of the rest of the companies in its portfolio). Finally, a shareholder interested in ends activism would be willing to ask companies to sacrifice return in order to preserve a social or environmental system for its own sake, and without any corresponding financial benefit at the portfolio level.

These three different forms of activism and their respective purposes and contemplated trade-offs are set out in this chart:

	RETURN ORIENTATION	WOULD HAVE PURPOSE OF PROVIDING FINANCIAL BENEFITS TO BENEFICIAL OWNERS	CONTEMPLATED TRADE-OFFS
ESG INTEGRATION	Alpha-oriented	Yes	No trade-offs contemplated
SYSTEM STEWARDSHIP	Beta-oriented	Yes	Trades off individual company returns to increase diversified portfolio value
ENDS ACTIVISM	Not oriented to shareholder returns	No	Trades off returns of individual companies and portfolios to improve social and environmental systems

In this Section B, we explain why system stewardship is of paramount importance to efficient capital markets. In Section C, we explain why more complete and timely reporting of proxy voting is necessary to support system stewardship and the efficiencies it engenders.

market and the return of a particular security). However, practitioners have taken to using the term to contrast market return with individual security return and we do the same in this comment letter.

2. *Modern Portfolio Theory requires diversification*

Investment principles mandate that fiduciaries adequately diversify their portfolios.[4] Diversification allows investors to reap the increased returns available from risky securities, but to greatly reduce that risk; this insight defines Modern Portfolio Theory.[5]

This core principle is reflected in federal law, which requires fiduciaries of federally regulated retirement plans to "diversify[] the investments of the plan."[6] Similar principles govern investment fiduciaries under other legal regimes.[7] The wisdom of a diversified investment strategy was summarized by the late John Bogle, founder of Vanguard, one of the largest mutual funds companies in the world: "Don't look for the needle in the haystack; instead, buy the haystack."[8]

3. *The performance of a diversified portfolio depends upon beta (overall market return)*

Diversification is thus required by accepted investment theory and imposed by law on investment fiduciaries. As a consequence, Beneficial Owners are largely diversified. However, once a portfolio is diversified, the most important factor determining return will not be how the companies in that portfolio perform relative to other companies, but rather how the market performs as a whole. Beta is more important to Beneficial Owners than is alpha.

Craig Lazzara, an S&P Dow Jones Indices executive, provided a timely hypothetical to illustrate the power of the beta effect, arguing that diversified shareholders with a COVID-19 vaccine manufacturer ("X") in their portfolios could financially benefit if the manufacturer sacrifices potential financial returns. We quote the essay at length, because it goes to the heart of our request:

> *Why? From a narrow perspective, X should charge quite a lot for its vaccine, since it's obviously worth a great deal. But from a universal owner's[9] perspective, X should give the stuff away (or at least sell it for marginal variable cost, which would be close to the same thing). X might well lose money, but an effective and plentiful vaccine would arguably cause the whole market to move upward sharply. Index funds would profit far more from the beta effect on their portfolios than from the alpha on a single stock.*

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[4] *See generally*, Burton G. Malkiel, A Random Walk Down Wall Street (2015).

[5] *Id.*

[6] 29 USC Section 404(a)(1)(C).

[7] *See* Uniform Prudent Investor Act, § 3 ("[a] trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.")

[8] John C. Bogle, The Little Book of Common Sense Investing: The Only Way to Guarantee Your Fair Share of the Stock Market, 86 (2007).

[9] The term "universal owner" is used to refer to investors that are required to invest for long time periods and who must broadly diversify to avoid the idiosyncratic risk of particular companies. Pension funds, endowments, foundations and other IIMs and their beneficial owners are quintessential universal owners.

> *Notice three things:*
>
> *This argument is not altruistic. It may well be "socially responsible" for X to give the vaccine away, but that's not why universal owners are putatively for it. The argument that they should disregard X's profitability to boost the world's stock markets is entirely self-interested.*
>
> *Sufficiently diversified active managers [i.e., asset managers who pick stocks to try to "beat" the market] have the same incentives as index funds. A given active manager might have an overweight in X, but it probably wouldn't be big enough to negate the advantage of a general bull market.*
>
> *The relevant balance of control at X is not the percentage ownership of individuals versus institutions or even of active managers versus index funds. The most important distinction is between the relative ownership of universal versus undiversified owners. "Undiversified" is a broad and relative term, of course, but might include concentrated "high conviction" active managers and hedge funds. And the most obvious group of undiversified shareholders, interestingly, is the management of the corporation itself.*[10]

As the essay notes, a plan need not be indexed for the effects of beta to outweigh alpha—that will be the case whenever a portfolio is adequately diversified. As one work describes this, "[a]ccording to widely accepted research, alpha is about one-tenth as important as beta [and] drives some 91 percent of the average portfolio's return."[11]

Moreover, from the perspective of the Beneficial Owners, it is not the performance of the assets held by a particular manager that matters, but rather the aggregated performance of all of the diversified assets being held by or on their behalf. For example, if a worker is counting on a defined benefit plan to fund retirement, it would not be helpful for one of multiple fund managers (such as a hedge fund or high conviction manager alluded to in the Lazzara essay) to pursue positive alpha that was associated with poor ESG performance that threatened the systems that support the companies in all of the funds held by the pension plans. While that individual manager might claim success because of the alpha achieved within its non-diversified portfolio, it would really be harming its ultimate client, the Beneficial Owner relying on beta to support the entire diversified portfolio of the pension plan.

One business-press columnist recently described the situation as follows:

> *In modern markets, the paradigmatic shareholder is broadly diversified, and there is less reason to care about what any particular company*

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[10] *Alpha, Omicron: Why?*, Craig Lazzara, Indexology Blog (December 8, 2021), available at https://www.indexologyblog.com/2021/12/02/alpha-omicron-why/

[11] Stephen Davis, Jon Lukomnik, and David Pitt-Watson, What They Do with Your Money (2016).

> *does. … Companies are just data points; what you care about is aggregates.*[12]

4. *Beta depends upon global economic performance*

Over long time periods, beta is influenced chiefly by the performance of the economy itself, because the value of the investable universe is equal to the percentage of the productive economy that the companies in the market represent.[13] Of course, valuation multiples of stocks (i.e., the ratio of share price to earnings or other valuation metrics) rise and fall, but they ultimately revert to a mean, leaving GDP as the key determinant of the value of a diversified portfolio:

> *[T]he long-term price of a universally-owning institutional investor's portfolio represents the Universal Owner's part of the appropriately discounted sum of all future GDP proportions of corporations. …*
>
> *[T]he relationship between GDP and the price of the portfolio of a Universal Owner is linear in the long term.*[14]

While the quoted work puts this idea into a mathematical proof, Warren Buffet, the world's most famous investor, uses common-sense language to make the same point, explaining that the ratio of total market capitalization to GDP "is probably the best single measure of where valuations stand at any given moment."[15] In other words, a healthy GDP means healthy diversified portfolios.

5. *Global economic performance depends upon healthy social and environmental systems*

It seems intuitive that a productive economy—and consequent GDP growth—is built upon healthy social and environmental systems. It would be difficult to do business in a society that lacked trust, cohesion, order, and a shared sense of norms. By the same token, where the natural systems upon which we depend are failing, it is difficult to grow the economy.

Recent economic literature reinforces this intuition. The World Economic Forum estimates that more than half the world's GDP is dependent on nature and the services it provides:

> *Our research shows that $44 trillion of economic value generation – more than half of the world's total GDP – is moderately or highly*

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[12] Matthew Levine, *Money Stuff* (Bloomberg Sept. 30, 2021) available at https://news.bloomberglaw.com/mergers-and-acquisitions/matt-levines-money-stuff-goldman-compliance-analyst-slipped-up.

[13] Principles for Responsible Investment & UNEP Finance Initiative, Universal Ownership: Why Environmental Externalities Matter to Institutional Investors, Appendix IV, https://www.unepfi.org/fileadmin/documents/universal_ownership_full.pdf.

[14] *Id.*

[15] Warren Buffett & Carol Loomis, Warren Buffett on The Stock Market, Fortune (December 10, 2001), https://archive.fortune.com/magazines/fortune/fortune_archive/2001/12/10/314691/index.htm. *See also* James Hawley and Andrew Williams, *The Rise of Fiduciary Capitalism: How Institutional Shareholders Can Make America More Democratic* (2000), p.xv ("a universal owner's cumulative long-term return is determined not merely by the performance of each individual firm it owns, but by the performance of the economy as a whole.")

> *dependent on nature and its services, and therefore exposed to risks from nature loss.*[16]

A 2011 article estimated the value of services provided by the earth's ecosystem at $125 trillion.[17] The same article estimated that land use had reduced the value of eco-services by $4.3 trillion to $20.2 trillion per year between 1997 and 2011.[18] The *Dasgupta Review,* a 2021 study of the economics of biodiversity commissioned by the United Kingdom Treasury, explained the nature of this dependence:

> *We rely on Nature to provide us with food, water and shelter; regulate our climate and disease; maintain nutrient cycles and oxygen production; and provide us with spiritual fulfilment and opportunities for recreation and recuperation, which can enhance our health and well-being. We also use the planet as a sink for our waste products, such as carbon dioxide, plastics and other forms of waste, including pollution. Nature is therefore an asset, just as produced capital (roads, buildings and factories) and human capital (health, knowledge and skills) are assets.*[19]

Social systems support productivity just as do environmental systems: "a lack of social development, including poverty, inequality and weak rule of law, can hamper business operations and growth."[20] Examples of specific social and environmental risks that threaten GDP are included in the following section.

The relationship between GDP, social and environmental systems, and market returns means that the centrality of beta cannot be avoided simply by picking stocks that outperform. Diversified investors cannot avoid certain common risks almost all companies face. These are the risks to the social and environmental systems in which the economy is embedded. One recent work explained that these systematic risks inevitably "swamp" any alpha strategy:

> *It is not that alpha does not matter to an investor (although investors only want positive alpha, which is impossible on a total market basis), but that* ***the impact of the market return driven by systematic risk swamps virtually any possible scenario created by skillful analysis or trading or portfolio construction****.*[21]

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[16] *Nature Risk Rising: Why the Crisis Engulfing Nature Matters for Business and the Economy,* New Nature Economy, World Economic Forum (2020), available at https://www3.weforum.org/docs/WEF_New_Nature_Economy_Report_2020.pdf.
[17] Robert Costanza, et al, *Changes in the Global Value of Ecosystem Services,* 26 Global Environmental Change 152 (2014).
[18] *Id.*
[19] *The Economics of Biodiversity: The Dasgupta Review; Headline Messages* (2021), available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/957629/Dasgupta_Review_-_Headline_Messages.pdf.
[20] United Nations Global Compact, *Do Business in Ways that Benefit Society and Protect People,* available at https://www.unglobalcompact.org/what-is-gc/our-work/social.
[21] Jon Lukomnik & James P. Hawley, Moving beyond Modern Portfolio Theory: Investing that Matters, Chapter 5, Routledge (April 30 2021) (emphasis added).

A new report from the international law firm Freshfields Bruckhaus Deringer explains how the reality of externalized costs reverberates in the fiduciary duties of investment trustees across jurisdictions:

> *In recent years investors have increasingly focused on what must be done to protect the value of their portfolios from system-wide risks created by the declining sustainability of various aspects of the natural or social environment. System-wide risks are the sort of risks that cannot be mitigated simply by diversifying the investments in a portfolio. They threaten the functioning of the economic, financial and wider systems on which investment performance relies. If risks of this sort materialised, they would therefore damage the performance of a portfolio as a whole and all portfolios exposed to those systems.*[22]

6. *Systemic health depends upon investee behavior*

The foregoing sections have established that (1) the Beneficial Owners served by Covered Fiduciaries are likely diversified, (2) they therefore rely on beta, (3) beta relies on a healthy economy, and (4) a healthy economy relies on critical social and environmental systems. In this section, we show that the companies at which Covered Fiduciaries exercise proxy votes are responsible for whether those systems thrive, due to the social and environmental impacts they externalize.

A recent study determined that, in 2018, publicly listed companies around the world imposed social and environmental costs on the economy with a value of $2.2 trillion annually—more than 2.5 percent of global GDP.[23] This cost was more than 50 percent of the profits those companies reported. Not surprisingly, climate change is one of the critical externalities that companies create. One study estimated that a global temperature increase of 2.1 degrees Celsius by 2050 would reduce GDP by 17.78 percent.[24] Moreover, just 100 companies are responsible for 71 percent of industrial global greenhouse gas emissions.[25] The carbon footprint of these companies affects beta, and thus the return of a diversified portfolio, no less (and perhaps more) than their own profitability.

Climate change is not the only systemic issue where corporate activity has enormous effects on global economic performance. For example:

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[22] *A Legal Framework for Impact: Sustainability Impact in Investor Decision-Making* (2021). The report, which ran to 558 pages, studied the law of jurisdictions significant to global capital markets, including the United States, and the conclusions cited in this comment letter extend to U.S., trustee law.

[23] Andrew Howard, *SustainEx: Examining the social value of corporate activities,* Schroders (April 2019), available at https://www.schroders.com/en/sysglobalassets/digital/insights/2019/pdfs/sustainability/sustainex/sustainex-short.pdf.

[24] *See supra,* n.13.

[25] Swann Bommier & Cécile Renouard, *Corporate Responsibility in the Climate Crisis,* PUBLIC BOOKS and LA VIE DES IDÉES (January 21, 2019), available at https://www.publicbooks.org/corporate-responsibility-in-the-climate-crisis/#:~:text=Although%20states%20are%20largely%20responsible,global%20industrial%20greenhouse%20gas%20emissions.

- *Obesity.* The World Health Organization assesses the unpriced social burdens of obesity as equaling almost 3 percent of global GDP annually.[26] The food and beverage business bears significant responsibility for this issue.[27]

- *Inequality.* It has been estimated that inequality has reduced demand by 2 to 4 percent of GDP in recent years.[28] In the United States, corporate depression of wages for low-income workers and exploding executive pay are expanding inequality.[29]

- *Racial and gender disparities.* Gender and racial gaps created $2.9 trillion in losses to U.S. GDP in 2019,[30] and racial disparities are projected to cost the U.S. economy $5 trillion over five years.[31] Corporations have means to address this issue should they choose to do so.[32]

- *Antimicrobial Resistance.* The World Bank projects that antimicrobial resistance will reduce global GDP by as much as 3 percent by 2030 and almost 4 percent by 2050; at an intermediate discount rate, this will amount to economic losses by 2050 with a current value of $54 trillion.[33] A UK government-commissioned study puts the figure at $100 trillion.[34] Scholarship links this increasing resistance in part to commercial pressures in agriculture and consumer packaged goods industries.[35]

- *Democracy at risk.* Social media companies, in their search for platform traffic and advertising revenues, have been fundamental to the rise of far-right and authoritarian politicians and

[26] *See* Andrew Howard, *supra n. 23.*

[27] *See, e.g.,* https://www.hsph.harvard.edu/nutritionsource/healthy-drinks/sugary-drinks/.

[28] Josh Bivens, *Inequality is slowing U.S. economic growth: Faster wage growth for low- and middle-wage workers is the solution,* Economic Policy Institute (December 12, 2017), available at https://www.epi.org/publication/secular-stagnation/

[29] Sam Pizzigati, *Putting the Brakes on Corporate America's Inequality Engine,* Inequality.org (November 15, 2019), available at https://inequality.org/great-divide/putting-the-brakes-on-corporate-americas-inequality-engine/#:~:text=Corporations%20are%20contributing%20to%20inequality%20on%20two%20fronts.&text=The%20legislation%20%E2%80%94%20the%20Tax%20Excessive,the%20higher%20the%20tax%20rate. *See generally*, Heather Boushey, UNBOUND: HOW INEQUALITY CONSTRICTS OUR ECONOMY AND WHAT WE CAN DO ABOUT IT, Harvard University Press (October 15, 2019).

[30] Shelby R. Buckman et al., *The Economic Gains from Equity,* Federal Reserve Bank of San Francisco (January 19, 2021), available at https://www.frbsf.org/our-district/files/economic-gains-from-equity.pdf.

[31] Dana M. Peterson and Catherine L. Mann, *Closing the Racial Inequality Gaps: The Economic Cost of Black Inequality in the U.S.*, Citi GPS (September 2020), available at http://citi.us/3olxWH0.

[32] *Id.*

[33] Drug-Resistant Infections: A Threat to Our Economic Future, World Bank Group (March 2017), available at http://documents1.worldbank.org/curated/en/323311493396993758/pdf/final-report.pdf

[34] *Antimicrobial Resistance: Tackling a crisis for the health and wealth of nations,* UK Government Review on Antimicrobial Resistance (December 2014), available at https://amr-review.org/sites/default/files/AMR%20Review%20Paper%20-%20Tackling%20a%20crisis%20for%20the%20health%20and%20wealth%20of%20nations_1.pdf.

[35] Carolyn Anne Michael, Dale Dominey-Howes, and Maurizio Labbate, *The Antimicrobial Resistance Crisis: Causes, Consequences, and Management,* Frontiers in Public Health vol. 2 145 (September 16, 2014), available at https://www.ncbi.nlm.nih.gov/pmc/articles/PMC4165128/.

governments.[36] The election of Jair Bolsonaro as president of Brazil is due in part to this phenomenon, and is hastening the climate crisis.[37]

- *Political influence.* Companies also affect systems through political influence. A recent International Energy Agency study estimates that the investment necessary to create a net-zero economy by 2050 would increase global GDP by 4 percent by 2030,[38] which would benefit diversified investors greatly. Yet to increase their own financial returns, many individual companies spend considerable resources trying to convince policymakers and the public that constraining climate change is unnecessary.[39]

One commentator recently explained that the external costs of business activity were the most important factor with which investors should be concerned:

> *Hence, far from externalities being peripheral, they may be the main event! In other words, more of the environmental and social exchanges that shape our wellbeing may be unpriced than priced, yet we increasingly steer by the priced exchanges only.*[40]

C. System Stewardship Practices of Covered Fiduciaries Should Be Transparent

1. *Beneficial owners should know when Covered Fiduciaries are prioritizing alpha over beta*

Part B of this comment letter demonstrates the following causal chain of relationships:

CORPORATE SOCIAL AND ENVIRONMENTAL IMPACTS→SYSTEMIC HEALTH→GLOBAL ECONOMIC PERFORMANCE→BETA→DIVERSIFIED PORTFOLIO PERFORMANCE

While other factors (including alpha) also affect portfolio performance, the above relationships are very strong. In particular, beta is a more important factor in portfolio performance than alpha, and the pursuit of alpha by individual companies can threaten beta.

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[36] Heidi Beirich and Wendy Via, *Democracies under Threat,* Global Project against Hate and Extremism (March 2021), available at https://www.politico.eu/wp-content/uploads/2021/03/16/GPAHE_Democracies-Under-Threat.pdf.

[37] Jonathan Witts, *Amazon Rainforest 'Will Collapse If Bolsonaro Remains President',* The Guardian (July 14, 2021) ("There are also global repercussions because land clearance is turning the Amazon region from climate friend to climate foe. A study published in Nature reveals forest burning now produces about three times more CO_2 than the remaining vegetation is able to absorb. This accelerates global heating.")

[38] Stéphanie Bouckaert *et al.*, *Net Zero by 2050: A Roadmap for the Global Energy Sector,* International Energy Agency (May 2021), available at https://www.iea.org/reports/net-zero-by-2050.

[39] *See, e.g.,* Hiroko Tabuchi, *How One Firm Drove Influence Campaigns Nationwide for Big Oil,* New York Times (November 11, 2020), available at https://www.nytimes.com/2020/11/11/climate/fti-consulting.html. (Reporting that FTI Consulting, a publicly traded company, "helped design, staff and run organizations and websites funded by energy companies that can appear to represent grass-roots support for fossil-fuel initiatives.")

[40] Austin, D. (2019), *Greenwish: The Wishful Thinking Undermining the Ambition of Sustainable Business,* available at https://preventablesurprises.com/publications/blog/greenwish-the-wishful-thinkingundermining-the-ambition-of-sustainable-business-by-duncan-austin/.

Given the very different relationships alpha and beta have to portfolio performance, Beneficial Owners should have the tools to determine whether and how Covered Fiduciaries are confronting conflicts between beta and alpha. Without this information, Covered Fiduciaries may be richly rewarded for the successful pursuit of positive alpha, even if that success relies upon corporate behavior that threatens beta, the aspect of return matters most to the returns of diversified Beneficial Owners.

2. *Pursuit of alpha without prioritizing system stewardship encourages social and environmental cost externalization*

Beneficial owners have an interest in understanding whether Covered Fiduciaries are addressing situations where portfolio companies optimize their own financial returns by externalizing social and environmental costs, as described in Section B.5. The costs might include harmful emissions, resource depletion, and the social instability and lost opportunities caused by poor treatment of employees. Diversified Beneficial Owners internalize the collective costs of such externalities (more than $2 trillion in 2018 according to the Schroders report cited above) because these costs degrade and endanger the stable, healthy systems upon which economic growth and corporate financial returns depend.[41]

PRI, an investor initiative whose members have $89 trillion in assets under management, recently described a variety of corporate practices that can boost individual company returns while threatening the economy and diversified investor returns:

> *A company strengthening its position by externalising costs onto others. The net result for the [diversified] investor can be negative when the costs across the rest of the portfolio (or market/economy) outweigh the gains to the company;*
>
> *A company or sector securing regulation that favours its interests over others. This can impair broader economic returns when such regulation hinders the development of other, more economic companies or sectors;*
>
> *A company or sector successfully exploiting common environmental, social or institutional assets. Notwithstanding greater harm to societies, economies, and markets on which investment returns depend, the benefits to the company or sector can be large enough to incentivise and enable them to overpower any defence of common assets.*[42]

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[41] *See The Economics of Biodiversity: The Dasgupta Review: Abridged Version* ("The inability of societies to honour [extra-legal] property rights even when they can be defined gives rise to externalities, which are the unaccounted-for consequences for others, including future people, of actions taken by one or more persons.") available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/957292/Dasgupta_Review_-_Abridged_Version.pdf

[42] *Active Ownership 2.0: The Evolution Stewardship Urgently Needs,* PRI (2019) available at https://www.unpri.org/download?ac=9721. ***See also Addressing Climate as a Systemic Risk: A call to action for U.S. financial regulators,*** Ceres (June 1, 2020), available at https://www.ceres.org/resources/reports/addressing-climate-systemic-risk. ("The SEC should make clear that consideration of material environmental, social and governance (ESG) risk factors, such as climate change,

Thus, while individual companies driven by alpha alone can profitably externalize costs from their own narrow perspective (and the perspective of a shareholder of just that company), a diversified investor will almost surely pay these costs through lowered return on their diversified portfolios for the reasons discussed above.

This conflict between alpha and beta does not just exist at the company level. If a Covered Fiduciary is overweight in a portfolio company that engages in beta-threatening practices in order to generate alpha, the Covered Fiduciary's comparative performance may be enhanced and rewarded, while any beta damage affects all investors equally, so that the market will not attribute the damage to any particular Covered Fiduciary's decision not to engage in system stewardship.

3. System stewardship is a critical facet of managing a diversified portfolio

Because Covered Fiduciaries have the power to vote on directors and other matters at investees that endanger systems critical to all companies, they have the power—and the responsibility—to steward companies away from such practices. The PRI report cited above described the investor action necessary to manage social and environmental systems:

> *Systemic issues require a deliberate focus on and prioritisation of outcomes at the economy or society-wide scale. This means stewardship that is less focused on the risks and returns of individual holdings, and more on addressing systemic or 'beta' issues such as climate change and corruption. It means prioritising the long-term, absolute returns for universal owners, including real-term financial and welfare outcomes for beneficiaries more broadly.* [43]

In a similar vein, the Freshfields report suggests that alpha-oriented strategies (e.g., ESG integration) are of limited value to diversified shareholders, and that system stewardship is the best way for investors to improve performance:

> ***The more diversified a portfolio, the less logical it may be to engage in stewardship to secure enterprise specific value protection or enhancement.*** *Diversification is specifically intended to minimise idiosyncratic impacts on portfolio performance…*
>
> *Yet diversified portfolios remain exposed to nondiversifiable risks, for example where declining environmental or social sustainability undermines the performance of whole markets or sectors…* ***Indeed, for investors who are likely to hold diversified portfolios in the long-term, the question is particularly pressing since these are likely to***

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to portfolio value is consistent with investor fiduciary duty.") Ceres is a non-profit organization with a network of investors with more than $29 trillion under management.

[43] *Id.*

> ***be the main ways in which they may be able to make a difference.***[44]

For similar reasons, Professor John Coffee, the Adolf A. Berle Professor of Law at Columbia University Law School and Director of its Center on Corporate Governance, predicted that system stewardship would surpass ESG integration in a recent law review article:

> *This latter form of activism [system stewardship] is less interested in whether the target firm's stock price rises (or falls) than in whether the activist investor's engagement with the target causes the total value of this investor's portfolio to rise (which means that the gains to the other stocks in the portfolio exceed any loss to the target stock). This recognition that change at one firm can affect the value of other firms in the portfolio implies a new goal for activism: namely, to engineer a net gain for the portfolio, possibly by reducing "negative externalities" that one firm is imposing on other firms in the investor's portfolio.*[45]

The logic in both these resources is undeniable: given the critical importance of overall market return, and the danger to that return from corporate activity that damages social and environmental systems, Covered Fiduciaries should be voting to protect the Beneficial Owners they are representing from individual companies that focus on their own performance to the detriment of overall market return.

However, the financial system is not necessarily structured in a manner that accommodates system stewardship. The Commission can address this structural concern by providing Beneficial Owners with information concerning Covered Fiduciary proxy voting efforts to limit threats to the social and economic systems upon which other companies in their portfolios rely.

4. *Investment professionals have structural incentives to focus on alpha and ESG integration, but ignore beta and system stewardship*

There is a risk that Covered Fiduciaries and their advisors may focus on alpha (and thus ESG integration) in preference to beta (and system stewardship) because the former is much more salient when gauging the performance of portfolios. Alpha—both positive and negative—is assessed in relation to the performance of others. Thus, the alpha that Covered Fiduciaries achieve will always be known, and low positive or negative alpha may trigger lower compensation, client loss, or employment termination for responsible individuals.

In contrast, measuring contribution to beta is very difficult because all diversified portfolios share the benefits (and losses) of beta changes. Thus, investment professionals may perceive little career or

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44 *See supra,* n.22.

45 Coffee, John C., The Coming Shift in Shareholder Activism: From "Firm-Specific" to "Systematic Risk" Proxy Campaigns (and How to Enable them), p.2 (August 26, 2021). Available at SSRN: https://ssrn.com/abstract=3908163 or http://dx.doi.org/10.2139/ssrn.3908163

relative compensation risk in ignoring beta threats since their relative performance will not suffer. As Lukomnik and Hawley put it:

> *[T]he benefit to the industry as a whole does not neatly translate to any individual firm. Because impacts of [system stewardship] are market-wide, this does not allow firms to differentiate themselves the way trading (alpha seeking) does. This is a traditional "free-rider" problem, in which those firms that do not contribute to [system stewardship] will still benefit . . .*[46]

System stewardship can also present business challenges to service providers. The proxy advisers and asset managers who provide services to IIMs may also have corporate customers. For example, asset managers who manage IIM portfolios may also seek business from corporations that need retirement plan managers. Engaging in system stewardship could put the asset manager in the position of asking clients or potential clients to sacrifice internal financial return. As discussed in the next two sections, some of the largest service providers (including RMICs) appear to engage in ESG integration only, to the exclusion of any system stewardship efforts.

5. Proxy advisory services do not provide system stewardship advice

To contend with the large number of proxy voting decisions that a diversified shareholder must make on an annual basis, many plan fiduciaries rely on proxy advisory services to vote their shares, or use asset managers who rely on such services. Two companies dominate the market for these services,[47] but these services only provide advice based on how a vote would affect the financial performance of the company at which the vote is taken. **This means Covered Fiduciaries relying on these services are receiving voting advice that runs counter to the best interests of Beneficial Owners.** For example, if a shareholder proposal requests that a company adopt a 1.5ºC Science-Based Target, but such a target would impair the company's long-term financial performance (even while raising portfolio performance for the diversified client of the proxy advisor), both services would recommend a "no" vote.

Glass Lewis' voting guidelines are clear:

> *Glass Lewis evaluates all environmental and social issues through the lens of long-term shareholder value.*
>
> *…*
>
> *When evaluating environmental and social factors that may be relevant*

[46] *Supra,* n.21 at 108. The authors point out that there is an overall compensation benefit to asset managers of lifting beta, because asset management fees are a function of the value of the assets being managed

[47] Paul Rose, Manhattan Institute, *Proxy Advisors and Market Power: A Review of Institutional Investor Robovoting* (April 22, 2021) ("Institutional Shareholder Services Inc. (ISS) and Glass, Lewis & Co. (Glass Lewis) . . . together control[] more than 90% of the proxy advisory market.") available at https://www.manhattan-institute.org/proxy-advisors-market-power-review-investor-robovoting

> *to a given company,* ***Glass Lewis does so in the context of the financial materiality of the issue to the company's operations****.*[48]

ISS takes the same position in its description of its "Global Approach" to "Social and Environmental Issues":

> *While a variety of factors goes into each analysis, the overall principle guiding all vote recommendations* ***focuses on how the proposal may enhance or protect shareholder value*** *in either the short or long term.*
>
> *… Management and the board should be afforded the flexibility to make decisions on specific public policy positions based on* ***their own assessment of the most beneficial strategies for the company****.*[49]

6. Many large asset managers do not engage in system stewardship

Review of large asset managers' public statements demonstrates that they restrict ESG stewardship to matters that affect the alpha that individual companies achieve while ignoring the effect their proxy voting and other stewardship activities have on beta.

a. BlackRock

BlackRock is the largest investment manager in the world. In a recent document codifying its views on environmental activism, BlackRock stated:

> *[BlackRock] asks companies to disclose how material natural capital risks and opportunities might affect their operations, long-term strategy, capital expenditures and risk management, as well as the communities in which they operate. We encourage companies to explain how relevant risks are identified, assessed, managed and mitigated, and how opportunities are harnessed.*
>
> *…*
>
> *A company's determination of its universe of material natural capital risks should be guided by SASB, public information, and the company's stakeholder engagement. We ask questions to understand the company's perspectives and provide feedback based on our assessment*

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[48] Glass Lewis, *2022 Proxy Guidelines-United States* (emphasis added) available at https://www.glasslewis.com/wp-content/uploads/2021/11/US-Voting-Guidelines-US-GL-2022.pdf?hsCtaTracking=257fcf1c-f11e-4835-81a3-d13fbc7b1f4c%7C1dad2378-213f-45f6-8509-788274627609.

[49] *ISS Proxy Voting Guidelines Benchmark Policy Recommendations, p. 57* (effective for 2021 proxy season)(emphasis added), available at https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf.

> *of a company's approach, but we do not tell management what to do.*[50]

The reliance on SASB as the primary determinant of materiality demonstrates BlackRock's failure to consider companies' environmental impact beyond the limited effect that impact has on the company itself. SASB is a reporting framework that establishes standards for reporting on social and environmental issues, but determines the materiality of such issues solely by reference to their effects on the reporting company's financial performance:

> *The SASB Standards… focus exclusively on enabling companies to identify the sub-set of sustainability information that is material for enterprise value creation.*[51]

Even more troubling is BlackRock's promise "not to tell management what to do." BlackRock and other investors' failure to impose boundaries on portfolio companies use of limited common resources, from carbon sinks to social trust, has led to a "tragedy of the commons" because in profit-driven markets, companies will not forgo profit opportunities unless their owners insist.[52]

This pledge by the world's largest asset owner not to establish limits eliminates the possibility of its effectively addressing companies' negative impact on society and the environment whenever the company in question can profitably externalize such costs. As Professor Coffee explained:

> *If some companies are imposing negative externalities on the market as a whole,* ***it would be both rational and feasible for large index investors to seek to curb such conduct*** *(at least when the gains from such efforts are expected to exceed the losses to the companies imposing such externalities).*[53]

But the world's largest asset manager—and service provider to many IIMs--has promised not to "curb" any corporate conduct because they will "not tell management what to do."

b. State Street

State Street Corporation is the world's fourth largest asset manager, and its public documents also reveal an exclusive focus on individual company value with respect to ESG matters.

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[50] Blackrock, *Our Approach to Engagement on Natural Capital*, pp.2-3 (2021), available at https://www.blackrock.com/corporate/literature/publication/blk-commentary-engagement-on-natural-capital.pdf.

[51] Statement of Intent to Work Together Towards Comprehensive Corporate Reporting (September 2020) available at https://29kjwb3armds2g3gi4lq2sx1-wpengine.netdna-ssl.com/wp-content/uploads/Statement-of-Intent-to-Work-Together-Towards-Comprehensive-Corporate-Reporting.pdf.

[52] *Supra,* n. 41 (explaining that tragedy of the commons occurs when resources are freely available: "Because users are not charged nor required to limit their use, everyone uses it excessively.")

[53] *Supra,* n. 45 at 6 (emphasis added).

State Street's description of "R-Factor"—its proprietary system for "building sustainable companies"—illustrates the problem.[54] R-Factor relies on materiality models that stretch across industries but are still focused on companies, not systems. It leverages "widely accepted, transparent materiality frameworks from the Sustainability Accounting Standards Board (SASB) and corporate governance codes to generate a unique ESG score for listed companies."[55] As discussed above, use of SASB metrics precludes the type of system stewardship necessary to protect diversified shareholders.

The focus on systemic impacts on companies rather than on company impacts on systems is consistent with statements from its Proxy Voting Guidelines:

> *At State Street Global Advisors, we take our fiduciary duties as an asset manager very seriously…* ***The underlying goal is to maximize shareholder value****…*
>
> *Proposals that are in the best interests of shareholders,* ***demonstrated by enhancing share value or improving the effectiveness of the company's operations****, will be supported.*[56]

7. *Accountability requires full and timely transparency of all votes by Covered Fiduciaries*

The foregoing discussion is not meant to criticize the firms described or other market participants; rather, it is intended to show that even though the fiduciary analysis described in this letter should lead Covered Fiduciaries to steward systems, our capital markets have built-in biases that may discourage such stewardship, and that even the largest firms available to service IIMs often misunderstand the need for system stewardship.

Accordingly, the Proposed Rule should require full and timely transparency as to proxy votes cast on behalf of Beneficial Owners, in order that they know whether Covered Fiduciaries are stewarding systems when necessary to protect their financial returns based on the risks that ESG performance by portfolio companies pose to plan portfolios.

This increased knowledge base will allow Beneficial Owners to better monitor Covered Fiduciaries and to encourage increased stewardship where necessary, or to insist that IIMs select RMICs that are willing to "tell management what to do" when such instruction is necessary to protect the full portfolio that benefits the Beneficial Owner.

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[54] *R-Factor™ — A Roadmap to Build Sustainable Companies*, available at https://www.ssga.com/us/en/institutional/ic/capabilities/esg/data-scoring/r-factor-transparent-esg-scoring.
[55] *Id.*
[56] Global Proxy Voting and Engagement Policies (March 2020) available at https://www.ssga.com/library-content/pdfs/ic/proxy-voting-and-engagement-guidelines-principle.pdf.

8. Specific recommendations

In answer to Question 7, we recommend that all votes by Covered Fiduciaries be reported. As discussed above, the manner in which shares are voted is as important as the holdings in a portfolio.

In answer to Questions 77 and 86, we recommend that reporting take place more frequently than annually; Covered Fiduciaries should promptly update their websites after votes are taken at annual meetings.

These changes simply require information already in the hands of Covered Fiduciaries to be filed on a website or SEC form; they are far from burdensome, especially in light of the tremendous responsibility these entities have to Beneficial Owners, and would greatly contribute to the protection of investors and the efficiency of our capital markets.

*   *   *   *

For all the reasons expressed above, we urge that the Proposed Rule be modified to provide that all proxy votes by Covered Fiduciaries be reported and that Covered Fiduciaries should promptly update their websites after votes are taken at annual meetings. Such enhancements will provide clear, complete and timely information to the markets, leading to greater accountability for system stewardship responsibilities and consequently more efficient proxy voting decisions by Covered Fiduciaries.

Sincerely,

Frederick Alexander
Chief Executive Officer
The Shareholder Commons

Holly Ensign-Barstow
Director of Stakeholder Governance and Policy
B Lab US/CAN