# REPORT FROM THE FIELD

## The Growing Resonance of System Stewardship

Most shareholders are diversified, so that the most important factor determining their investment success will be the average return of the markets in which they invest, not the financial performance of any individual company. This creates a natural divergence of interest between corporate executives and most of their shareholders: executives understandably focus on the value of their own companies and are motivated to make business decisions that increase that value, even when doing so threatens the value of the economy, thereby reducing the values of their shareholders' diversified portfolios.

This conflict of interest crystallizes when companies profit from business models that impose excessive costs on the critical social and environmental systems that support the economy in which diversified portfolios are invested.

The Shareholder Commons (TSC) is a nonprofit organization that addresses this conflict. We have a series of programs designed to protect diversified shareholders from companies that prioritize enterprise value over systemic well-being. These tactics include litigation, policy influence, driving public awareness, and the promotion of guardrails.

This report reviews our 2022 proxy season campaign on behalf of diversified investors.

## VOTES FOR OUR 2022 PROPOSALS MORE THAN DOUBLE 2021 VOTES

In the 2021 and 2022 proxy seasons, we used the shareholder proposal process in the United States as a means of introducing our core concepts at companies in a variety of industries.

### THE PREQUEL: 2021 AND PUBLIC BENEFIT CORPORATIONS

In the 2021 season, our campaign focused on proposals that asked companies to convert to public benefit corporations (PBCs). This new corporate form expressly requires directors and executives to account for the effects companies have on social and environmental systems.

In the arguments we presented to shareholders in support of these proposals, we explained how the PBC form would permit companies to account for systemic impacts that might be damaging to diversified portfolios. This expanded duty could protect investors from companies that boosted their own bottom lines by externalizing costs that investors internalized through other companies they owned.

**A:** PO Box 1268 | Northampton, MA 01061 | USA **P:** +1-302-485-0497 **E:** info@theshareholdercommons.com

After the end of the season, we determined that the PBC proposal was perceived as an overcorrection because there is not yet a clear method for focusing PBCs on benefits in which diversified shareholders are interested. Accordingly, we retooled our 2022 strategy to focus on a refinement of a different proposal that we had used at several companies in 2021.

## 2022 AND EXTERNAL COST PROPOSALS

The refined proposal directly addressed our core concern: that companies focus on increasing their own enterprise value without regard to the impact of their conduct on the systems that support all the companies held in investment portfolios. All but one of our 15 proposals in 2022 asked for a report on social or environmental costs that a company was externalizing and how those systemic costs burdened the diversified portfolios most investors hold. At the Coca-Cola Company, for example, we asked how its reliance on products that injure public health affected its diversified shareholders:

> *RESOLVED, shareholders ask the Board of The Coca-Cola Company (the "Company" or "Coke") to commission and disclose a report on the external public health costs created by the Company's food and beverage businesses and the manner in which such costs may affect its diversified shareholders, whose ability to meet their financial goals depends primarily on overall market returns rather than the relative performance of individual companies.*

We received a considerably greater proportion of the non-insider votes in 2022 than we had in the previous season, increasing our average from 4.84% to 11%, for an increase of 149%. All 14 of the proposals satisfied the SEC threshold that allows for a first-time proposal to be resubmitted in a subsequent year. (A fifteenth proposal that requested a different action did not meet the threshold currently on the books, although it did meet the threshold in place prior to a rule change that came late in the Trump administration; that change is the subject of a legal challenge.) A complete list of our 2022 proposals is available here.

We believe the significant increase in votes reflects the greater precision of our revised proposals, but also an increased recognition by shareholders of the importance of stewarding companies in a manner that protects the investor's entire portfolio. The latter change is reflected in the more than 15% increase in "yes" votes received at two companies that received proposals to provide external cost reports in both 2021 and 2022.

## VOTE ANALYSIS

We recognize that our vote totals do not equal those of many more traditional ESG integration proposals that have received much higher vote totals in recent proxy seasons. ("ESG integration" proposals ask companies to address their social or environmental impacts solely for the purpose of improving the subject company's own enterprise value.) We are nevertheless encouraged by the progress we are seeing. The external cost proposals articulate an idea that is new to many in the market: they expressly contemplate the need for companies to deprioritize enterprise value when doing so is necessary to protect the critical systems that undergird shareholders' diversified portfolios.

The implications of this idea may seem radical to many in the market who have long assumed that a company's financial performance is the ultimate measure of its success. Asking for a report on a company's external costs implies that investors independently value systemic impact, and that they may prioritize reducing those costs over an individual company's enterprise value. That may in turn require corporate executives and fiduciaries who manage investment portfolios to go beyond treating each individual company as an isolated exercise in value enhancement and consider the interdependence among companies. Such a reprioritization foreshadows significant changes in the financial industry and will not be taken up in a single year. We are nevertheless heartened by the fact that at the 15 companies where we supported proposals this year, shares with a value of more than $300 billion were voted in favor of just that proposition. This level of early adoption bodes well for movement toward a paradigm shift in measuring success in business.

# 2022 PROXY ADVICE ON OUR PROPOSALS DID NOT SERVE DIVERSIFIED SHAREHOLDERS

While we were heartened by the early levels of support from shareholders, we were frankly disappointed by the stance of prominent proxy advisory services, who play a critical gatekeeper role in our financial system. Many institutional shareholders rely on these advisors to provide direction in how to vote the hundreds or thousands of positions they hold on behalf of beneficiaries.

Almost all the clients (or the beneficiaries of the clients) proxy advisory firms serve are diversified. Their portfolios are put at risk by individual companies that choose to externalize social and environmental costs. The external cost reports requested by our proposals would help shareholders to understand whether these portfolio costs outweigh the benefits they receive from their relatively small interests in the externalizing company.

But when analyzing our proposals, many proxy advisory firms gave advice as if the only stock their clients held was the one to which the recommendation pertained. This stance ignores the real-world financial situation of their clients, resulting in recommendations contrary to the clients' best interests.

## ISS AND GLASS LEWIS MISS THE POINT

For example, at CVS Health, a proposal requested a report that examined the public health impact of marketing junk food to vulnerable healthcare customers and the implications of that impact for CVS's diversified shareholders. ISS recommended against the proposal with the following argument:

> *The requested report does not seem to not [sic] be a standard industry practice at this time.* ***Additionally, it is unclear what value a report that examines how the company's strategic decisions may affect diversified shareholders would benefit shareholders.***

The emphasized language makes sense only if you assume that shareholders are not diversified. This would certainly be a troubling assumption for pension fund clients and other fiduciaries, *who are required by law to diversify their investments.* To state it clearly, a report examining how diversified portfolios were affected by CVS decisions that threatened public health would benefit diversified shareholders by helping them decide whether to engage the company to stop making such decisions. ISS also argued that addressing negative effects on shareholders' portfolios just isn't something shareholders ought to be doing:

> *Economic reports examining public health costs imposed on society are publicly available and the issue of chronic disease care is an economy-wide issue that is more appropriately dealt with through legislation or government regulation, as well as personal responsibility.*

Our translation:

> ***Even though ISS has been hired by shareholders to help them decide how to vote their shares, and even though the shareholders might benefit from voting to curb CVS practices that externalize costs, ISS has decided that public health issues should only be addressed by government regulation or "personal responsibility," i.e., if CVS wants to push its diabetic clients to eat more candy and doing so isn't illegal, shareholders should just stay out of it, even if remaining silent hurts their other investments.***

ISS took the same position with respect to other proposals seeking reports. For example, our proposal at Pfizer sought an analysis of the impact of the company's COVID-19 vaccine technology hoarding on the economy and consequently on diversified portfolios. ISS recommended against the proposal, noting:

> *[T]he scope of a study on the public health costs and impact on market returns to diversified shareholders associated with IP rights and vaccine production is overly broad for one company* ***and best left to others, such as the scientific and economic communities.*** *Therefore, support for this proposal is not warranted at this time.*

ISS's primary competitor, Glass Lewis, takes a similar approach. Their 2022 voting policies required that they only look to the impact of company decisions on company returns, and only consider environmental and social factors in "the context of the financial materiality of the issue to the company's operations." As a result of their blinkered mindset, ISS and Glass Lewis consistently recommended that shareholders vote against our proposals.

There is no legal, financial, or economic argument to justify the assertion that issues that directly affect portfolio values are "best left to others." In fact, a recent report from the leading international law firm Freshfields Bruckhaus Deringer shows that **the law requires just the opposite from the pension trustees and other fiduciaries that rely on ISS for voting advice**. The report explains how the economic 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.*

This report echoes a recent analysis from PRI, an investor initiative whose members have $121 trillion in assets under management, which 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.*

The reports from PRI and Freshfields are a refreshing counterpoint to the head-in-the-sand philosophy espoused by ISS and Glass Lewis in their recommendations. More than that, however, the reports suggest that fiduciaries must demand broader advice from these two industry giants—or look elsewhere for advice—to meet their fiduciary obligations.

## EOS MAKES ITS OWN ERRORS

EOS at Federated Hermes is another important firm that provides proxy voting advice. In their recommendation against our proposal for an external costs report at Meta Platforms, they conceded that a vote in favor might benefit the shareholders (i.e., EOS's own clients). Yet they recommended a vote against because such a vote might not be in the interest of Meta itself (presumably not EOS's client):

> *We have concerns that the phrase 'diversified shareholders' presents a misunderstanding of fiduciary duty as the company has no duty to ensure returns for diversified shareholders, only shareholders of the company* ***. While fulfilling the request of the proponent may be in the best interest of shareholders,*** *the wording is overly broad and founded on a claim that we believe is incorrect. We could have supported the proposal if the proponent had drafted the resolved clause as being in the interest of the company to address these issues.*

Our translation:

> ***We understand Meta may be conducting its business in a manner that maximizes its own enterprise value by creating social discord that will ultimately damage the economy and thus the diversified portfolios most of its shareholders own. And we understand those shareholders, whom we are paid to advise, might want the company to end such practices in order to preserve the value of their portfolios. But we nevertheless recommend against asking the company to report on that issue because we believe, despite what our clients might want, the companies they own are required by law to make decisions that are harmful to their owners.***

Interestingly, this echoes an argument recently made in *The Wall Street Journal* by Vivek Ramaswamy, a leading voice in the political campaign to stop investors from incorporating ESG considerations into their investment strategies:

> *Some ESG proponents argue that even if socially motivated proxy voting doesn't help individual companies, it nonetheless maximizes value across investment portfolios… Reducing the value of companies one at a time is a dubious way to increase the value of a portfolio—**and in any case, a board's fiduciary duty is to its own shareholders, not other companies'**.*

On Monday, October 3, a class action was filed against the directors of Meta Platforms (formerly Facebook, Inc.) with our assistance. The lawsuit challenges this narrow understanding of fiduciary duty, alleging multiple breaches based on the conduct outlined in The Facebook Files series published last year in *The Wall Street Journal*. The complaint alleges not that the conduct was bad for Meta's finances, but rather that the conduct harms the global economy, thereby threatening the portfolios of Meta's diversified shareholders.

## SEASON TAKEAWAYS AND CALLS TO ACTION

The increase in votes we received in 2022 reflect lessons we've learned, but also increased understanding of the need to move beyond enterprise-value metrics as the sole measure of company success for investors. We plan to capitalize on that momentum in 2023 and beyond by catalyzing campaigns that seek to establish guardrails to ensure that companies are not profiting from practices that externalize costs that their own investors pay for through the rest of their portfolios. For a full explanation of the guardrail strategy, see our case studies on climate change and antimicrobial resistance.

These campaigns may take the form of shareholder resolutions, but they may also evolve toward vote "no" campaigns against directors at companies that continue to externalize costs. Whatever the tactic, we want to focus on pushing companies to act within parameters that encourage healthy competition for profit within bounds that protect social institutions and environmental systems. Contact Sara E. Murphy, our Chief Strategy Officer, if you are interested in learning about our upcoming guardrail campaigns.

But the success of these campaigns depends on investment professionals understanding the need to prioritize the systems that support diversified portfolios. Currently, the proxy advisory business is failing its clients in this area. It is important that their clients—asset owners and managers alike—communicate the need for advice that accounts for the diversified nature of their beneficiaries. Investors interested in voting policies and mandates that communicate just such an approach can visit the System Stewardship Tools section of our website or contact us directly.

## A FINAL WORD

TSC is very grateful for its community of supporters, including our funders, our hard-working board, the commenters who contributed to our case studies and other publications, and the many investors and members of the financial services community who work with us. We are also grateful to be part of a larger movement seeking to change the paradigm of investing, and to be able to stand on the shoulders of the pioneers who came before us.

Thanks to all.

**A:** PO Box 1268 | Northampton, MA 01061 | USA **P:** +1-302-485-0497 **E:** info@theshareholdercommons.com