Corporate Governance

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Retirement Security

Congress passed the Employee Retirement Income Security Act (ERISA), which governs private pensions, in 1974, in response to widespread concerns at the time that both private employers and union officials were mismanaging pension funds and that American workers were being shortchanged on retirement benefits that they had been promised. ERISA requires pension fund managers "to act solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits to participants." However, in recent years, politically motivated pension managers have sought to direct capital toward other, unrelated "non-pecuniary" goals, including those associated with environmental, social, and governance (ESG) theory.

In November 2020 the Department of Labor published a final rule, "Financial Factors in Selecting Plan Investments," to protect pension plan beneficiaries from having the value of their retirement assets eroded by this trend. Then in December 2020, the Department published a related rule, "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights," modifying the expectations for proxy voting by pension fund managers with respect to ESG considerations. This rule, as with the previous one, had the goal of protecting retirees' assets from politically motivated mismanagement.

However, in March 2021 the Biden administration's Department of Labor announced that it would not enforce these recently enacted rules and intended to "revisit" them. This was, in part, an effort to comply with President Biden's executive order 13990, "Protecting Public Health and the Environment and Restoring Science to Tackle the Climate Crisis," which directed federal agencies to review existing regulations promulgated under the previous administration that may be inconsistent with the current administration's policies on climate change. The new rule on ESG and pension management from the Department of Labor, overturning the two previous rules from the Trump administration, was published in November 2022.

Congress should:

- End the back-and-forth rulemakings at the Department of Labor by amending Title I of ERISA to clarify that pension fiduciaries must pursue *only* pecuniary benefits for beneficiaries, as was the standard expectation during most of the time since the law was passed.

That process of revisiting the 2020 rules resulted in a new rule proposed in October 2021, "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights," which has now effectively repealed both of the previous rules.

That new rule cites the language of executive order 13990 as justification, but omits the section of the order that calls for it to be "implemented in a manner consistent with applicable law." Overriding the investment security of pension fund beneficiaries in pursuit of climate goals is not consistent with the requirements of current law, and therefore the new rule should not be considered valid. ERISA requires pension funds and the people who administer them to direct investment decisions solely toward funding the retirements of workers. There is no mention of climate change, gender diversity, or denying capital to firms that are not considered to be "socially responsible."

The two Trump-era rules restated that expectation and warned against the increasingly frequent practice of using ESG factors, rather than traditional return calculations, to select investments and guide their proxy voting. Managers who did choose to include ESG factors in their investment decisions were expected to demonstrate that these political considerations were not resulting in lower profits, but were only being used as a tiebreaker among options with otherwise identical expected returns.

Safeguarding the retirement security of working Americans is a vital societal goal, and a key element of the American dream. Men and women who have worked and saved for decades, especially when they have no ability to take their pension benefits into an individualized plan, should not have their financial future determined by the political and social whims of fund investment managers.

Securities and Exchange Commission

The popularity of environmental, social, and governance theory in the business world has fueled an enthusiasm in recent years for integrating such factors into both individual firm management and portfolio selection. This generally takes one of two major forms:

- As a purely profit-driven way of avoiding business risks associated with things like climate change; or
- Via a semi-concessionary altruistic method in which investors accept the likelihood of lower investment returns through divestment from firms that are legal, but considered ethically problematic, such as fossil-fuel, tobacco, and firearms producers.

ESG integration and investing is often defended as a mainstream, non-ideological approach to financial management, but critics insist that it is part of an ideologically driven effort to introduce controversial policy positions into management practice, industry standards, and regulatory policy. In the last few years, conservative, centrist, and even left-leaning critiques of ESG have multiplied, as have legislative and regulatory efforts to stop or reverse government policy that encourages this trend.

One of the most significant instances of this overreach is the climate disclosure rule proposed by the Securities and Exchange Commission in March 2022. This proposal will effectively require firms to prioritize an array of politically motivated "stakeholder" groups ahead of the legal owners of corporations, their shareholders. The proposal is legally unjustified, not needed to cover legitimate climate concerns, misapplies the concept of materiality, will not lead to consistent data reporting, and ignores significant compliance costs.

Congress should:

- Amend the Securities Act of 1933 and the Securities and Exchange Act of 1934 to reestablish and permanently define the traditional understanding of "materiality" and limit the SEC's ability to establish disclosure requirements and prescribe other behavior by registrant firms in ways that are consistent with that definition. This would stop future commissions from engaging in further mission creep into the non-finance realms of environmental and social policy. There is nothing stopping any future Congress from legislating separately on those issues, if future majorities decide that federal action is necessary. But the SEC should not, on its own, be allowed to independently redefine its mission, especially when that redefinition involves massively increasing its purview over topics that Congress did not grant it authority over, and in some cases explicitly refused to legislate on.

Other future rules that SEC commissioners have hinted at, including ones regarding management of "human capital," will suffer from many of the same flaws that accompany all central planning schemes. Even if the federal government were to create a quantitative method for measuring all of the relevant data categories in question, no prescriptive rule can replace the discernment of corporate managers, board members, and voting shareholders when it comes to the relative costs and benefits of engaging with these topics. Different firms will be exposed to climate and workforce management risks to differing degrees and the calculus for what policies to adopt and what data to disclose will vary by firm. This is what the SEC's longstanding "principles-based" materiality standard is built around.

Furthermore, the SEC seems to be acting on flimsy legal authority in this regard. Former SEC Deputy General Counsel Andrew Vollmer argues that the agency does not have the authority to issue the kind of climate disclosure rule it has proposed. He writes in an August 2021 study that "even if climate-change information is material to investors, the SEC does not currently have statutory authority to make rules requiring companies to disclose it."

Moreover, the kind of disclosures that the SEC seeks to require would be subjective and inherently disparaging in the context of an administration policy explicitly seeking to choke off access to capital by energy-intensive firms. This would put the legality of the rule in significant peril in light of the precedent in *National Association* *of Manufacturers v. SEC,* which partially invalidated the Dodd-Frank conflict-minerals disclosure requirement on compelled-speech grounds.

Corporate Chartering

From the earliest days of general-purpose financial corporations in the United States, companies have been chartered and regulated at the state level, with each state having its own particular process and demands. This diversity of legal approaches to incorporation and governance has yielded significant benefits. States with the most practical and efficient legal regimes have prospered, while corporate founders have been able to steer their firms toward the best-governed systems. Combined with the freedom of corporations to do business across the entire country with a single state charter, this means that legally necessary governance and liability issues are handled with the least amount of red tape and bureaucratic hoop-jumping for firm managers and shareholders.

We can see the value of this federalist approach in the fact that the popularity of corporate chartering in various states is highly uneven. Delaware, with its Chancery Court for resolving business disputes, is famously the most popular state for U.S. corporations. If the varying corporate governance statues across the 50 states were equally advantageous, we would likely see little difference in rates of incorporation among states, relative to their total amount of economic activity. That the reality is extremely lopsided tells us that some legal frameworks work significantly better than others, and that the competition between the states is the most important factor in shaping those better regimes.

Unfortunately, some policy advocates would prefer to replace this federalist system of corporate chartering with a federal takeover of corporate governance. Federal agencies like the Securities and Exchange Commission already regulate public companies, but those regulations govern matters such as when firms go public and their equity shares are traded, not whether and how they can come into existence at all. Moreover, the SEC's mission is to "protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation." The expansion of federal chartering to U.S. corporations would actually endanger those goals.

Congress should:

- Reject any corporate governance legislation that would federalize corporate chartering, require employee approval of board members, or otherwise undermine the property rights of shareholders.

The clearest example of this threat in recent years is the Accountable Capitalism Act (S. 3215, 117th Congress), most recently introduced by Sen. Elizabeth Warren (D-MA), which would require corporations with over $1 billion in annual revenue to obtain a charter from a newly created office within the Department of Commerce. It would also require such firms to reject the traditional obligation—backed by longstanding legal precedent—to maximize value for shareholders and instead embrace a "stakeholder" model that requires company directors to consider the interests of "all corporate stakeholders."

The new Office of United States Corporations would have the authority to punish any company deemed insufficiently solicitous to said stakeholder interests. The legislation further invites politically motivated state attorneys general to petition the director of the Office of Corporations to revoke specific corporate charters. The director would have it in his or her power to do so, giving the company in question one year until its ability to operate expires. The only apparent escape from such a verdict would be a direct appeal to Congress, which would be required to pass a sort of reverse bill of attainder to save the corporation in question from legal oblivion.

Legislation like the Accountable Capitalism Act would put the continued existence of every large corporation in the country in the hands of a single sub-cabinet-level political appointee, empowered to determine whether a firm's "misconduct" had "caused significant harm" to customers, employees, shareholders, or business partners.

The last category is especially problematic, as any company unhappy with the current state of competition could attempt to undercut its industry peers by lobbying to have them hauled before the Office of Corporations. Even if unsuccessful, such a review could torpedo the share price of the targeted company. Such vague standards adjudicating disputes in which billions, and even trillions, of dollars of economic value are at stake would invite the very worst abuses of power. No procedure close to this level of gravity should be decided administratively rather than through the due process provided by an Article III court.

The Accountable Capitalism Act would also require a major change to board composition. One, frequently promoted by Sen. Bernie Sanders (I-VT), would require 40 percent of a firm's board of directors to be elected by employees. This would turn the definition of stock ownership on its head and give individuals who have not supplied the firm with any capital and bear no liability for its debts a massive amount of control over its operations. Shareholders who hold large stakes in a corporation, and have foregone other investment opportunities to continue holding their shares, would see the value of their investment massively diluted in favor of whoever happens to be on the payroll the week such legislation comes into effect.

There is nothing wrong with a company's employees having a voice in management decisions and even participating in board elections. Many corporations have long included employee stock purchase and reward plans as part of their compensation packages. Such programs give employees more say in corporate affairs and a share of profits via dividend payments. But those programs, approved by each firm's management, do not simply hand over control of a corporation to employees regardless of their tenure, level of responsibility, and contributions to the firm. A corporation should no more be required to let all employees vote for its board members than home repair contractors should be given an ownership share in every private house they renovate or build.

Corporations can bind themselves voluntarily to such requirements, if their management sees the value of doing so, but it would be counterproductive and unjust for Congress to override the rights of shareholders in the interest of some vague notion of "social responsibility."

Expert: Richard Morrison

For Further Reading

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