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VIA ELECTRONIC FILING

Office of Regulations and Interpretations  
Employee Benefits Security Administration  
Room N-5655  
U.S. Department of Labor  
200 Constitution Avenue NW  
Washington, DC 20210  
[www.regulations.gov](http://www.regulations.gov)

RE: *Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights* (RIN 1210-AC03)

Submitted by: Bernard S. Sharfman and James R. Copland\*

Dear Acting Assistant Secretary Khawar,

We respectfully submit this letter as a means to bring to your attention deficiencies in the Department's proposed rule, *Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights* ("the Proposed Rule"), 86 Fed. Reg. 57272 (Oct 14, 2021).

### **Delegating Shareholder Voting Rights to Investment Advisers of Index Funds**

The Employee Retirement Income Security Act requires a fiduciary governed by the act to "discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."<sup>1</sup> The Department first took the position, in the "Avon Letter" back in the 1988,<sup>2</sup> that the fiduciary act of managing plan assets includes the management of voting rights (as well as other shareholder rights) appurtenant to shares of stock. We find it appropriate that the proposed rule would clarify the Department's position in formal rulemaking.<sup>3</sup> However, we strongly, but respectfully, disagree with the Department's approach. Specifically, for purposes of this comment letter, we object to the Department's treatment of investment advisers to funds, as delineated in paragraph (d) of the proposed rule.<sup>4</sup> The Department's approach does not reflect how dramatically

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<sup>1</sup> Employee Retirement Income Security Act of 1974 § 404(a)(1)(B), *codified at* 29 U.S.C. § 1104(a)(1)(B).

<sup>2</sup> U.S. Dep't of Labor, Pension & Welfare Benefit Admin., Opinion Letter on Avon Products, Inc. Employees' Retirement Plan (Feb. 23, 1988) [Avon Letter].

<sup>3</sup> U.S. Dep't of Labor, Employee Benefits Security Administration, *Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights*, 86 Fed. Reg. 57272, 57286 (Oct. 14, 2021).

<sup>4</sup> Specifically, the Department states: "Paragraph (d) would not affect plans with respect to stock held through registered investment companies, because it would not apply to such funds' internal management of such underlying investments. Paragraph (d) of the proposal also would not apply to voting, tender, and similar rights

the rise of large investment advisers to mutual funds and exchange traded funds (“ETFs”) has changed the control of voting authority in the U.S. stock markets.

## 1. The New Controllers of Shareholder Voting Authority

The U.S. equities markets are now dominated by five investment advisers: The Vanguard Group, Inc., BlackRock, Fidelity, American Funds, and State Street Global Advisors.<sup>5</sup> As of July 2021, Vanguard was reported to have under management \$6.8 trillion in U.S. equities, BlackRock \$2.65 trillion, Fidelity \$2.4 trillion, American Funds \$2.2 trillion and State Street \$970 billion.<sup>6</sup> In total, the Big 5 investment advisers managed approximately \$15 trillion in U.S. equities,<sup>7</sup> or roughly 30% of the total U.S. stock market value.

Along with this concentration of equity assets under management has come a parallel concentration of shareholder voting into the hands of these investment advisers. This concentration has come about because of the industry practice of mutual funds and exchange traded funds (“ETFs”) delegating their shareholder voting authority to the investment adviser that has been contractually hired to manage its portfolio. This “decoupling” or “unbundling” of voting interests from economic interests in the context of shareholder voting is referred to as “empty voting”<sup>8</sup>—here, the empty voting of investment advisers on behalf of equity mutual funds and ETFs.<sup>9</sup> In this case, unless the investment adviser has purchased shares or some other interest in the fund itself, it has no economic interest in the underlying equities owned by the fund.<sup>10</sup>

These large investment advisers, like all investment advisers, contract with their mutual fund and ETF clients to manage their investments. However, with both investment and shareholder voting power delegated to them, and no economic interest in the underlying securities, they can be understood in economic terms as agents working on behalf of their principals -- their mutual fund and ETF clients and their respective beneficial investors.<sup>11</sup> Like all agents, these investment advisers may be tempted

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with respect to securities that are passed through pursuant to the terms of an individual account plan to participants and beneficiaries with accounts holding such securities.”

<sup>5</sup> Oisín Breen, *Suddenly Vanguard, BlackRock, State Street not only have the assets but the power of ESG mandates, which make them a growing threat to shareholder democracy, critics say*, RIABIZ (July 28, 2021), <https://riabiz.com/a/2021/7/28/suddenly-vanguard-blackrock-state-street-not-only-have-the-assets-but-the-power-of-esg-mandates-which-make-them-a-growing-threat-to-shareholder-democracy-critics-say>.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> Henry T. C. Hu, *Financial Innovation and Governance Mechanisms: The Evolution of Decoupling and Transparency*, 70 BUS. LAW. 347, 355 (2015).

<sup>9</sup> See Bernard S. Sharfman, *Mutual Fund Advisors’ “Empty Voting” Raises New Governance Issues*, Colum. L. Sch.: Blue Sky Blog (July 3, 2017), <http://clsbluesky.law.columbia.edu/2017/07/03/mutual-fund-advisors-empty-voting-raises-new-governance-issues/> [https://perma.cc/5KLJ-42M8]. Mr. Sharfman was the first to refer to empty voting in the context of investment advisers. See Jill E. Fisch, *Mutual Fund Stewardship and the Empty Voting Problem*, BROOK. J. OF CORP., FIN. & COM. L. at 3, n.17 (Oct. 2021; forthcoming), (“I am not the first to describe mutual funds as engaging in empty voting.” See Bernard S. Sharfman, *Mutual Fund Advisors’ “Empty Voting” Raises New Governance Issues*, THE CLS BLUE SKY BLOG (July 3, 2017), <https://clsbluesky.law.columbia.edu/2017/07/03/mutual-fund-advisors-empty-voting-raises-new-governance-issues/> (describing and criticizing “the ‘empty voting’ of mutual fund advisors”)), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3939112](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3939112).

<sup>10</sup> Bernard S. Sharfman, *Mutual Fund Advisors’ “Empty Voting” Raises New Governance Issues*, The CLS Blue Sky Blog (July 3, 2017), <https://clsbluesky.law.columbia.edu/2017/07/03/mutual-fund-advisors-empty-voting-raises-new-governance-issues/>.

<sup>11</sup> Jensen and Meckling “define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves

to act opportunistically, utilizing their large amounts of delegated voting authority as a means to maximize the value of their own entities or the utility of their executive management and not necessarily the value of the index funds they manage.<sup>12</sup>

For example, just prior to voting in GameStop's 2020 proxy fight, BlackRock, Vanguard, and Fidelity held roughly 40% of GameStop shares.<sup>13</sup> However, as a result of their ability to lend out GameStop stock at extremely high short-term fee rates, 80% to 190% based on the value of the shares on an annualized basis, it was reported that only a small number of these shares were actually eligible to be voted at the annual meeting.<sup>14</sup> In sum, in exchange for enhancing their fee income, these investment advisers gave up the opportunity to vote an overwhelming portion of their GameStop shares.

## 2. The Issue under ERISA

When a plan manager utilizes index mutual funds and/or ETFs for its portfolio or offers them as selections in self-directed individual accounts, the plan has delegated away its voting authority to the investment advisers of those funds. These investment advisers, as long as they do not participate in managing an ERISA plan,<sup>15</sup> do not have fiduciary duties under ERISA. Therefore, the issue becomes whether an ERISA plan manager, investing in investment funds where the delegation of voting authority has occurred, either directly or through self-directed accounts, has a fiduciary duty to investigate the investment adviser's shareholder voting and engagement with portfolio companies?

This is the issue addressed in Mr. Sharfman's recent law review article, *The Conflict Between BlackRock's Shareholder Activism and ERISA's Fiduciary Duties*.<sup>16</sup> The issue has been little examined

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delegating some decision making authority to the agent." See Michael C. Jensen and William H. Meckling, *The Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

<sup>12</sup> According to Jensen and Meckling, "If both parties to the relationship are utility maximizers, there is good reason to believe that the agent will not always act in the best interests of the principal. *Id.* Moreover, "it is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal's viewpoint."

<sup>13</sup> See Dawn Lim, *How Investing Giants Gave Away Voting Power Ahead of a Shareholder Fight*, WALL STREET J., <https://www.wsj.com/articles/how-investing-giants-gave-away-voting-power-ahead-of-a-shareholder-fight-11591793863>.

<sup>14</sup> According to Lim, BlackRock, Vanguard, and Fidelity lend out so much of their holdings in GameStop stock that their shares eligible to vote went from approximately 40% to roughly 5%. See *id.* Lim also reported that State Street lent out GameStop stock prior to the proxy vote at the annual meeting, but how much was not known. *Id.*

<sup>15</sup> ERISA § 3(21)(B), 29 U.S.C. § 1002(21)(B) provides:

If any money or other property of an employee benefit plan is invested in securities issued by an investment company registered under the Investment Company Act of 1940 [15 U.S.C. 80a-1 et seq.], such investment shall not by itself cause such investment company or such investment company's investment adviser or principal underwriter to be deemed to be a fiduciary or a party in interest as those terms are defined in this title, except insofar as such investment company or its investment adviser or principal underwriter acts in connection with an employee benefit plan covering employees of the investment company, the investment adviser, or its principal underwriter. Nothing contained in this subparagraph shall limit the duties imposed on such investment company, investment adviser, or principal underwriter by any other law.

<sup>16</sup> Bernard S. Sharfman, *The Conflict Between BlackRock's Shareholder Activism and ERISA's Fiduciary Duties*, 73 CASE W. RES. U. REV. 1275 (2021), <https://scholarlycommons.law.case.edu/caselrev/vol71/iss4/10/>.

in the academic literature, but the concentration of shareholder voting power in the hands of a small number of investment advisers makes it ripe for study.

### 3. Plan Manager Duties Under ERISA

Mr. Sharfman's article takes the position that a plan manager has a fiduciary duty, *the duty of prudence*, to investigate BlackRock's shareholder voting and engagement with portfolio companies. This duty applies not only to the BlackRock mutual funds or ETFs that an ERISA plan invests in but also to those BlackRock fund selections that it makes available to its participants and beneficiaries in self-directed accounts. The fiduciary objective in this investigation is to ensure that BlackRock is utilizing shareholder activism consistent with a plan manager's duty of loyalty under ERISA; that is, "solely in the interest of the participants and beneficiaries" and for the *exclusive purpose* of providing financial benefits to them. If that is not happening, these funds should be excluded from an ERISA plan.

Given this fiduciary duty of investigation, Mr. Sharfman's paper also argues that if a plan manager were to investigate BlackRock's shareholder activism, it would find this use to be in conflict with the plan manager's fiduciary duties. For example, the paper finds that one objective of BlackRock's shareholder engagement is to increase the marketing of its investment products to millennials. Another objective is to appease shareholder activists who threaten to attack the business decisions, procedures, and objectives of its own corporate management. In both cases, shareholder voting and engagement are not being executed *solely* in the interest of its beneficial investors, including those beneficial investors who are participants and beneficiaries of an ERISA plan. As a result, those BlackRock-managed funds where its investment stewardship team has been delegated voting and engagement authority should not be allowed to become part of an ERISA plan until remedial action is taken.

While the focus of Mr. Sharfman's paper is on BlackRock's delegated voting authority and associated shareholder activism, it is meant to apply to any investment advisers who attempt to leverage their delegated voting authority for purposes of engaging in opportunistic voting and engagement with portfolio companies. In addition, the Department should provide guidance to plan managers on when to exclude the investment products of investment advisers with delegated voting authority.

### 4. Implications for Judicial Review

The Administrative Procedure Act calls upon courts reviewing agency rulemaking to "decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action"—as well as to review all "findings" and "conclusions" and rejecting those deemed to be "arbitrary," "capricious," or "an abuse of discretion."<sup>17</sup> The Supreme Court has long determined to give agency rulemaking a "hard look," under *State Farm*,<sup>18</sup> though it has traditionally deferred to agency interpretations of ambiguous statutory language under *Chevron*.<sup>19</sup> Regardless of which review standard courts adopt here, we are very concerned that the Department's final rule may not address the issue as stated above. Given how significant and important the delegated voting authority of investment advisers to investment funds has become, we believe that not addressing

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<sup>17</sup> Administrative Procedure Act, Pub. L. 79-404, 60 Stat. 237 (1946), § 706, *codified at* 5 U.S.C. § 706.

<sup>18</sup> *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

<sup>19</sup> *Chevron U.S.A., Inc. v. NRDC*, 467 U.S. 837, 844-845 (1984).

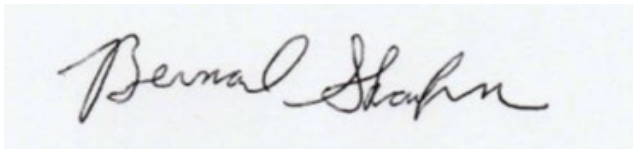
the issue may be found by a reviewing court not to be “acceptable reasoning”<sup>20</sup> and therefore “an abuse of discretion” under the Administrative Procedures Act (“APA”).<sup>21</sup> Therefore, we believe the Department must address this issue or face a potential court challenge.

## 5. Summary

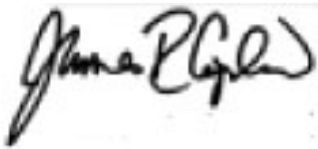
While the voting authority of an investment adviser on behalf of a mutual fund or ETF does not come under the fiduciary duties of ERISA, it is doubtful that the intent of the Avon Letter and all subsequent guidance in this regard was meant to absolve a plan manager of any fiduciary duty associated with the shareholder voting of shares that it now owns indirectly through its share ownership in mutual funds and ETFs. The result would be an abdication of fiduciary duties in the context of shareholder voting and would lead in many cases to the absurd result that the plan manager has totally abdicated its fiduciary duties in this respect.

In sum, an ERISA plan manager cannot simply delegate away its fiduciary duties when delegating its shareholder voting authority to an investment adviser. The plan manager’s duty of prudence requires it to investigate an investment adviser’s shareholder activism to see what financial impact it will have on its participants and beneficiaries. Therefore, we would like to see the proposed rule modified accordingly.

Very truly yours,

A handwritten signature in black ink on a light blue background. The signature is cursive and reads "Bernard Sharfman".

Bernard Sharfman

A handwritten signature in black ink on a white background. The signature is cursive and reads "James R. Copland".

James R. Copland

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<sup>20</sup> Ronald M. Levin, *The Anatomy of Chevron: Step Two Reconsidered*, 72 CHICAGO-KENT L. REV. 1253, 1270 (1997) (“Analysis under step one of Chevron could proceed, as the Supreme Court had said it should, from the “traditional tools of statutory construction.” Abuse of discretion review, on the other hand, could be used to assess the rationality of an agency’s exercise of discretion. The court seems to be headed towards a fairly tidy analytical structure, in which step one asks whether the agency violated a clear mandate in the statute itself, and step two asks whether the agency used acceptable reasoning to get from the statute to its ultimate result.”).

<sup>21</sup> Quoting 5 U.S.C. § 706(2)(A).