What Would Milton Friedman Say About Proxy Voting and ESG?

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Executive Summary

- Milton Friedman believed the only role of a company was profit maximization and he was against Socially Responsible objectives as a role for the private sector. He believed these goals were best achieved by the public sector.
- Since Friedman's time socially responsible investing (SRI) has evolved into environmental, social, and governance (ESG) factors and a growing body of academic literature shows ESG principles, implemented in corporate management, can increase margins, profits, and performance.
- ESG integration into the investment process includes the proxy process.
- The number of ESG proxy initiatives are on the rise and becoming a dominant part of the proxy voting landscape.
- At the same time, the SEC and Congress are examining the role of proxy service providers such as ISS and Glass Lewis, and whether they have too much power.
- The SEC is particularly concerned that investment firms that use proxy service providers no longer develop an independent view point and have instead become robo-voters, voting the recommendation of proxy service providers without critical thought.
- Yet, proxy service providers can help investment firms and the investors they serve gain operational efficiencies in the proxy voting process and reduce costs through the delivery of a breadth of research that any individual firm may be unable to replicate.
- The UN PRI commits investment firms and investors to engage with the companies they own and the proxy process is an important way for investors to influence corporate policies.
- Fiera Capital Corporation is a UN PRI signatory and has adopted its own proxy policy that we believe best represents the interests of our clients, and our firm's own views on ESG related policies.
- Clients of proxy service providers need to conduct their own due diligence to ensure the proxy service provider they select meets their needs and that they are satisfied the firm they use has strong policies and governance to manage potential conflicts of interest.

As we enter proxy season, a time when shareholders express their views about board governance, executive compensation and, in 2019, a range of environmental and social initiatives through the proxy voting process, we would be well served to understand Friedman's perspective on capitalism and the role of profit maximization as the linchpin that makes capitalism function properly.

Milton Friedman was unaware of the yet to be invented acronym ESG, yet back in 1970 he foresaw that the rise of social responsibility would force capitalism to perhaps rethink how it functions, how it organizes itself, and the role of profit maximization itself in the process. By examining the proxy process, in part through Friedman's framework, we can also better understand the tensions that are emerging in the investment community as ESG investment process integration is ascendant, and as regulators and other interested parties reconsider the role of proxy advisors in this process. Friedman's views, and the ideas he suggested for thinking through this issue, help us understand why the Securities and Exchange Commission (SEC) is now so interested in the proxy process, as is the United States Congress, the United Nations, the New York Stock Exchange, pensions and endowments around the globe, and individual investors whose voices have often been lost in this conversation. First, let's recall why proxies are so important: In free market capitalism, shareholders matter because they own the company.

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Shareholders have the right to express their views on executive compensation, board governance, and a range of Environmental, Social, and Governance (ESG) issues through the proxy voting process.

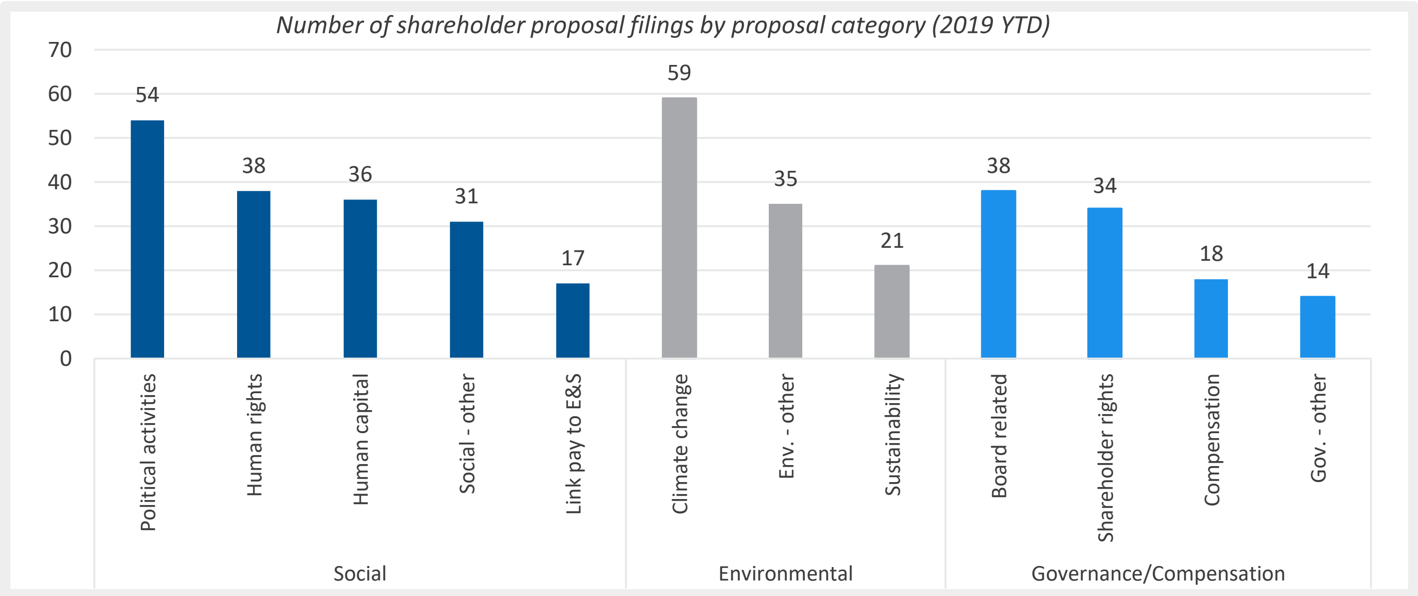
In the heated debate about ESG investing, proxies are now taking center stage. Investors are not only expressing views about executive pay and governance, but on corporate policies that impact a range of social matters. As the table below shows, as of February 28th there have been 395 shareholder proposals filed with US corporations and ESG related issues are a dominant share of these proposals. Many of these proposals relate to environmental themes such as sustainability, climate change risks or requirements for corporations to disclose carbon emissions targets. Others relate to matters one might typically associate with government and political reform, such as requiring greater corporate disclosures on lobbying and political contributions. The rising cost of drugs, important in the general political debate, has also entered into the debate about proxy votes.

There are shareholder proposals that require greater reporting on drug price increases and greater corporate oversight of these pricing decisions, including the links between drug price increases and executive pay. Healthcare is the sector that has thus far received the most interest from shareholders this proxy season, and given the concerns about the environment, the energy sector cannot be far behind.[1]

The proxy process is the mechanism that gives the owners of corporations the ability to determine how they are run and operated and the SEC is worried that this process no longer functions properly.

In 2018, the Chairman of the SEC, Jay Clayton, announced an SEC Staff Roundtable to spotlight the SEC's developing concerns and to open a more energetic dialogue with the public. The SEC is particularly interested in understanding if "the U.S. proxy system as a whole operates with the accuracy, reliability, transparency, accountability, and integrity that shareholders and companies should expect." Some of the SEC's more specific concerns include "over-voting and under-voting of shares." To clarify, whether it's by accident, or by design, over-voting means that more votes are cast for a shareholder proposal than actually exist. As the nation remains consumed with an investigation of Russian interference in a US Presidential election, proxy voting irregularities are not hard to imagine.

E&S Proposals Outnumber Governance Proposals in Early 2019



Source: ISS Analytics

The SEC is also concerned that the proxy process has become so complex that the voice of individuals has been lost. Retail shareholders voted less than 30% of their shares in 2017, while institutional investors voted over 90% of their shares.[2] When the SEC is concerned about the accuracy and accessibility of a process that is a bedrock of capitalism, and wonders if it has adequate integrity and reliability, everyone who thinks healthy democracy rests on healthy capitalism should worry.

The SEC's staff roundtable in late 2018 gave voice to a range of stakeholders in this process including proxy advisors, investment firms (both passive and active), pensions, and policymakers. There was significant discussion about the role of proxy advisors such as ISS, Glass Lewis, and Egan Jones. The SEC has shown great interest in the role of proxy advisors in recent years and has increasingly stressed that investment firms are accountable for overseeing the voting process, the views they express through votes, and the quality of research that supports those views, even when they rely on a proxy advisor.[3] The SEC acknowledges that proxy advisors can help investment firms reduce the cost of managing the proxy process for investors, but is concerned that the oligopoly of firms that controls this space is too powerful and perhaps conflicted.

At the same time, there has been an extraordinary concentration of power in the hands of institutional investors and now more than 80% of the market value of both the S&P 500 and the Russell 3000 is controlled by institutional investors.[4] Capitalism works best when free markets discount the views of many voices. Now, we have a concentrated number of institutional voices speaking out in the proxy process and a concentrated number of proxy service advisors making recommendations to this audience.

The SEC is worried about these developments and the SEC is not alone in its concerns on this subject. In fact, a bipartisan group in Congress has expressed concerns as well. They have introduced legislation called the Corporate Governance Fairness Act and it would require the SEC to regulate proxy advisors under the Investment Advisors Act. This bill would require the proxy firms to be subject to audits like investment firms to ensure there are no conflicts of interest in how they research and recommend proxy votes to investors. Importantly, this legislation has been endorsed by the New York Stock Exchange, the Society for Corporate Governance, and the Consumer Federation of America.[5] A wide range of senators and public interest groups have raised their voices in support.[6] The concern about the possibility of conflicts is reasonable. As Reuters has reported, "ISS offers consulting services to the same companies on which it provides voting recommendations, while Glass Lewis is largely owned by an activist investor, the Ontario Teachers' Pension Plan."[7] While the possibility of a conflict does not mean a conflict exists, the concentration of power in these two firms is certainly worthy of public debate. As a practical matter, the SEC also acknowledges the important role proxy service providers play in increasing the efficiency of the proxy process, and as a result, reducing the cost of the proxy process for shareholders.[8] Nonetheless, it's important for the clients of these proxy service providers to conduct their own due diligence to make sure their services meet their needs, regardless of the cost savings and efficiencies they offer, and to conduct their own evaluation of a service provider's conflicts policy to ensure it is satisfactory.

While the proxy service providers play an important and constructive role in the proxy voting process, it's worth noting the New York Stock Exchange has expressed concerns about the proxy process that should make every investor pay attention to this important subject:

> **"Over time, two firms, have captured the vast majority of market share for proxy advisory services. These firms design opaque, and in the view of many, subjective standards to benchmark corporate issuers across a variety of corporate governance and other measures. Based on these non-public benchmarks, proxy advisory firms issue recommendations to their institutional clients electronically, with the default setting designed to steer the client to vote in-line with their recommendation.[9]"**

Clearly, The New York Stock Exchange would like the public to focus more on this process, so central to the proper functioning of capitalism, and investors with an ESG orientation are already taking action, and as noted at the beginning of this essay, shaping the agenda items dominating this proxy season. And, what would Milton Friedman say about all of this?

Fifty years ahead of his time, Milton Friedman foresaw the essential dimensions of the ESG debate raging at investment companies, pension funds, mutual funds, and foundations today.

In his essay, "The Social Responsibility of Business Is To Increase Profits", Friedman outlines examples of behavior that many today would applaud as socially responsible and in certain cases as the proper integration of ESG concepts in the management of a modern corporation:

- A company that spends more on reducing pollution than is required by law
- A company that fights inflation by holding back price increases
- A company that hires long-term unemployed workers that require training

While the objectives above are notable, they were not, in Friedman's thinking, the role of a company. He believed these objectives were best achieved through government policy. In 1962's *Capitalism and Freedom*, Friedman argued that the only social responsibility of business is "to increase profits so long as it stays within the rules of the game."[10] Here is why Friedman valued profits over social policy as the objective of a corporation:

All three of the socially responsible examples noted by Friedman cost a company money (or reduce profits) and Friedman argues they are counter to meeting the only objective that should matter to shareholders – profit maximization. Pollution control is costly, training workers who have been unemployed for a long time rather than hiring workers with experience costs money, and holding back prices (think drug companies today) costs money.

Yet, academic literature today increasingly shows that the integration of ESG principles in corporate management contributes to risk management and profit maximization. Research conducted at Harvard Business School demonstrates that corporations that utilize ESG concepts in enterprise management are developing competitive advantages over their peers and that investors that own shares in these companies have historically enjoyed returns that are superior to conventional portfolios with less risk. While there is a growing awareness that ESG principles can reduce risk, the research at Harvard demonstrates that ESG focused management has achieved increased efficiencies, and improved market positioning.[11] As *The Financial Times* recently reported, "Companies with better environmental, social and governance standards are more profitable and trade at a premium to rivals."[12] A major source for this viewpoint is a research study conducted by Boston Consulting Group (BCG) that evaluated over 300 major companies. This study showed that companies with strong ESG performance show improved margins and performance. Companies with superior performance in key ESG categories exhibited superior margins when compared to the median performers.[13]

Today, a growing number of investors want the companies they own to integrate ESG concepts and objectives into corporate management. Is this reasonable and is it feasible?

Most companies in the United States are domiciled in Delaware and under the laws of that state corporate directors are elected by shareholders and "owe their loyalty to those who elect them." This is as significant as it sounds – If, shareholders want their directors to hire executives who focus on ESG issues, and adopt ESG policies, that's the direction the company needs to go. Professors from the University of Chicago (Friedman's old home) and Harvard argue that in 2019 shareholders clearly want corporations to focus on maximizing social welfare, not short-term profits alone. They also argue (and these are economics professors) that it is in fact the fiduciary duty of corporate directors to "maximize shareholder welfare, not value."

Today, "shareholders care about more than just money. Many shareholders pay more for fair-trade coffee, or buy electric cars rather than cheaper gas guzzlers, because, using the current economic lingo, they are prosocial. They care, at least to some degree, about the health of society at large. Why would they not want the companies they invest in to behave similarly?" And, as the Harvard and BCG studies referenced earlier highlight, these policies can also contribute to improved market share, improved margins and profits, and better performance.

The world in 2019 is vastly different than the world Friedman inhabited in 1970 when the largest agents in the globe were governments, and social change was best engineered by those governments. Back in 1970, Friedman's view that governments should be the agent of social change seemed sensible. Today, "69 of the largest 100 entities in the world by revenues are corporations", not governments.[14] Perhaps that is also why many Americans likely feel corporate America is their best hope for a more just society, and a healthier planet – in addition to the role that ESG can play in enhancing performance. And, not only do corporations have more power than many governments today, they are more trusted than government. Trust in government has collapsed in the United States. Barely a third of United States citizens believe government will "do what is right." For perspective, it's worth noting that back in the 1960's trust in government was over 80%.[15] Today, Congress is held in particularly low regard. Only 8% of Americans have a great deal of confidence in the institution.[16] According to the Gallup organization, trust in big business is meaningfully higher than trust in Congress when we screen by respondents who have either a great deal of trust, or quite a lot of trust in the institutions. Congress wins 11% in these categories, big business garners 25%. Smaller companies are held in especially high regard and win 67% of America's trust defined in this way.[17]

Today, private corporations have the power to change the world, and that is one reason some investors care about the proxy process and its use as a transformational tool to promote ESG principles.

If shareholders want change, the proxy process is in fact their best vehicle to direct change in the companies they own. Other investors embrace principles and support ESG initiatives through the proxy process because they understand an increasing body of academic literature shows that companies that adopt ESG policies perform better. As this movement gains momentum, it's important to note that it is also occurring at a time when the SEC and Congress is paying especially close attention to the proxy process. As a result of the intersection of these trends, we can expect reforms in corporate governance will likely be on the national white board for continued discussion by investors, regulators, and policymakers alike. **This includes a reexamination of how proxies are voted, so all stakeholders in this process – both individual investors and institutional investors – are equally heard.**

Important Disclosures

ENDNOTES - SOURCES

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