RESPONSIBLE ASSET MANAGERS: NEW FIDUCIARY RULES FOR THE ASSET MANAGEMENT INDUSTRY

ISSUE BRIEF BY **LENORE PALLADINO** AND **RICK ALEXANDER** | JUNE 2021

ABSTRACT

The vast holdings of asset managers give them unparalleled power over the allocation of resources in our economy. The rules that govern their responsibilities lead these asset managers to make allocation and stewardship decisions that prioritize profits at individual companies over the preservation of critical social and environmental systems. As a result, asset manager choices often exacerbate inequality, environmental degradation, and the decline of social institutions—leading to a system that is antithetical to the needs of the very households whose savings are being managed. This issue brief describes critical public policy issues raised by this misalignment in priorities and proposes legislation to address it. In particular, we propose two new fiduciary duties for asset managers. First, we propose requiring asset managers to be *responsible* for considering the total impacts of their decisions on their beneficiaries (the households on whose behalf they are investing), rather than just giving asset managers *permission* to do so, including for the welfare of communities and the environment. And second, we propose mandating substantive adherence to portfolio carbon neutrality for all asset managers.

INTRODUCTION

US households' financial assets—currently over $60 trillion in value—are held and managed as shares in corporations in ways that worsen the climate crisis, income inequality, and other societal ills. This does not happen because the workers and households that have these retirement and financial accounts (such as pensions, 401ks, and mutual funds) desire these effects; it is because their asset managers (companies like BlackRock, Vanguard, and State Street) and asset owners interpret their duty to households as being to maximize the dollar value of each company within a portfolio, even if the actual behavior of the companies in which they invest hurts the very same households and portfolios. Fiduciaries are supposed to be responsible for the actual interests of the economic beneficiaries they serve—that is, the US households whose financial assets are held by asset managers—but today's conception of asset manager fiduciary duty distorts "interests" into a narrow focus on individual companies' financial returns. However, households are made up of people who have a stake in whether we decarbonize our economy, raise job standards, and live in a healthy and more equitable society—not just in whether individual companies are optimizing their own returns. Businesses must decarbonize their production processes in order to avert climate disaster—less than one hundred global companies account for 63 percent of all emissions (Quigley 2021)—and asset managers must ensure that this transition occurs as quickly as possible.

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It is time to rewrite the rules of asset manager fiduciary duty—that is, the responsibilities that those who manage money have to those whose money it is—to more accurately reflect the interests that households have in a sustainable economy and livable planet. The climate crisis in particular necessitates new rules to ensure that all asset managers are required to invest with the long-term interests of beneficiaries in mind, which means taking action now to mitigate further climate harm and other types of systemic risk, even if such action does not optimize returns for each company in a portfolio separately. Though the majority of financial assets are held by wealthy, white households, about half of American families hold at least some corporate equity. Public policy should update the responsibilities of asset managers to meet the current structure of financial intermediation and multiple economic challenges of the 21st century. In this issue brief, we describe the current framework for how the duties of asset managers are interpreted, explain the harm that this set of standards causes, evaluate current proposals for reform through disclosure, and propose a new framework to meet the needs of the American public.

Seventy years ago, households that held stock largely did so directly. The rise of institutional investors and Modern Portfolio Theory (described in Section 2) drove the trend toward diversification and passive investing, which became enshrined in law for pension funds in 1990 with the Prudent Investor Rule (29 U.S.C. §1104 2012) (Gary 2019). In the 21st century, US households that own financial assets have largely become "universal owners" of corporate equity, meaning that their wealth is bound up in the entire stock market, not just in a small subset of companies (though the wealthiest shareholders often take a targeted approach). The majority of US households that own financial assets for retirement or other savings purposes—especially those outside of the top 10 percent of households by wealth—have little sense of how investment decisions are ultimately made (we describe this complex "financial intermediation chain" in more detail below). Families do not themselves decide where their retirement investments go: Their pools of capital are managed by asset manager fiduciaries who have legally defined fiduciary duties (i.e., the duties that define their responsibilities) to the households whose incomes are invested through the financial intermediation chain into the shares of companies. "Fiduciaries" are people or institutions who have control over a set of assets but are not the economic beneficiaries of those assets.

Today's laws are often interpreted to require fiduciaries to exclusively increase returns for each individual company they manage, which means that asset managers have an incentive to underweight the value of costs that companies externalize, because any single company will bear an infinitesimal percentage of the cost while receiving all of the benefit. Households bear all the effects of corporate "negative externalities"—an economic term that refers to the ability of an economic entity to externalize costs, as in when a company pollutes the environment and does not have to pay for it. However, an interpretation of fiduciary duty that favors underweighting the value of externalized costs creates systemic costs and risks to the beneficiaries themselves, so that the current fiduciary construct is working against the interests of the beneficiaries it was meant to protect. Thus, investing in companies that are worsening the climate crisis is incentivized if they can produce high financial returns, even if those returns are created by increasing systemic risk in the portfolio. The rise of "ESG" (Environmental, Social, and Governance) investing is a laudable step toward broadening the scope of how asset managers view risks to the companies in the portfolios they manage, but it does not yet fully account for the real-world systemic risks created by those companies to either portfolios or to beneficiaries. The majority of asset managers have only begun to call for ESG-risk *disclosure*—meaning that companies can simply disclose their harm, without a mandate to change their behavior.

We propose a set of policy reforms to the fiduciary duties of asset managers so that portfolio decisions are made with the *actual* long-term interests of US households in mind, rather than solely concerned with a company-by-company approach. Policymakers should revise the Investment Advisers Act of 1940 and the Employee Retirement Income Security Act of 1974 (ERISA) such that all asset managers are "responsible for the impact they have on the shared social and natural systems needed for a just, equitable, inclusive, and prosperous economic system" (Kassoy, Alexander, Palladino, and Ensign-Barstow 2000). Though implementing this new standard for fiduciary duties would bring up many questions that would need to be addressed through policy discussions, legislative design, and a rulemaking process, we argue that the 117th Congress should pass legislation to revise fiduciary duties for ERISA and the Investment Advisers Act, and that states should follow suit for the funds over which they have jurisdiction.[1]

We propose two specific areas for federal policy reform:

1. A substantive redefinition of asset manager fiduciary duty that calls for managers to consider the impacts of their portfolio on their beneficiaries' *common* interests, including on the welfare of communities and the environment; and
2. A substantive bright line such that portfolios must be carbon neutral by 2050 at the latest, in compliance with the Paris Agreement.

US HOUSEHOLDS AND THE GROWTH OF ASSET MANAGERS

To understand fiduciary duties, it is important to clarify what it means to be a financial "fiduciary," and the relationship this person or institution has to households. A person or individual becomes a fiduciary when they manage the funds for another individual or institution. This means that the economic benefits of a pool of money flow to the "beneficiary" of that pool of money, but the person or institution who gets the economic benefits does not make decisions about the management of the funds—those decisions are in the hands of the "fiduciary." The relationship between the

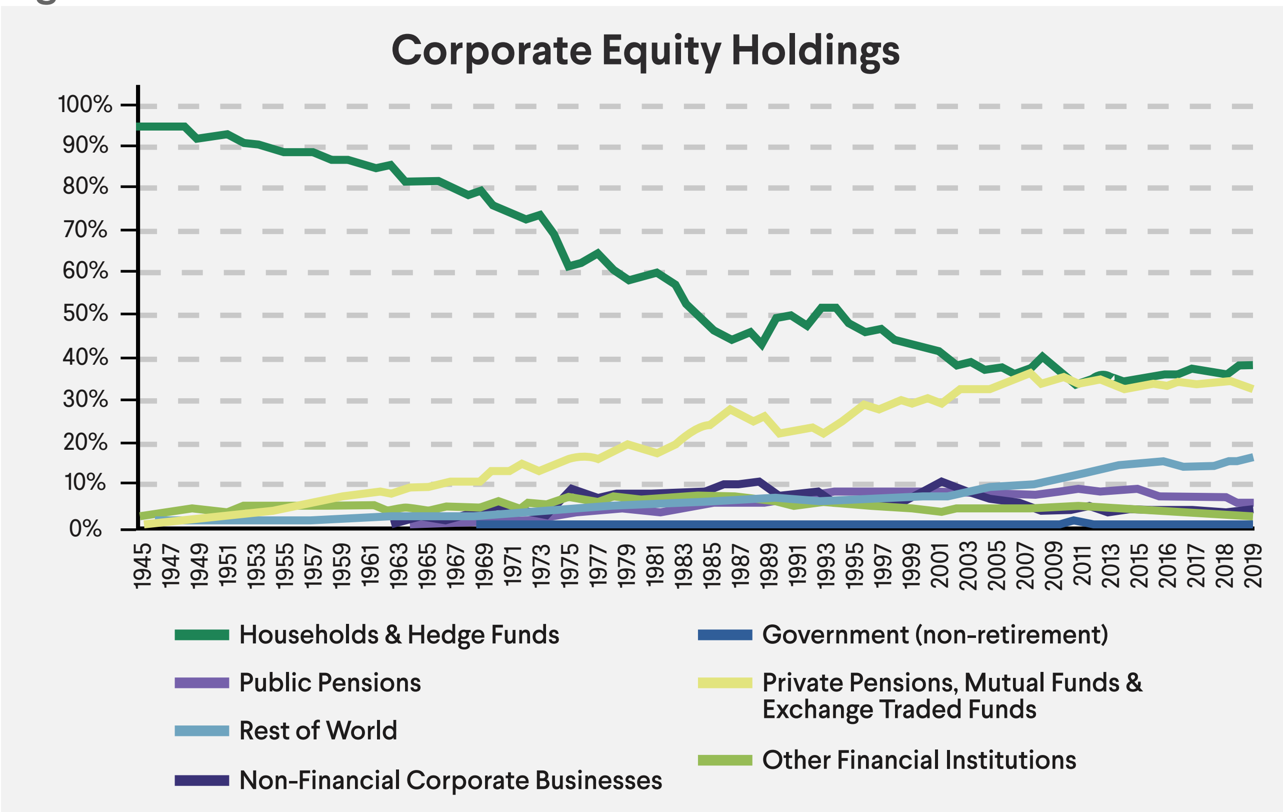
[1] Reforming asset manager fiduciary duties is a complementary policy to reforming the fiduciary duties of corporate directors, along with a wide range of policies to reform corporate governance and government action to directly support the transition of the economy away from fossil fuels.

household buying financial assets and the asset manager is a *vulnerable* relationship, because the fiduciary has control over the assets of the household (Jackson and Gillis 2019), and legal standards therefore exist for how fiduciaries must act so that they are not taking advantage of their control of another's assets.

The ways in which fiduciary duties for asset managers are defined and regulated have changed in the 21st century as households have shifted to universal ownership, as the asset manager sector itself has become increasingly concentrated, and as US households increasingly rely on their financial assets for core lifecycle needs such as retirement and higher education (Braun 2019; Steele 2020). It is important to understand the evolution of the financial intermediation chain: Over the last century, US households have shifted from investing directly in corporate equities by buying and selling individual company shares through brokers or through a pension entitlement with a relatively undiversified portfolio, to investing through several layers of financial institutions with a goal of holding a broad portfolio (Braun 2021, 7) (see Figure 1, below). In the several decades after World War II, as a result of union strength in collective bargaining, pension funds grew as channels of workers' capital into the financial system (Drucker 2013; van der Zwan 2017). At first, in order to safeguard the retirement security of their pensioners, many pension funds were required to invest only in "safe" assets—such as Treasury securities and, later, corporate bonds. The range of asset classes that this worker capital could be invested in dramatically expanded in the late 20th century as fund managers began adhering to modern portfolio theory (MPT), which emphasizes diversification as the key to risk management (though public pension funds were slower to transition than private pension funds) (van der Zwan 2017, 558—559).

MPT claims that the best approach to risk management is to limit the idiosyncratic risks that could stem from any given stock, and broadly diversify one's portfolio to reduce the impact of such risks. At the same time, the theory assumes that systemic risks to the portfolio are outside the scope of what investors can impact. The "Prudent Investor Rule," established in 1990 as the standard for investor fiduciaries, shifted responsibility to a whole-portfolio approach and eliminated restrictions on what types of assets could be held in fund portfolios, reducing limitations that kept pension funds holding only safe assets (Gary 2019, fn. 291). At the same time, the rise of mutual funds and the bias toward diversification meant that employer-based funds and household financial assets were increasingly held in index or quasi-index funds, in which idiosyncratic risk was seemingly managed because index funds track the entire market. However, these funds provide no escape from systemic risks.

Figure 1



Source: Federal Reserve Financial Accounts of the United States, L.223.

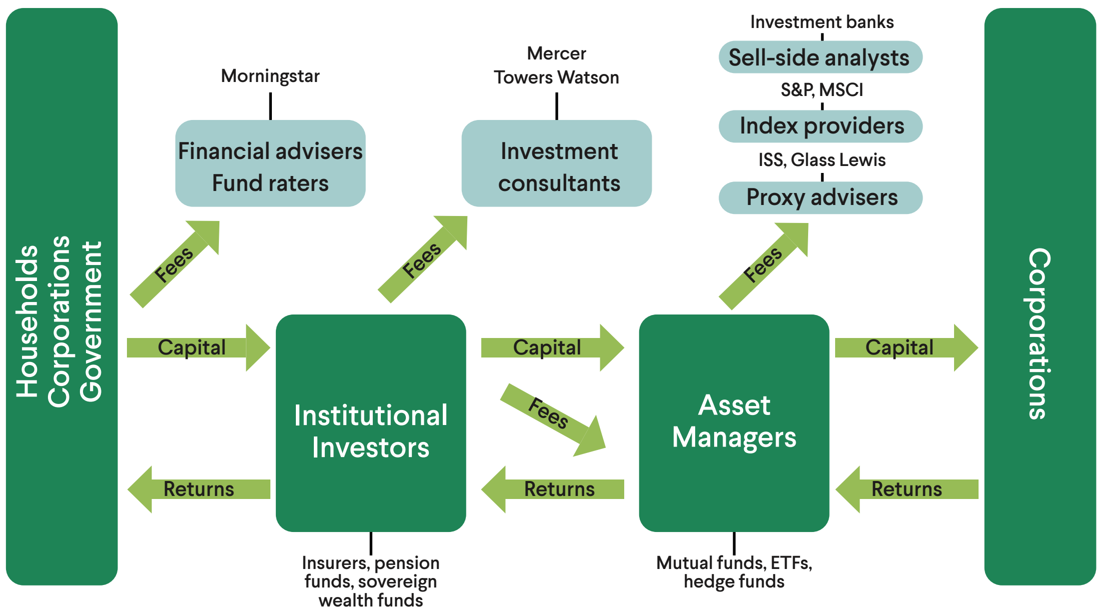
As household wealth grew, a new set of financial institutions became more important in the intermediation process: asset managers. The funds entrusted to institutional investors by employees and households—pension funds, insurance companies, or other types of funds—were no longer invested directly, but instead through asset managers in exchange for a fee, based on the idea that asset managers would be best poised to bring about high returns for the funds.[2] In this system, asset managers become the legal owners of corporate stocks, and thus have the ability to engage in corporate governance as a shareholder but are still not the *economic* beneficiaries of the funds they steward. The most prominent of these asset managers were mutual funds, which by the 1980s began to dominate private funds' portfolios as equity investments became more widespread (van der Zwan 2017, 564—565; Braun 2021, 6—7).

[2] These fees also pay financial service providers such as index providers (see footnote 1). Fee income is important, as it is a notable arena of competition between managers and is increasingly visible to the public. The rise of passive investment pushed management fees downward, as the largest asset managers increasingly claimed funds both from institutional investors and directly from workers themselves through cheap investment accounts.

Hedge funds, exchange-traded funds (ETFs),[3] private equity, and venture capital funds became a second link in the equity investment chain (Braun 2021, 6—7). Figure 2 below, by Braun (2021), depicts the resulting investment chain:

Figure 2

The Financial Intermediation Chain



US HOUSEHOLD FINANCIAL ASSETS AND CORPORATE EQUITY HOLDINGS IN 2021

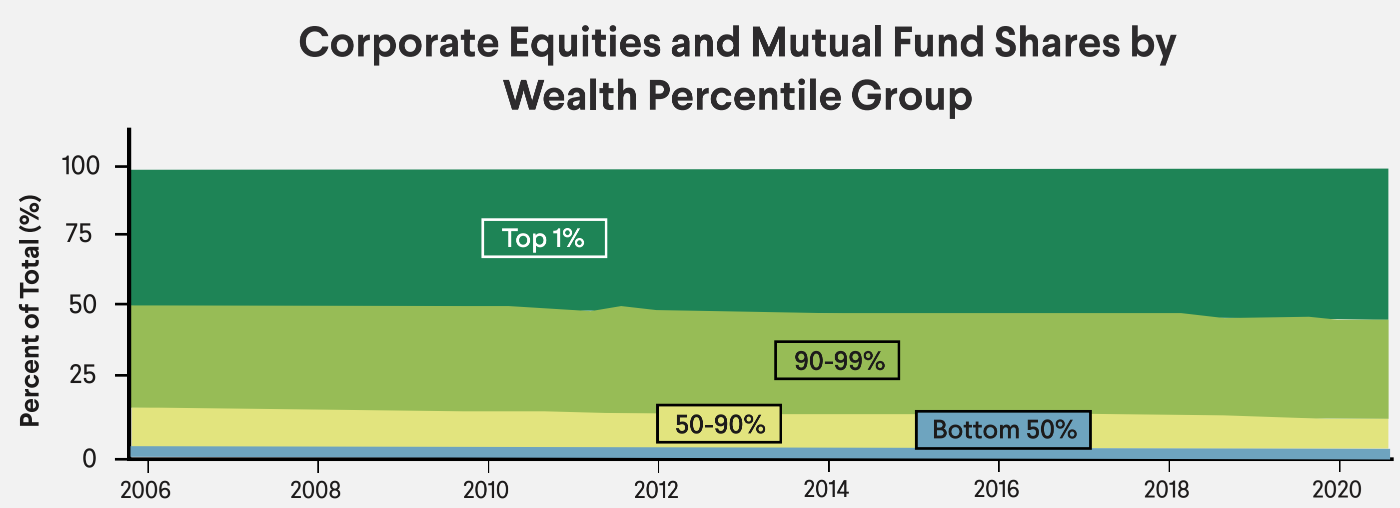
Today, US households' financial assets are the bedrock of the financial market: As of the fourth quarter of 2020, there was $30 trillion invested in the United States in employer-held retirement accounts and $33.5 trillion in other corporate equity and mutual funds (Board of Governors of the Federal Reserve System 2021). Though corporate equity holdings are highly unequal by household wealth and race, these financial assets still represent the savings for the future of millions of American families. The stewards of their assets need to invest household financial assets in a manner that *actually benefits* workers and society over the long-term.

[3] "An exchange-traded fund (ETF) is a type of security that tracks an index, sector, commodity, or other asset, but which can be purchased or sold on a stock exchange the same as a regular stock" (Chen 2021).

Employer-held funds are highly stratified by household wealth and by race and ethnicity. As of the fourth quarter of 2020, the bottom 50 percent of US households by wealth held just 3 percent of pension entitlements and just 0.6 percent of other corporate equity and mutual funds. Pension entitlements are concentrated at the top, with the top 10 percent of households by wealth holding 54 percent of pension entitlements and 88 percent of other corporate equity (Board of Governors of the Federal Reserve System 2021). Stratification by race is even starker due to intergenerational transmission of wealth, labor market discrimination, and many other factors rooted in structural racism: White households hold 80 percent of pension entitlements and 90 percent of corporate equity, while Black households own just 1 percent of corporate equity and 8 percent of pension entitlements, and Hispanic households own 0.4 percent of corporate equities and 3.1 percent of pension entitlements.[4]

Distribution of Household Wealth in the US Since 1989

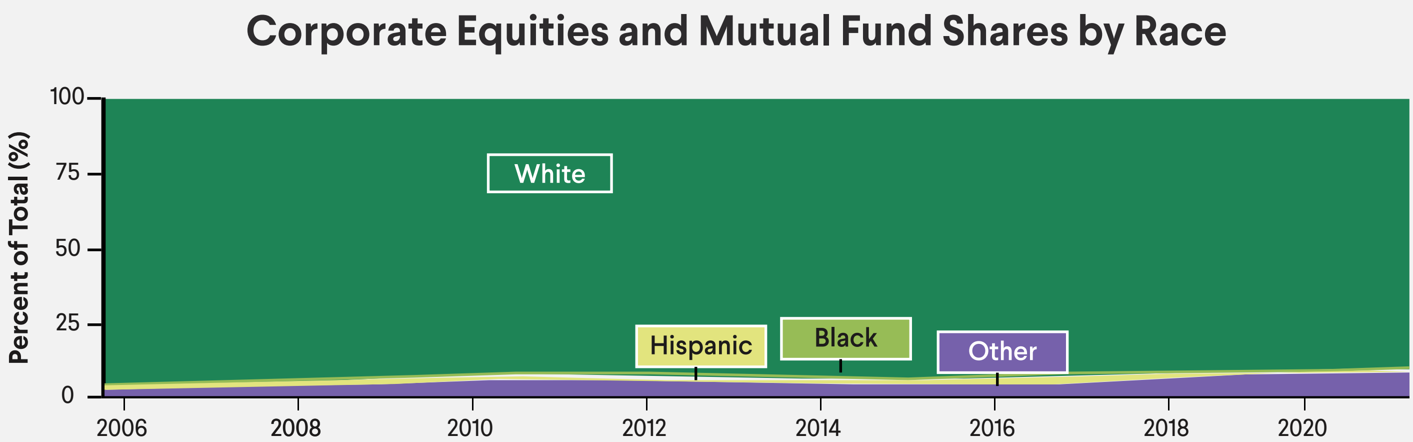
Figure 3a



Source: Survey of Consumer Finances and Financial Accounts of the United States.

[4] Unfortunately, the Federal Reserve's Distributional Financial Accounts do not report wealth for additional racial and ethnic groups, except as a generic "Other" category, which includes mixed-race households. For more background, see "The Contribution of Shareholder Primacy to the Racial Wealth Gap" (Palladino 2020).

Figure 3b



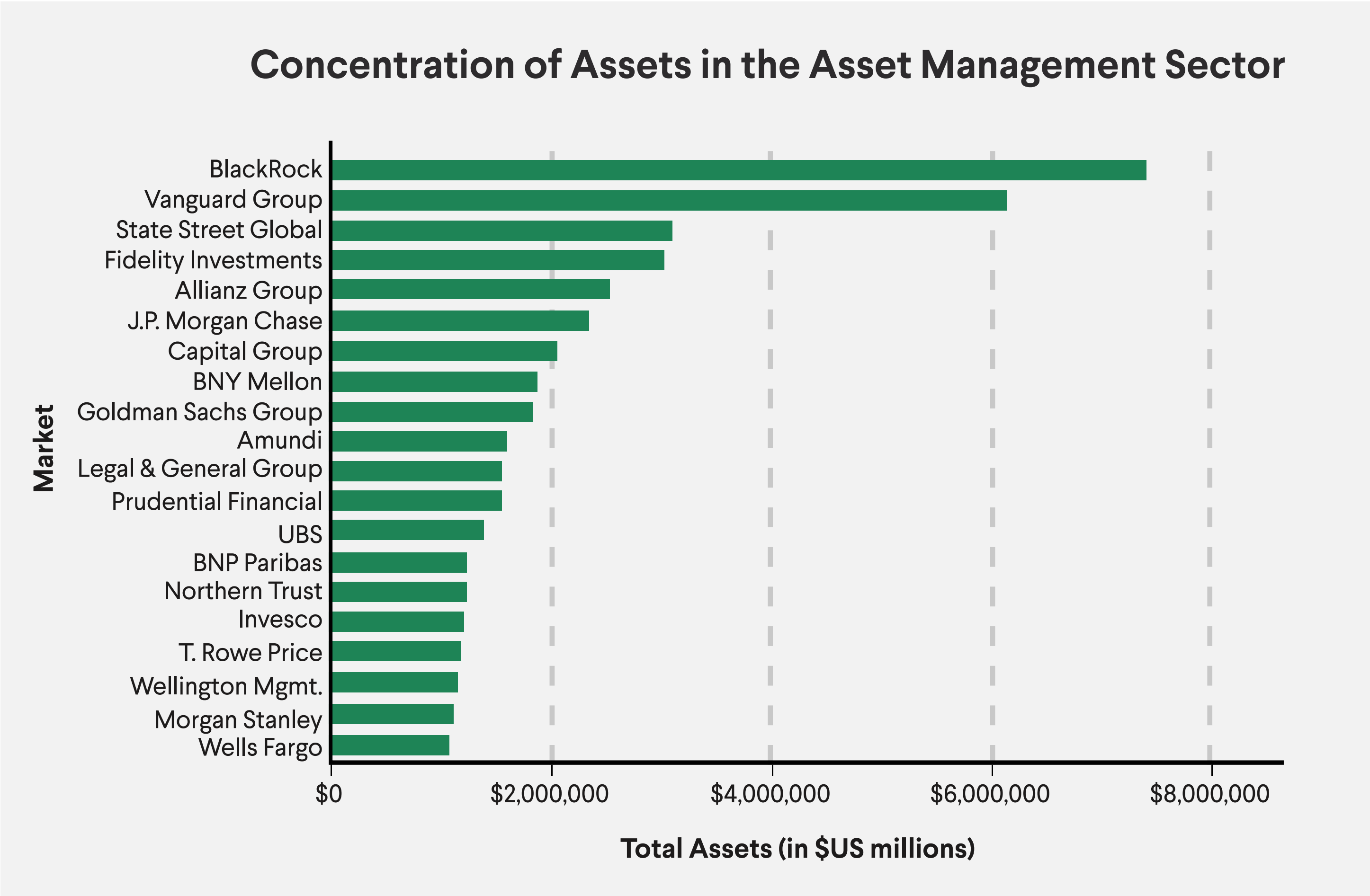
Source: Survey of Consumer Finances and Financial Accounts of the United States.

A concurrent important trend in the 21st century has been concentration *within* the asset management sector. The largest asset managers now control over 10 percent of the stock market as the legal owners of corporate stock—up from 1 percent in 1990. Just three firms—Blackrock, Vanguard, and State Street—own 80 percent of the ETF market. Lucian Bebchuk and Scott Hirst (2019) note that these firms could cast up to 40 percent of the votes in S&P 500 companies (the stock market index of the largest companies) in the next two decades.[5]

The vast holdings of asset managers give them a great deal of power in corporate governance, whether they exercise it or not. Whether or not asset managers make investment and governance decisions that align with the preferences of those who invest with them (their "beneficiaries"), or that at least minimally consider the public impact of those investments, is an important public policy question. Yet today, the law *limits* what funds can do on behalf of their investors. In the next section, we explore the development of asset manager fiduciary duties and current proposals for increased disclosure. We then detail our proposal for substantive reforms.

5 The increasing reliance on indices has given the generators of indices a lot of power. The makeup of an index—who is in and who is out—is inherently a political choice, one that influences the inflow of outflows of portfolio investment to and from its subjected firms. The indices—already a benchmark against which even active investors measure performance—thus exert ever-growing control over the fate of private capital (Petry et al. 2019).

Figure 4



Source: Boston Consulting Group, https://www.bcg.com/publications/2020/global-asset-management-protect-adapt-innovate.

THE DEVELOPMENT OF ASSET MANAGER FIDUCIARY DUTY AND "ESG" INVESTING

The historical development of fiduciary duty regulation is useful to review because it shows that fiduciary duties are historically contingent. There are two main federal statutes that govern the fiduciary duties for asset managers: The Investment Advisers Act of 1940 and the Employee Retirement and Income Security Act of 1974 (ERISA) (as well as state statutes defining fiduciary duties for state funds). The Investment Advisers Act regulates firms or individuals compensated for advising others about securities investments; §410 of the Dodd-Frank Act promulgated new rules amending the Investment Advisers Act by setting a threshold for federal registration for those funds with at least $100 million of assets under management (smaller firms register at the state level) (Securities and Exchange Commission 2013). Though fiduciary duties are not explicit in the statute itself, they have been found to be implied by §206, which prohibits self-dealing, fraud, deception, and manipulation. The Supreme Court interpreted the Act as recognizing the fiduciary nature of an investment adviser relationship and creating a positive duty for investors to act on behalf of clients (Jackson and Gillis 2019). However, what is meant by "positive duty" has often been given a narrow interpretation under both the federal and state statutes that govern fiduciaries to mean raising the dollar value of funds by focusing on individual company return, rather than looking at the best interests of investment adviser clients as a whole. In the next section, we propose a new interpretation of "best interests" that considers the risks companies pose to households, both directly and through threats to portfolio value. Put simply, fiduciary duties of care, loyalty, and impartiality should remain the same, as fiduciaries are still in the privileged position of managing money for others. But the "best interests" of beneficiaries must be interpreted today according to what is actually in the best interests of households as humans and members of a society, which cannot be boiled down to maximizing financial return.

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ERISA codifies the general responsibility of trustees who manage health and retirement funds in the private sector. At first, ERISA trustees permitted investment only in relatively riskless securities. The subsequent "prudent man rule," promulgated by the Department of Labor (which oversees ERISA), enabled the trustee to take into account "the needs of the beneficiaries, the needs of the principle, and the amount and reliability of the income." In 1992, the concept of fiduciary duty was modified once more, enshrining modern portfolio theory (MPT) to mean that fiduciaries would have to diversify the portfolio to sufficiently minimize the risk of large losses. Specifically, MPT demanded that the "prudent" investor now focus on the entirety of the portfolio and not simply on the riskiness of a particular asset. Today's plain language definition of ERISA fiduciary duty is as follows:

> The primary responsibility of fiduciaries is to run the plan solely in the interest of participants and beneficiaries and for the exclusive purpose of providing benefits and paying plan expenses. Fiduciaries must act prudently and must diversify the plan's investments in order to minimize the risk of large losses. In addition, they must follow the terms of plan documents to the extent that the plan terms are consistent with ERISA. They also must avoid conflicts of interest. In other words, they may not engage in transactions on behalf of the plan that benefit parties related to the plan, such as other fiduciaries, services providers, or the plan sponsor. (DOL n.d.)

The problem with this approach is that "diversification" is not a way to avoid *systemic* risk (Quigley 2021). Diversification requires fiduciaries to not concentrate their holdings in one particular asset or company, so that if it fails to produce a return, the whole portfolio is not as affected, as it would be if the portfolio were concentrated in one particular asset. However, as the financial crisis of 2007 showed, diversification is not a sufficient strategy to protect investors when systemic risks affect all assets at the same time. Climate change and the harms of growing economic inequality and wage stagnation are two kinds of systemic risk that cannot be diversified away. The Department of Labor's Investment Rule, issued in late 2020, clarified that ESG considerations are appropriate for fiduciaries when they serve the financial benefits of the plan. This means that, for example, "trustees can refuse to invest in companies that pollute if they believe that polluting companies ultimately make less money . . . [and] discourage[] portfolio companies from engaging in behaviour that harms society and the environment, and consequently the value of shareholders' diversified portfolios" (Kassoy et al. 2020).

However, consideration of the systemic risks to portfolios' financial value from harms created in the real economy does not effectively consider the harm flowing directly to beneficiaries. Following the previous example, under the current rules, fiduciaries cannot choose to not invest in a polluting company simply "because they want their beneficiaries to live in a cleaner world" (Kassoy et al 2020). For this reason, we propose further clarifying that serving the interests of economic beneficiaries requires considering the risks *externalized* by companies, whether to households' diversified portfolios, or directly to the households themselves.

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Current Asset Manager Fiduciary Duties

Fiduciary responsibilities are based upon a number of component duties (Gary 2019).[6]

- Under the duty of **obedience**, the fiduciary must obey the authority and instructions of their beneficiaries (784—785).
- Under the duty of **loyalty**, the fiduciary must act in the "sole interests" of the beneficiary (785). This, however, does not imply acting in the "personal interest" of the beneficiary (785—786).
- Under the duty of **care**, the fiduciary must act with "reasonable care, skill and caution" as per the requirements of the prudent investor standard (789).
- Under the duty of **impartiality**, fiduciaries must treat beneficiaries of different generations—say from a trust—without preference by generation (794). It does not demand that these beneficiaries be treated equally, but rather that the fiduciary consider each generation's needs (794—795).

In recent years, there has been a rising focus on ESG (Economic, Social, and Governance) investing (sometimes referred to as socially responsible investing). ESG investing refers to the broad practice of taking factors that affect pecuniary outcomes,

[6] A revision of fiduciary duty usually refers to a revision of some or all of these duties. This issue brief will identify the differences as needed.

such as environmental risk or supply chain disruption risk, into account in the investing process. But to date, there is not one standardized framework for what factors must be considered (Gellasch and Thornton 2020). ESG is primarily focused on improving individual company outcomes by mitigating risk, rather than mitigating risks generated *by* companies (Alexander 2018; Hawley and Lukomnik 2021).

Though ESG investing has become mainstream as a choice for household and institutional investors, whether or not consideration of "non-financial factors" should be required—or, in the opposite direction, not allowed at all—has been at the center of the fiduciary duty conversation. In 2008, the Department of Labor issued a guideline stating that consideration of "non-economic" factors should be rare, and funds are prohibited outright from ever subordinating economic considerations to those "unrelated" objectives (Webber 2014). Funds are instead expected to consider "prospective investment return, diversification, liquidity, the prudence of the investment, its impartiality as between participants and beneficiaries, and whether it complies with the fund-first view of fiduciary duty" when making investment decisions (Webber 2014, 2168). For example, this "fund-first" view prohibits fund managers from negotiating with companies to keep jobs safe on the assumption that this would reduce returns, even though it would save jobs of the beneficiaries (Webber 2014, 2111). In 2015, the Department of Labor issued an Interpretative Bulletin clarifying that considering ESG factors is an important tool for risk mitigation, and that such factors are material for prudent fiduciaries (Gary 2019, 792). However, this approach did not consider the contribution of the portfolio itself to systemic risks (Quigley 2021).

Some contend that fiduciary duties already include a broader conception of the interests of underlying beneficiaries, and that narrow focus on pecuniary outcomes is a result of norms in the financial sector, not a matter of law. For instance, the duty of impartiality requires a fiduciary to *balance* long- and short-term investing considerations. If excessive reliance on short-term investing goals *harms* long-term value creation, income growth, or capital growth, then there is space to modify fiduciary duty so that long-term factors must be more explicitly considered. Gary (2019, 799) echoes this argument: Investors should consider long-term returns in order to comply with the prudent investor standard, especially since the negative effects of climate change and economic inequality create long-term risk. But again, for universal owners, there is no way to diversify away systemic risks in order to construct a safe portfolio. The only approach is to proactively use the portfolio as a tool to reduce systemic risks. In the next section, we propose how to set this as the standard for asset managers.

CURRENT PROPOSALS FOR DISCLOSURE AND STANDARDIZED REPORTING OF ESG PRACTICES

There are a variety of proposals for legislative and regulatory reform currently under discussion that would require investors and asset managers to more fully disclose whether or not ESG factors are considered in their portfolio decisions and governance engagement.[7] In our view, while disclosure is a necessary step, it is not sufficient to compel investment fiduciaries to fully consider the impacts of their investment decisions on their economic beneficiaries. Put differently, disclosure of systemic risks for all households that hold index funds does not create many options for those households. For example, simply disclosing risk and waiting for investors to respond is not enough to reach the carbon neutrality required to keep global warming below 1.5 degrees.

The SEC has been proactively taking steps to explore requiring disclosure of ESG consideration by investors and asset managers.[8] One proposal called for by Acting SEC Chair Allison Herren Lee is for the agency to consider requiring investment advisors to "maintain and implement policies and procedures governing their approach to ESG investment" (Gellasch and Thornton 2020). The Center for American Progress has proposed that all ERISA plan fiduciaries and SEC-registered investment advisors be required to publicly disclose their approach to the specific ESG factors that the fiduciary considers in its decision-making. This approach, often referred to as a "sustainable investment policy," is an important step toward clarifying the approach of different asset managers, and critically, would apply to investment decisions in both publicly traded and privately held companies. However, it is not a substantive requirement for any changes from today's status quo in asset manager investing or governance practices.

Two legislative bills introduced into the 117th Congress by Representative Andy Levin (D-MI) focus on investor fiduciary duties and go a step beyond disclosure to require that ERISA plan managers and asset managers registered under the Investment

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7 The Trump Administration issued a rule through the Department of Labor that would have limited the ability of ERISA plans to consider ESG factors in their investment process; though the final rule was much more lax according to Gellasch and Thornton (2020), they argue it could still hold back the consideration of ESG factors by fiduciaries. By rolling back the protections of the Avon letter (which summarizes the duties of employee plan fiduciaries), the Department of Labor would effectively relegate ESG considerations to a category of votes that can be skipped on account of being "nonpecuniary." This would force fiduciaries to demonstrate that a particular vote has a direct connection with positive financial returns. Within hours of his inauguration, President Biden's team listed that rule as under review for possible reversal. As the administration considers this decision, a series of state and federal legislative proposals sit as potential models for future action. Nevertheless, this order highlights the weakness of reforms through the executive branch. Changes without legislation still leave fiduciary duty vulnerable to a change that tries to reverse the slow movement away from pure focus on financial returns.

8 Gellasch and Thornton (2020) detail substantial action taken by international regulators.

Advisers Act have an affirmative obligation to consider ESG factors in their investment and governance. The first bill—the Sustainable Investment Policies Act (2020)—requires investment advisers to file a sustainable investment policy with the SEC. In addition to addressing several social concerns, the policy would require including information on the following items:

- Environmental risks to the assets and properties of the entities in which the fund is invested;
- "Climate risks and contributions";
- Environmental risks unrelated to climate change, such as "industrial pollution, habitat destruction, and other forms of environmental degradation";
- Pollution related to the operations of the entity in which the fund is invested;
- Practices surrounding "supply chain management," including worker, environmental, and human rights; and
- International tax avoidance strategies, tax payment disclosure, and other tax practices.

The bill's stated purpose is to ensure that fiduciaries incorporate "all relevant factors, including environmental, social, and governance factors, into investment analysis"; to "encourage the adoption of best practices for ESG performance" in the firms with which they invest; to consider the sustainability interests of the plan participants; and to consider the impact of investment decisions on the financial system. The second bill—the Retirees Sustainable Investment Policies Act (2020)—incorporates this same set of investment plan requirements into the guidelines for the sustainable investment policies that retirement fiduciaries face under ERISA. The CLEAN Future Act, introduced in March 2021, proposed in §852 "Disclosures Relating to Climate Change" that companies issuing stock must disclose their evaluation of the risks that they face due to climate change in a standardized format.

States have not waited for federal action. The Illinois Sustainable Investing Act (2020) requires any governmental unit or public agency to develop investment policies applicable to the funds under its control. Those same public agencies are also required to develop "sustainability factors" that will be used in making investment decisions, portfolio construction, due diligence, and the exercise of their "fiduciary duty." Every investment fund under the jurisdiction of this act must have material on sustainability factors, which include but are not limited to: "(1) corporate governance and leadership factors; (2) environmental factors; (3) social capital factors; (4) human capital factors; and (5) business model and innovation factors" (IL Sustainable Investing Act 2020). The same is also required of pension funds and the Treasurer of the State of Illinois. In 2018, Delaware passed S.B. 195 (2018), which stated:

> In making investment decisions, a fiduciary may consider the general economic conditions, the anticipated tax consequences of the investment and the anticipated duration of the account and the needs of the beneficiaries; when considering the needs of the beneficiaries, the fiduciary may take into account the financial needs of the beneficiaries as well as the beneficiaries' personal values, including the beneficiaries' desire to engage in sustainable investing strategies that align with the beneficiaries' social, environmental, governance or other values or beliefs of the beneficiaries.

Furthermore, the legislation states that provisions of the law may alter elements of fiduciary duty, including the manner of investment into assets, and whether to engage in socially responsible investment strategies in addition to or in place of other strategies, or without regard to investment performance.

Though state-level action is important for the public pension funds whose fiduciary duties are defined at the state level, federal action is necessary to regulate the majority of investment advisers and ERISA pension funds. Federal reforms should preempt state registration for medium and large asset managers, in order to prevent forum shopping and a "race to the bottom" by states that put forward weaker standards in order to attract registration.

NEW FIDUCIARY DUTIES FOR ASSET MANAGERS

Our proposal for new fiduciary duties for asset managers for the 21st century[9] has two goals:

1. To make fiduciaries *responsible* for considering the total impacts of their decisions on the households on whose behalf they are investing, rather than just giving them *permission* to do so without a mandate; and

[9] It is worth noting that while the Investment Company Act regulates investment companies, and ERISA and Taft-Hartley control private pension fund fiduciary requirements, public pension funds at the state level are controlled by state law (as discussed above regarding the IL Sustainable Investment Act). Though federal reform is crucial to see widespread change in investment manager behavior, state policymakers can adopt these proposals to reform fiduciary duties for investment managers inside their states.

2. To mandate substantive adherence to portfolio carbon neutrality for all asset managers.

The first goal would make sure that all investor fiduciaries must actively consider the potential benefits and harms of their total portfolio on the households for whom they invest, which concretely means considering not just financial returns, but also long-term harms to the climate and the negative impacts of economic inequality on economic growth. The second goal more specifically mandates that the investment fiduciary's overall portfolio be climate neutral. Disclosure is a critical first step, but it leaves investors free to continue to invest in companies that are harming the ecosystem on which we all depend, as long as they tell us where they put the money. Disclosure is not sufficient to ensure that investment managers act responsibly toward the US households that entrust fiduciaries with their money. Asset managers would continue to be responsible for evaluating the traditional range of factors that affect stock prices of individual companies, as well as ESG and systemic factors that have the potential to impact the entire portfolio. The reforms presented here are not meant to negate these duties, but rather to expand the aperture so that asset managers are required to consider the downside as well as the upside of investments—i.e., costs that have previously been externalized by individual companies and thus have necessarily been internalized by underlying beneficiaries.

In order to meet this first goal, a new fiduciary duty should require all investment managers to be "responsible for the impact they have on the shared social and natural systems needed for a just, equitable, inclusive, and prosperous economic system" (Kassoy et al. 2020). This re-focuses fiduciaries on the interests that beneficiaries—US families—have in a sustainable and durable social system, rather than measuring their interests as simply financial return. It also recognizes that financial returns themselves will be negatively affected by economic inequality and climate change, and puts the responsibility on fiduciaries to proactively take steps to mitigate harmful impacts on plan assets, something that is arguably already contained in the 2020 Investment Rules. Though such a standard immediately raises questions about how to enforce the duty, creating a baseline standard is the only way to ensure that bad actors do not use a disclosure framework to simply disclose—but not stop—harmful behavior that generates high rewards in the short term. This framework functions essentially as permission for fiduciaries to make corporate governance and portfolio decisions with consideration of the full impact of company decisions on beneficiaries, meaning that they cannot be sued for deviating from a narrow focus on rapid share price increases.[10]

> ***A new fiduciary duty should require all investment managers to be "responsible for the impact they have on the shared social and natural systems needed for a just, equitable, inclusive, and prosperous economic system" (Kassoy et al. 2020).***

MANDATORY DUTIES

One legislative approach, included in the Shareholder Commons and B Lab Policy Agenda (of which we were co-authors) is to reform the Investment Company Act of 1940 directly (15 U.S.C. 80a). The "Stakeholder Capitalism Act" would add language after paragraph 54 of Section 2 and after subsection (c) of Section 36 (see Kassoy et al., Exhibit A, for the full draft). The language of the Act focuses on the common interests of beneficiaries and the new duty of fiduciaries to look out for their common good. These "common interests" are defined as:

> Interests held generally in common by beneficiaries and the person and communities served by such beneficiaries, including interests in (A) securities market performance, (B) the effect of economic, social and environmental systems on beneficiaries and the persons and communities served by such beneficiaries and (C) the effect of such systems on the welfare of communities of which such beneficiaries and the persons and communities served by such beneficiaries are a part.

A CLIMATE GUARDRAIL

Though the set of reforms in the "Stakeholder Capitalism Act" go beyond disclosure, requiring "consideration" of the full range of beneficiary impacts still leaves the onus on beneficiaries (institutional investors) to bring claims that their interests have not been respected, which in practice is very difficult for many beneficiaries,

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[10] A specific proposal to counteract labor cost-cutting has been made by David Webber: Webber (2014, 2169) proposes a "member-first" conception of fiduciary duty in which the fiduciary would be "required to assess the potential impact on participant jobs." Once a particular investment is flagged, the fiduciary would have to assess the impact on jobs themselves, or have the investee conduct an analysis (2170).

who are far along the financial intermediation chain from asset managers. That is why an additional proposal for policy reform is substantive compliance with carbon neutrality by 2050, as outlined in the Paris Agreement, along with standardized metrics to measure the carbon footprint of a given portfolio. This "climate guardrail" standard should include a specific set of actions that should be developed through a consultation process, but may include features such as: engaging in stewardship and corporate governance to ensure that all portfolio companies support (and, at minimum, do not make effort to oppose) regulatory action to mitigate climate change; stewardship that engages portfolio companies whose business model is tied to climate change and urges a wholesale business model transition; and overall monitoring of all companies' plans to move toward climate neutrality.

Momentum for pension fund compliance with a carbon neutrality standard has already begun. In December 2020, New York State's pension fund, with more than one million employees and retirees and with assets of $226 billion, publicly committed to a goal of carbon neutrality by 2040 (NYOSC 2020). It is worth noting that while New York viewed this commitment as consistent with its current interpretation of the fiduciary duties of its trustees, in order to ensure broad compliance, federal legislative action to explicitly require this commitment as part of investor fiduciary duty would need legislative and regulatory reform. This approach narrows the substantive focus to specific climate change objectives, rather than a broader set of environmental, social, and governance metrics, but would compel fiduciaries to go beyond disclosure of their approach to environmental impact. Proposals also include how to standardize measurement of a portfolio's carbon footprint, which is critical to ensure that required compliance cannot be manipulated.

CONCLUSION

As American households save for their future, their investments are being used to buy shares of companies that, in some cases, undermine their chances of enjoying that future. The money managers who make investment decisions for millions of households are currently bound by fiduciary standards that mistake what the true interests of the American people are. At a time of widening economic insecurity and disastrous climate change, economic and legal theory must catch up to the reality that there are no "externalities" for universal owners. When companies do not pay family-sustaining wages to the workforce and put off decarbonizing their production processes, these choices hurt the abilities of holders of corporate equity to thrive. As the financial intermediation chain lengthens and a few asset managers increase their market share, it is even more important to consider what their duties should be to their beneficiaries in the 21st century.

Investment advisor and asset manager fiduciary duties must be reformed so that asset managers are required to consider the impact of their portfolio decisions on the whole interest of their beneficiaries. This reform by itself will not mandate specific investment choices, but it will no longer allow responsibility for harmful behavior to be passed along the investment chain in the name of maximizing shareholder value. Such a reform will also require increased disclosure by companies and investors, so that informed decisions can be made. Beneficiaries must also have mechanisms available to them to hold their money managers responsible for upholding the beneficiaries' interests. Reforming fiduciary duties alone will not solve our societal challenges given their scale and scope, but it will bring decisions made on behalf of US households in line with their interests in a secure and prosperous future for themselves and their children.

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ACKNOWLEDGMENTS

The authors wish to thank Chirag Lala for excellent research assistance; Andrew Kassoy, Hollie Ensign-Barstow, and many others at B Lab for earlier collaboration; and Roosevelt Institute staff Rhiana Gunn-Wright, Kristina Karlsson, Sonya Gurwitt, and Tayra Lucero.

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