November 14, 2015

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: File No. 4-725: SEC Staff Roundtable on the Proxy Process

Dear Mr. Fields:

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I am a Sr. Fellow in Business and Economics at the Pacific Research Institute (PRI). The mission of PRI is to champion freedom, opportunity, and personal responsibility for all individuals by advancing free-market policy solutions. Since its founding in 1979, PRI has remained steadfast to the vision of a free and civil society where individuals can achieve their full potential.

In its "Statement Announcing SEC Staff Roundtable on the Proxy Process", the Securities and Exchange Commission has asked for input, including comments on the services provided by proxy advisory firms, and whether reliance on these firms "is in the best interests of investment advisers and their clients, including funds and fund shareholders".

Summarizing my key points:

- Without reforms that better align the interests of the proxy advisory firms and the interests of fund shareholders, *reliance on these firms is not in the best interests of fund shareholders*.
- The two major proxy advisory firms control 97 percent of the proxy advisory market. These firms are biased towards supporting environmental, social, and corporate governance (ESG) proxy statements, as evidenced by the existence of their own ESG advisory services. This bias exemplifies how the actions of the proxy advisory firms can harm the interests of fund shareholders – particularly shareholders in public pension funds.
- While ESG investing may be worthwhile for individual investors, studies have linked ESG investing to lower returns, making ESG criteria inappropriate for public pension funds that have fiduciary responsibilities to investors. The differing ESG positions of public pensions' beneficiaries who have no choice but to invest their money with the fund make ESG criteria even less appropriate.

- Research has found that increased shareholder activism by public pension funds is negatively correlated with stock returns. Particularly noteworthy, the firms who received proposals from public pension funds that were demonstrably advancing social agendas were valued 14 percent lower than similar companies that did not receive such proposals.
- Private sector pension funds rarely hold screened investments (e.g. apply ESG criteria). This is likely because the fiduciary responsibility requirements of the Employee Retirement Income Security Act of 1974 (ERISA) make it difficult to defend policies that arbitrarily limit a pension fund's investment options.
- The $1.4 trillion in unfunded public pension liabilities already threatens the economic vitality of most states. In California, for instance, covering the unfunded liabilities through tax increases will cause the state economy to be 18.4 percent smaller in 30 years compared to the baseline projections based on my past research. As stronger investment returns can help alleviate these burdens, the lost potential returns due to ESG investing on pensioners and taxpayers could be costly.
- Despite the inappropriateness of ESG investing for public pension funds, large institutional investors support ISS and Glass Lewis recommendations, which are biased in favor of ESG programs, 80 percent of the time, with some funds supporting the recommendations 100 percent of the time.
- To address these problems, policy reforms should ensure that proxy advisory firms act in a manner that promotes fund managers' fiduciary responsibilities to shareholders, and create greater transparency regarding the proxy advisory firms' biases and conflicts of interest. Without such reforms, the current proxy process will continue to create additional, and unnecessary, risks for investors.
- The SEC should also consider eliminating the requirement that institutional investors vote on all items on corporate proxy statements. Enabling institutional investors to focus on only those corporate proxy statements they deem material would reduce the artificial demand for the proxy advisory services, and therefore improve the competitive environment.

ISS' and Glass Lewis' support of ESG policies create a conflict of interests

Two proxy advisory firms, ISS and Glass Lewis, control 97 percent of the proxy advisory market – effectively, the proxy advisory market is controlled by a duopoly. ISS is an arm of Genstar, a private equity firm; and, Glass Lewis is an arm of the Ontario Teacher's Pension Plan Board and the Alberta Investment Management Corporation. The potential conflicts of interest between these duopolists and fund shareholders, and their potential adverse consequences, are exemplified by the proxy advisory firms' biases toward environmental, social, and corporate governance (ESG) investing and programs.

ESG investing, sometimes referred to as sustainable investing, is an imprecise term. As generally applied, ESG investing imposes investment screens based on companies' environmental activities, social impacts, and corporate policies (e.g. diversity). The goal of ESG investing is to explicitly account for issues that some people believe are important, and want to promote, sometimes at the expense of financial returns. Companies also implement ESG programs as a means to demonstrate their social responsibility, and many ESG policies are raised via proxy statements.

Both ISS and Glass Lewis sponsor their own ESG programs. ISS has a program known as ISS ESG. According to their website, "ISS ESG solutions (ISS-ethix, ISS-climate and ISS-oekom) provide ESG screening, ratings and analytics designed to enable investors to develop and integrate responsible investing policies and practices into their investment strategies."[1]

Glass Lewis has formed a strategic partnership with Sustainalytics, which Glass Lewis describes as "the leading independent provider of global governance services".[2] According to Glass Lewis, the firm "features data and ratings from Sustainalytics in the ESG Profile section of our standard Proxy Paper reports. The goal is to provide summary data and insights that can be efficiently used by clients as part of their process to integrate ESG factors across their investment chain, including effectively aligning proxy voting and engagement practices with ESG risk management considerations."[3]

ISS' and Glass Lewis' ESG programs illustrate a belief in ESG programs, and biases these firms to universally support these programs. Put differently, the activities of the major proxy advisory firms, which control 97 percent of the proxy advisory market, indicate that the firms have a pre-ordained belief that pro-ESG proxy statements should be supported.

ESG programs can make sense. For a specific publicly-owned company, consumers may demand that the products are produced in a manner consistent with ESG criteria. In this case, ESG achieves its mantra of doing well by doing good. The company is providing its customers with the products they desire in the manner they want it produced, and proxy statements that demand the company comply with specific ESG criteria are consistent with basic profit-maximizing behavior.

From an individual investor's perspective, voting in favor of specific ESG programs can also make sense. There are profitable companies that could benefit from ESG programs, therefore there is evidence that ESG programs can improve corporate performance. Similarly, there is evidence that ESG investment strategies can earn competitive financial returns.

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[1] https://www.issgovernance.com/introducing-iss-esg/.

[2] http://www.glasslewis.com/sustainalytics-and-glass-lewis-team-up-to-integrate-esg-factors-directly-into-the-proxy-voting-and-engagement-process/.

[3] http://www.glasslewis.com/understanding-esg-content/.

Just as important, should individual investors' support of ESG programs harm the company's financial performance, or individual investors' ESG investment strategies produce lower-return portfolios, the individual investors knew the explicit constraints they were imposing, and bear the consequences from their actions. Perhaps the individual investors are content with the trade-off, perhaps not. Either way the individual investors' decisions reflect their values, and they bear the costs of their own actions.

While ESG programs can be financially viable, these programs can also be financially harmful and there are many studies that have determined that ESG proposals are, on average, detrimental to a firm's financial performance. The two major proxy advisory firms establish their position on ESG without adequate transparency, without considering how the programs can impact different investors (the advisory firms generally employ a one-sized fits all approach to deciding issues), and their internal ESG advisory programs demonstrate a conflict of interests/bias. As a result, institutional investors (particularly public pension funds) may be violating their fiduciary responsibilities when they adopt the ESG voting positions suggested by these proxy advisory firms.

Fiduciary concerns make ESG inappropriate for public pension funds

A 2002 study by Tracie Woidtke in the *Journal of Financial Economics* directly examined the impact from activist public pension funds on the market values of a sample of Fortune 500 companies.[4] Professor Woidtke's results illustrate that increased shareholder activism by public pension funds is negatively correlated with stock returns. Particularly noteworthy, the firms who received proposals from public pension funds that were demonstrably advancing social agendas were valued 14 percent lower than similar companies that did not receive such proposals.

Research by the Manhattan Institute similarly found "a positive association between ISS recommendations and shareholder voting and a negative relationship between share value and public pension funds' social-issue shareholder-proposal activism (which is much more likely to be supported by proxy advisory firms than by the median shareholder)."[5]

Munnell and Chen (2016) reviewed the impacts from ESG asking two questions: "1) can ESG-screened portfolios meet the same return/risk objectives as non-screened portfolios; and 2) are public plans the right vehicle for advancing ESG goals?"[6] The authors found "that although social

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[4] Woidtke T "Agents watching agents?: evidence from pension fund ownership and firm value" *Journal of Financial Economics* Vol. 63, Issue 1 (2002) January.

[5] Copland JR, Larcker DF, and Tayan B "Proxy Advisory Firms: Empirical Evidence and the Case for Reform" *the Manhattan Institute*, May 2018.

[6] Munnell AH and Chen A "New Developments in Social Investing by Public Pensions" *Center for Retirement Research at Boston College* Number 53, November 2016.

investing may be worthwhile for private investors, lower returns and fiduciary concerns make public pension funds unsuited for advancing ESG goals."[7]

The results of Munnell and Chen (2016) make sense because, unlike the individual investor, public pension funds represent many different individual investors who do not have the ability to choose the fund investing on their behalf. If you are a teacher in California, then CalSTRS will be investing your retirement savings on your behalf. You have no choice.

Perhaps some teachers agree with specific ESG policies that CalSTRS is supporting, perhaps others do not. Since the beneficiaries who do not agree with the ESG policies cannot self-select themselves out of the investment fund, public pension funds who support ESG programs are supporting political policies that violate the principles of some (many?) members, while possibly hurting returns for the beneficiaries as a whole.

As an example of the tensions created by ESG investing, there is a growing push for CalPERS to divest from fossil fuel companies despite the fact that 67 percent of the CalPERS members surveyed by Spectrem Group in 2018 stated that the oil and gas sector "is an essential element of a balanced, diversified portfolio".[8]

Beyond the issue of conflicting values between the beneficiaries of a public pension fund, there are concerns that ESG investing violates a public pension fund's fiduciary responsibility. As Munnell and Chen (2016) note, through 2014 "almost none of the screened money [the practice of excluding/investing in specific companies based on ESG criteria not financial criteria] is held by private defined benefit plans. The likely reason is that these plans are generally covered by the Employee Retirement Income Security Act of 1974 (ERISA), and the U.S. Department of Labor (DOL) has stringently interpreted ERISA's duties of loyalty and prudence. ***In 1980, a key DOL official published an influential article warning that the exclusion of investment options would be very hard to defend under ERISA's prudence and loyalty tests***."[9]

As this DOL opinion correctly notes, options have value. Limiting the investment opportunities based on ESG criteria eliminates options and, therefore, imposes costs on public and private sector pension funds. By not holding screened investments, the investment decisions of private pension funds recognize that imposing investment restrictions based on non-financial criteria violates their fiduciary responsibilities.

SEC Commissioner Hester Peirce echoed these beliefs in remarks at the 2018 Annual SEC conference:

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[7] Ibid.

[8] "Tensions with Pensions: An analysis of public pension fund members' knowledge and sentiment about how their money is being invested" *Spectrum Group*, 2018.

[9] Munnell AH and Chen A "New Developments in Social Investing by Public Pensions" *Center for Retirement Research at Boston College* Number 53, November 2016. (emphasis added)

It may be useful to pause here and clarify an important point. If an individual wants to invest in companies that align with her moral beliefs, that is fine. An individual investor is certainly free to make trade-offs to risk lower returns for whatever other interest she may have. Nor is there a problem with certain funds pursuing stated social interest goals. Many such funds exist. Assuming they have disclosed their objectives as a part of their investment strategies they not only may, but must pursue the ESG guidelines they have set for themselves. Such funds have proliferated in recent years, and investors seeking to apply ESG standards to financial interests will find many options available to them. I am not taking issue with these arrangements as long as ESG investors do not force the companies in which they invest to take steps that harm the company's long-term value.

The problems arise when those making the investment decisions are doing so on behalf of others who do not share their ESG objectives. This problem is most acute when the individual cannot easily exit the relationship. For example, pension beneficiaries often must remain invested with the pension to receive their benefits. When a pension fund manager is making the decision to pursue her moral goals at the risk of financial return, the manager is putting other people's retirements at risk.[10]

The same is true for public sector pension funds. The costs are particularly worrisome with respect to public sector pension funds due to their large unfunded liabilities, and the large economic costs these unfunded liabilities will impose on public sector employees, public sector retirees, and taxpayers.

According to the Pew Charitable Trusts, the 2016 unfunded liabilities of the state pension systems was $1.4 trillion.[11] The Pew estimates are based on actuarial estimates of the unfunded liabilities that do not properly account for the discrepancy between the risky investment portfolios compared to the riskless pension promises. Once the risk discrepancies are properly considered, the unfunded liabilities are even larger than the estimated $1.4 trillion estimated by Pew. These large funding gaps of the public pension funds are fiscally unsustainable, and will impose large economic costs on the states.

California – A key example of ESG's failings for pensioners

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[10] "Peirce HM "My Beef with Stakeholders: Remarks at the 17th Annual SEC Conference, Center for Corporate Reporting and Governance" *U.S. Securities and Exchange Commission*, September 21, 2018; https://www.sec.gov/news/speech/speech-peirce-092118.

[11] "The State Pension Funding Gap: 2016" *The Pew Charitable Trusts* April 12, 2018; https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2018/04/the-state-pension-funding-gap-2016. Accessed November 5, 2018.

Two previous studies I have conducted for PRI have quantified these costs with respect to California.[12] According to the Pew Charitable Trusts, California's current unfunded liabilities were nearly $170 billion as of 2016. Other estimates that account for market risks illustrate the value of these unfunded liabilities could be much higher – between $370 billion and $992 billion. Regardless of the actual value, there is little doubt that California's public pension systems are already woefully underfunded.

The large fiscal hole leaves Californians with few good choices. Based on my estimates, paying off California's unfunded liabilities will require the state and local governments to dedicate at least 4 percent of total state and local tax revenues toward paying off the unfunded liabilities for the next 30 years. Based on the high-end unfunded liability estimates, the annual payments could be as high as 24 percent. If these expenditures were funded through tax increases, then (depending on the assumptions) California's economy could be 18.4 percent smaller in 30 years compared to the baseline projections. The lost income and economic opportunities that results from the more anemic economy would harm all Californians. The alternative of not funding the unfunded liabilities means that future public sector retirees will face steep reductions to their promised retirement benefits, which will harm their future economic security.

Given these difficult economic trade-offs, any policy that limits CalPERS, CalSTRS, and the other California public pension systems investment options worsens California's pension crisis. A bias toward supporting ESG programs or ESG investing is such a policy. The election of Corona police officer Jason Perez to the CalPERS Board of Administration to replace Priya Mathur (who held the seat for 15-years and is a supporter of ESG investing), exemplifies that ESG policies are already harming the stability of California's public pension systems. According to CalPERS board member Perez's campaign questionnaire:

> All legal investments must be considered. Sometimes we make an investment decision to invest in socially unacceptable companies such as firearms and tobacco. We invest in these companies for the expected returns, (not) as a moral judgment. ***Divesting from the tobacco industry has cost our retirement fund dearly, $8 billion lost***. Recently there was a motion made by a board member to divest from any company manufacturing or selling firearms or accessories. The motion included any firearm accessory, ammunition, magazines, etc. If the motion had been successful, CalPERS would have divested from not only the manufacturers, but also large retail stores such as Walmart, Big 5 Sporting Goods,

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[12] See: Winegarden W "Reforming Public-Sector Pensions to Improve California's Fiscal Outlook" *Pacific Research Institute*, September 2018; https://www.pacificresearch.org/wp-content/uploads/2018/09/PensionChartStudy_FWeb.pdf; and, Winegarden W "California's Pension Crowd-out: California's defined benefit public pension plans are unaffordable and over-burden current and future taxpayers" *Pacific Research Institute*, January 2016; https://www.pacificresearch.org/wp-content/uploads/2017/06/CAPensionReform_web-1.pdf.

> Cabela's, and Outdoorsman…. This example clearly shows how CalPERS is being used as a Political Action Committee as opposed to a retirement fund.[13]

Given the precarious fiscal state of California's public pensions, meeting (or exceeding) the projected investment returns is vital. As documented by CalPERS board member Perez, CalPERS ESG investing has caused avoidable investment losses making it more difficult for CalPERS to meet its projected investment returns. As a result, current pensioners, future pensioners, and taxpayers all suffered avoidable costs.

Proxy advisory firms promote ESG shareholder resolutions against pensioners' best interests

Combining the potential investment losses with the diversity of opinions regarding contentious social issues, it is clear that ESG investing is inappropriate for public pension funds, just as it is for private sector pension funds. However, as the *American Council for Capital Formation* concluded:

> Institutions often vote in line with ISS and Glass Lewis recommendations. Notably, when proxy advisors recommend voting in favor of a proposal, large institutional holders support the resolution 80 percent of the time. And some funds automatically vote with the proxy advisors nearly 100 percent of the time, in a troublesome practice known as "robo-voting."
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> ***As a result, proxy advisory firms have emerged as "quasi-regulators," wielding their influence to require additional disclosure from public companies without any statutory authority, particularly around environmental or social issues***. These recommendations, which are drawn from unaudited data sources, create new disclosure requirements that ultimately encumber companies with additional costs and burdens. This type of quasi-regulatory process especially disadvantages small and mid-sized companies, in favor of larger companies that have the resources to comply.[14]

It is unclear that either ISS or Glass Lewis account for the specific needs of public pension funds when advising institutional investors about ESG proxy statements. In fact, based on their own ESG programs, it is reasonable to conclude that both firms are biased toward supporting such programs despite the clear negative impact these policies have on public pension funds.

ISS' and Glass Lewis' biases toward ESG programs is detrimental to the needs of public pension funds, pensioners, and taxpayers (who ultimately backstop the pensions). The fund shareholders are, consequently, ill-served by the proxy advisory firms on the ESG issue. Further, there is no

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[13] "Jason Perez Candidate Statement" *League of California Cities*; https://www.cacities.org/Resources-Documents/Policy-Advocacy-Section/Hot-Issues/Retirement-System-Sustainability/LCC_-CalPERS-BOD-Questions_Perez_Final.aspx. (emphasis added)

[14] Doyle TM "New Report: Proxy Advisory Firms Operate with Unchecked Power" *American Council for Capital Formation*, May 1, 2018; http://accf.org/2018/05/01/outsized-influence-minimal-oversight-new-accf-report-finds-that-proxy-advisory-firms-operate-with-unchecked-power/.

reason to believe that the problems associated with the ESG issue are unique. Instead, this problem raises concerns regarding the impact from proxy advisory firms on fund shareholders more broadly.

Policy reforms are vital for reining in proxy advisory firms' outsized influence

Without reforms that better align the interests of the proxy advisory firms and the interests of fund shareholders, reliance on these firms is not in the best interests of fund shareholders. To address these problems, reforms should ensure that proxy advisory firms act in a manner that promotes fund managers' fiduciary responsibilities to shareholders, and creates greater transparency regarding the proxy advisory firms' biases and conflicts of interest.

For example, reforms that require strict conflict of interest disclosures are necessary. As the ESG investing example demonstrates, the proxy advisory firms have preconceptions when they are evaluating specific proxy statements, and it is unreasonable to expect these preconceived notions to not impact their evaluation of the proposal's merits. Instead of assuming that the evaluations are objective, or allowing the proxy advisory firms to rely on their "general conflict of interest" statements as an adequate disclosure, requiring conflict of interest disclosures that are specific to the issue under evaluation should be required. More relevant conflict of interest disclosures will help ensure that the investors relying on the proxy firms' recommendations are aware of the proxy firm's specific biases and potential conflicts of interest as it relates to the specific issue under consideration.

The SEC should also consider eliminating the requirement that institutional investors vote on all items on corporate proxy statements. Enabling institutional investors to focus on only those corporate proxy statements they deem material would reduce the artificial demand for the proxy advisory services, and therefore improve the competitive environment.

Without such reforms, the current proxy process will continue to create additional, and unnecessary, risks for investors.

Thank you for the opportunity to comment on this important issue.

Sincerely,

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