Dear Ms. Countryman:

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.

The Securities and Exchange Commission’s proposed rule change regarding proxy advisory firms is a positive step that would lessen the problems currently being imposed on investment advisers and their clients. Due to these benefits, the SEC should implement the proposed rule.

While the rule is comprised of several changes that have merit, I would like to primarily focus my comments on the benefits from enhancing transparency, and will also discuss the benefits gained by strengthening the rules in order to ensure that investment managers do not blindly vote the recommendations of their proxy advisor (aka robo-voting).

Summarizing my key points:

- **Under the current regulatory rules, there are serious conflict of interest concerns.** Proxy advisory firms engage in numerous business lines that create conflicts of interests. The troubling disincentives that arise due to proxy advisory firms’ conflicts of interests are demonstrated by their position on environmental, social and governance (ESG) programs.

- **The requirement for greater transparency will meaningfully lessen the conflict of interest problem.** With full transparency, investors relying on the advice of proxy advisory firms will be fully aware of any potential conflict of interest. Further, the transparency rule will require proxy advisory firms to disclose the methodology behind their analyses. By eliminating the ability of proxy advisory firms to hide the
methodology used to form their recommendations, the proposed changes will better ensure that proxy advisory firms’ recommendations are directly linked to enhancing shareholder value.

- The proposed rule clarifies that **investment advisors cannot blindly follow the advice of a proxy advisory firm.** Investment advisers have a fiduciary responsibility to enhance shareholder value while adhering to the goals and objectives of the fund. It is inconsistent with this responsibility to outsource a fund’s voting decision to a third party without conducting adequate review of the recommended voting strategies.

- Finally, it is important to note that, while these reforms are important improvements, **more reforms are necessary.** An important reform not included would eliminate the requirement that investment managers must vote on every proxy statement. Forcing advisers to vote on every proxy statement creates an artificial demand for the services of proxy advisory firms that ultimately distorts the market. Removing this artificial demand will improve the dynamics of the proxy advisory market, ultimately leading to better proxy advisory services for investors.

**Proxy Advisory firms have clear conflicts of interest with respect to ESG programs**

The value that investors will gain if the SEC improves transparency requirements is illustrated by the current conflict of interests that plagues the advice provided by proxy advisory firms regarding ESG programs.

ESG is an imprecise term. With respect to corporate programs, ESG initiatives address social, environmental, or governance issues that are related to the corporation’s activities. Typically, companies implement ESG programs as a means to demonstrate their social responsibility and many ESG policies are raised via proxy statements. As applied to investing, ESG 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.

The two largest proxy advisory firms that control 97 percent of the proxy advisory market (ISS and Glass Lewis) have interests in ESG advisory services. ISS has an ESG program known as ISS ESG that provides “ESG screening, ratings and analytics designed to enable investors to develop and integrate responsible investing policies and practices into their investment strategies.”

Glass Lewis has formed a strategic partnership with Sustainalytics, which Glass Lewis describes as “the leading independent provider of global governance services”. According to Glass Lewis, the firm “features data and ratings from Sustainalytics in the ESG Profile section of our standard

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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.”

These programs illustrate that the two proxy advisory firms that control 97 percent of the market have a meaningful conflict of interest that could bias their advice on proxy statements relating to corporate ESG programs.

**ESG programs can harm shareholder value**

In many instances, a corporate ESG program can enhance shareholder value. For example, consumers often demand that products are produced in a manner consistent with ESG criteria. In this case, the company is providing its customers with the products they desire in the manner they want it produced. Alternatively, ESG programs may improve a company’s reputation/standing in the community sufficiently to warrant investor support. Under these circumstances, it is reasonable to conclude that these types of ESG proxy statements will enhance shareholder value.

While ESG programs can be financially viable, these programs can also be financially harmful. And, there is evidence that in many instances, ESG programs do not enhance shareholder value.

One way to view the potential negative impact from ESG programs is to examine the returns of funds that are dedicated toward investing in companies that meet selected ESG criteria. There is substantial evidence to suggest that ESG funds underperform non-ESG investing, therefore this is an indication that ESG programs can be detrimental to shareholder value.

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. 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 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).”

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5 Copland JR, Larcker DF, and Tayan B “Proxy Advisory Firms: Empirical Evidence and the Case for Reform” *the Manhattan Institute*, May 2018.
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 investing may be worthwhile for private investors, lower returns and fiduciary concerns make public pension funds unsuited for advancing ESG goals.”7

There are also 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.”8

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.

The findings of an analysis I conducted with the Pacific Research Institute concur with the above results. The analysis examined the financial performance of 30 ESG funds that have been cited as the top performing ESG funds. However, despite being cited as top performers, compared to the performance of a broad-based index fund, ESG funds exhibited higher financial risks, higher fund costs, and significantly lower financial returns.9

**Due to the potential negative impact on shareholder value, caution is warranted before investors support corporate ESG programs**

These results demonstrate that in order to understand whether a proposed ESG program is beneficial, the analysis must be an unbiased examination of the particular program and its value to the specific company considering implementing it. Due to the complete lack of transparency in how the two major proxy advisory firms establish their position on ESG programs, it is unknown whether the proxy advisory firm has adequately conducted this due diligence. Further, due to

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7 Ibid.

8 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)

their internal ESG advisory programs, these firms have a clear conflict of interest that could be biasing their analyses. As a result, institutional investors (particularly public pension funds) may be violating their fiduciary responsibilities when they adopt the ESG voting positions suggested by the two major proxy advisory firms.

It is, consequently, essential that investors receive full information regarding any positions the consulting services of ISS and Glass Lewis have taken on the specific ESG issue under consideration. Additionally, the proxy advisory firms should be required to provide the investment managers a comprehensive review of the methodology used to determine that the specific ESG issue under consideration enhances shareholder value.

The comprehensive transparency requirements under consideration will help provide investment managers with this important information. As the ESG issue demonstrates, the stricter transparency requirements will improve the ability of investment advisers to fulfill their fiduciary responsibilities.

**The value from an ESG program may differ across different investors**

In addition to the above, greater transparency is also necessary because the value of a specific ESG program may differ by the type of investor.

From the perspective of investors in an ESG fund, voting in favor of specific ESG programs can not only make sense, it could be required based on the goals and objectives of the fund. Perhaps the ESG program will enhance profits, perhaps it won’t. Either way, these investors are aware of the constraints they are imposing, and bear the consequences from their actions.

This nexus does not hold for many other institutional investors, particularly public pension funds because public pension funds represent many different individual investors who do not have the ability to choose which fund they would like to invest on their behalf. If you are a teacher in California, then CalSTRS will be managing your retirement savings. You have no choice. Since public pension funds represent many individuals who cannot self-select their investment adviser, it is inevitable that their ESG preferences will clash.

Taking the example of teachers in California, 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”.10

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

> 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.11

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 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.

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10 “Tensions with Pensions: An analysis of public pension fund members’ knowledge and sentiment about how their money is being invested” Spectrum Group, 2018.
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. The implication of this inappropriateness is straightforward. When evaluating whether an investor should support a specific ESG question, proxy advisory firms should adjust their evaluation depending upon the investor, and clearly define why the argued position is either appropriate/inappropriate for specific types of investors.

For example, an ESG fund may require an analysis that focuses on whether the proposal is an effective means to achieve the purported ESG goal; the impact of the ESG goal on corporate performance can be assumed.

Alternatively, for a public pension fund, the impact from achieving the ESG goal on corporate performance for the specific company under consideration cannot be assumed. The benefits of the ESG initiative on shareholder value must be demonstrated through a rigorous financial analysis in order to warrant the support of a pension fund in order to be consistent with that fund’s fiduciary responsibility.

By ensuring the financial models and analyses are transparently conveyed to investors, the proposed rule can empower investors to more comprehensively understand the implications of the ESG proposal based on the unique investment strategy they are charged with executing.

**The proposed rule is correct to prohibit “robo-voting”**

The different implications that can arise due to divergent investment strategies highlight the importance of ensuring that investment managers adequately review the recommendations provided by the proxy advisory firms. Unfortunately, according to the American Council for Capital Formation (ACCF), there is a disconcerting trend of institutional managers automatically voting with the recommendations of the proxy advisory firms without conducting their own review of the recommendation. Specifically, ACCF found that:

> 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.”

It is clearly a breach of an investment manager’s fiduciary responsibility to not conduct appropriate due diligence, which includes the voting recommendations provided by proxy advisory firms. Consequently, investment managers should never automatically vote the recommendations of a proxy advisory firm, but instead should review the recommendations and

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the justification for the recommendations to ensure that supporting the proxy statement is consistent with the goals and objectives of their particular fund.

The SEC rightly called attention to this practice in their proposed rule, and the final rule should place greater accountability on prohibiting automatic voting.

Additional reforms are vital for reining in proxy advisory firms’ outsized influence

Despite the benefits from increased transparency and stricter accountability regarding robo-voting, additional reforms could better align the interests of the proxy advisory firms and the interests of fund shareholders.

Paramount among these reforms, the SEC should 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.

While, ideally, the reforms would also eliminate the requirement to vote on all proxy statements, the proposed reforms are, on net, important improvements to the proxy advisory market that, if implemented, will reduce unnecessary risks for investors.

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

Sincerely,

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