WHAT IS THE ROLE OF PUBLIC PENSION PLANS IN PROXY VOTING?

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EXECUTIVE SUMMARY

For decades, proxy voting has been a pillar of capital markets, ensuring that shareholders have their voice heard through elected representatives. However, this process is under threat as shareholder influence has been consolidated by institutional investors and other organizations that now own between 70% and 85% of the ten largest American companies. Wielding tremendous market power, these large investors are often the most powerful voice at shareholder meetings and can influence corporate decision-making at a level unavailable to the individual and passive investor. Moreover, these large investors often have political motivations that conflict with their duty as fiduciaries.

This has led to the United States Securities and Exchange Commission (SEC) openly seeking possible reforms to the proxy voting process. With proper proxy voting reform, policy makers can restore balance to the shareholder voting process, increase overall transparency, and ensure that the individual investor’s voice is not overshadowed by the potentially-misguided political motivations of fund managers and other institutional forces.

- **Pension Funds Are Exercising Increasing Influence.** Pension funds continue to shift more of their money from fixed income assets to private equity. Today, these equity holdings make up as much as three quarters of pension fund holdings. This means that fund managers and large institutions investors wield increasing influence in shareholder votes.

- **Two Firms Control 97% of the Proxy Advisory Market.** Institutional Shareholder Services (ISS) and Glass Lewis maintain control of nearly all proxy voting processes. They are also themselves investment firms, meaning policy makers must remain vigilant about conflicts of interest and institute rules that ensure fair practices. The Ohio Public Employees Retirement System has previously cited conflicts with ISS. Similarly, Glass Lewis is owned and operated by the Ontario Teachers Union, raising potential conflicts when it comes to business practices labeled as ‘anti-union.’

- **Shareholder Votes Are Becoming More Politicized.** Those in charge of pension funds and others with shareholder influence are increasingly using their voice to put political agendas ahead of corporate profitability. According to a study at the University of Tennessee, shareholder activism is correlated with lower stock returns.

- **Pension Fund Developments in New York City and California Make a Strong Case for Reform.** The politicization of the New York City Employees’ Retirement System ($19 billion invested in equity securities) and the California Employees’ Retirement System and the California State Teachers’ Retirement System (together controlling $575 billion) over controversial climate activism provides compelling that the time for proxy voting reform is now. Pension funds must value profitability for pensioners over political activism.

- **Policy that Mandates Proxy Advisors Adhere to Their Fiduciary Responsibility and Ensure Greater Transparency Around Potential Conflicts of Interest is Necessary.** Proxy advisors should be required to adhere to their fiduciary responsibility with counsel and register with the SEC, disclosing possible conflicts. Likewise, increased accountability, including the ability for companies to identify and mediate clear inaccuracies prior to institutional investors review, is requisite. Noncompliance risks de-registration and possible SEC enforcement actions.
OVERVIEW

One of the hallmarks of capital markets is the proxy voting process, by which representatives make decisions on behalf of shareholders. However, glaring issues have become clear with the process since the rules governing this long-standing process were last updated in 2010. In light of this, the United States Securities and Exchange Commission (SEC) has announced a roundtable to discuss possible reforms to the proxy voting process. This announcement comes at a time when institutional investors, organizations that invest on behalf of its members, are estimated to own between 70% and 85% of the 10 largest American companies.1 With this much market power, these investors are often the most powerful voice at shareholder meetings and can influence corporate decision-making at a level unavailable to the individual and passive investor. Proper proxy voting reform would begin to shift this balance of power away from institutions and towards the individual, thereby increasing overall transparency of the process.

PROXY VOTING AND PENSION FUNDS

The issue of proxy voting is extremely relevant to the proper management of investment funds, including pensions. As large pension funds continue to invest more of their money into private equity, those investment funds will continue to have a more powerful voice in shareholder meetings for the firms that they are invested in. For decades now, public pension funds have been shifting their investment portfolio away from fixed income assets towards alternatives and equity. As of 2012, it was estimated that the latter forms of investment made up around 75% of public pension investments in the United States.2

Having such a large portfolio of equity holdings means that pension funds also serve as a powerful voice in corporate decision-making through their position as proxies for shareholders. Often, investment funds, including public pensions, rely on proxy advisors to guide voting decisions.

Two firms control the proxy advisory industry: Institutional Shareholder Services (ISS) and Glass Lewis. These two firms control over 97 percent of the proxy advisory market and each are themselves investment firms with financial stakes in various companies and industries, allowing for conflicts of interest. ISS, aside from operating as a proxy advisory firm, also sells a consulting service to firms considering management-sponsored proposals. Therefore, conflicts can arise if ISS recommends that investors vote for management reform if the firm is a consulting client. This relationship is exactly the reason the Ohio Public Employees Retirement System dropped ISS services in the 2000’s, citing management consulting as a possible conflict of interest in decision making.3

Glass Lewis is owned and operated by the Ontario Teachers Union, with obvious conflicts of interest occurring when businesses operate in ways interpreted as ‘anti-union.’ This demonstrates the current flaws of the proxy voting system, which does not require proxy advisors and other principled advice to provide full transparency to investors and pensioners. Increased transparency would afford companies the ability to review proxy advice and establish a process to mediate conflicts prior to a shareholder vote. Furthermore, increased oversight of proxy advisors would ensure that they and their work are in compliance and that advisors are adhering to their fiduciary responsibility.

Beyond the lack of transparency in the proxy advisory industry, is the increased politicization of shareholder votes. Unfortunately, there has been a rise in individuals in charge of pension funds using their voice to push their own political agendas, instead of using their power to push decisions that would increase corporate profitability, ultimately raising the value of their investments. In fact, one study by a professor from the University of Tennessee showed that shareholder activism on the part of pension funds is correlated with lower stock returns.4

This inclination of using shareholder power as a political tool is in stark contrast to the actions of private pension funds. According to the Employee Retirement Income Security Act of 1974 (ERISA), private pension funds may only consider factors related to investment value when undergoing shareholder voting. To make their responsibility even clearer, in 2008 the Department of Labor issued guidance requiring a cost-benefit analysis before a private plan partakes in a shareholder vote.5 Such a requirement facilitates greater transparency within the fund as individual pensioners are able to see the decision-making process behind shareholder votes.

Reforming the proxy voting process could begin to put more power into the hands of the actual pensioners, increase transparency, and help ensure that pension fund managers do not forgo their fiduciary responsibility. As the true owners of large pension funds, pensioners deserve complete transparency to know the details of the shareholder proposals and to have their voices heard as key shareholders in many of these large companies. The SEC should take the opportunity of this coming roundtable to lead a discussion about transferring the power away from institutional investment firms and to individual investors. Such an act would not only give more power to the people most affected by investment performance, but it would also create an additional level of transparency and accountability that is currently missing. In order to illustrate the relevance of this issue for pensions, below are two different case studies with pensions systems, in which the pensioners would benefit from the reform.

**Case Study: New York City**

As of the end of fiscal year 2017, the New York City Employees’ Retirement System (NYCERS) had almost $19 billion invested in equity securities.6 This level of investment has given New York City Comptroller Scott Stringer a great deal of power to influence the direction of many companies. In 2017 alone, Comptroller Stringer proposed 92 shareholder proposals to 88 companies, which was more than double the amount NYCERS made in 2014.7 With this much activity, NYCERS has become one of the most vocal institutional investors when it comes to wielding shareholder power.

Not only has Comptroller Stringer been active in the sheer number of proposals he has made, but it seems that many of these proposals exist to further his political agenda. The politicization of NYCERS is a major problem as Comptroller Stringer is the fiduciary of the pension funds. He is in charge of managing the retirement funds for thousands of New Yorkers and his duty is to ensure that they are given the payments that they are entitled to. However, as another example of politicizing the pension funds, Comptroller Stringer and Mayor Bill de Blasio announced in 2018 their intention to divest NYCERS funds from firms engaged in fossil fuel production, which only serves to further political agenda towards climate change.

Most pensioners in New York believe that NYCERS actions should be much more transparent. When polled, over 85% of pensioners wanted NYCERS to provide an explanation and justification for their shareholder proposals. Further, two thirds of NYC pensioners want Comptroller Stringer to focus his efforts on achieving strong financial returns and not political goals. This is why it is especially troubling that many of Comptroller Stringer’s actions are not clearly articulated to pensioners. Proxy voting reforms that put the power back in the hands of the individual pensioners in New York City would begin to pull politics out of NYCERS and get it back to focusing on strong financial performance.

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Case Study: California

The state of California has two statewide pension funds: the California Employees’ Retirement System (CalPERS) and the California State Teachers’ Retirement System (CalSTRS). These funds are two of the largest pension funds in the country, and together they are worth more than $575 billion. Unfortunately, much like Comptroller Stringer in New York, CalPERS and CalSTRS have used the weight of their investments to push forward a political agenda instead of focusing on fiduciary stewardship. Recently, CalPERS has used its position to pressure over thirty companies into allowing shareholders to nominate directors to corporate boards. Such a measure would give investment funds such as CalPERS even greater control over corporate decisions.

Allowing pension funds such as CalPERS and CalSTRS to have a greater say in corporate decision making is not inherently a bad thing, however the way that the funds are likely to use this power is in direct conflict with their fiduciary responsibility. During the same time that CalPERS was pushing for greater power over board decisions, it also supported 66 different proposals dedicated to environmental sustainability. If given more power in board decisions, we can expect CalPERS and CalSTRS to continue actions like this based off of their other politically-motivated moves. For example, both CalPERS and CalSTRS are members of the Investor Network on Climate Risk, a group of over 100 institutional investors that use their combined trillions of dollars in assets to address a political drive to pressure governments and regulators into implementing policies targeting carbon emissions.

Just like NYCERS, CalPERS and CalSTRS should be focused on achieving strong financial returns for the hundreds of thousands of annuitants they owe payments to. By reforming the proxy voting process and giving individual pensioners a bigger voice, CalPERS and CalSTRS can get back to focusing on their roles as fiduciaries and on reducing their $400 billion of unfunded liabilities.

Conclusion

The proxy voting process is in desperate need of reform. The growing market power of investment intuitions has pushed individual shareholders and passive investors away from the decision-making process. In the case of pension systems, it is the fund managers who have been wielding shareholder power and not the people to whom the money truly belongs, the individual pensioners. Often these managers have political motivations that conflict with their duty as fiduciaries. As the SEC examines reforms to the shareholder proxy voting process, the reforms should be focused on increasing transparency and accountability. The current system furthers the increased politicization of our public pensions, which puts the already underfunded pensions at greater risk, which public servant retirees and taxpayers will ultimately be on the hook for. Any SEC regulation that would result in the funds increasing their focus on improving the value of their investments over playing politics with other people’s money would be a benefit to retirees everywhere.

10. Ibid