

Mr. 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  
December 21, 2018

Dear Mr. Fields,

I write in response to a request for comments related to the SEC Staff Roundtable on the Proxy Process, held on November 15, 2018. My name is Benjamin Zycher. I am a resident scholar at the American Enterprise Institute in Washington, DC. I formerly was a senior economist at the RAND Corporation, an adjunct professor of economics at the University of California, Los Angeles (UCLA), and a senior staff economist at the President's Council of Economic Advisers. I hold a doctorate in economics from UCLA and a Master's degree in public policy from the University of California, Berkeley. The views I express in this letter are my own and do not purport to represent those of any institution with which I am affiliated.

In 2003, the Securities and Exchange Commission promulgated a regulation<sup>1</sup> that appeared benign but that has engendered effects unintended and adverse. It has resulted in an empowerment of two firms as among the most powerful arbiters of corporate governance in America. Those firms, Institutional Shareholder Services (ISS) and Glass Lewis (GL), account for 97 percent of the market for proxy advisory (PA) services.

Because of subsequent staff interventions, the 2003 regulation evolved from a simple requirement that investment funds provide transparency involving potential conflicts into an SEC policy that was interpreted to mean effectively that funds must vote on all proxy issues.

Unfortunately, the voting recommendations flowing from the PA services have been shaped by incentives very different from enhancing value for the shareholders and future pensioners who participate in the funds.

There are two problems. The first is that recommendations frequently lack an objective foundation. As James K. Glassman and J.W. Verret wrote in a 2013 paper<sup>2</sup> for the Mercatus Center of George Mason University: "The key question is, How good is the firms' advice? The objective of strong corporate governance is to enhance shareholder value, but it is by no means clear that ISS and Glass Lewis have achieved this objective with their recommendations."

A commentary by Stanford's Rock Center stated:

Ultimately, the accuracy of a recommendation can only be determined by rigorous statistical analysis showing positive impact of a governance choice on shareholder value. What rigorous empirical research supports each of the voting recommendations promulgated by proxy advisers? Why don't ISS and Glass Lewis disclose the specific research (either that

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<sup>1</sup> <https://www.sec.gov/rules/final/33-8188.htm>

<sup>2</sup> <https://www.mercatus.org/publication/how-fix-our-broken-proxy-advisory-system>

they have conducted or conducted by third parties) that justifies each of their recommendations?<sup>3</sup>

The second problem – the one that I want to emphasize in this letter – is that recommendations by ISS and GL are frequently driven by “environmental, social, and governance” (ESG) investing, a concept coined in 2005.<sup>4</sup> ESG substitutes an amorphous range of political goals in place of maximizing the funds’ economic value — that is, the wealth and pension benefits of current investors.

Precisely because political goals are political, they are shaped by conflicting value judgments, policy interests, and other such objectives about which there is strong disagreement. There is no obviously “correct” set of investments that satisfy the political demands of the myriad shareholders interested in how the funds allocate their capital.

ISS and GL serve as conduits for the spread of ESG political and ideological values, and the SEC has unwittingly increased the width and breadth of those conduits throughout the U.S. economy.

Meanwhile, ISS has developed an obvious conflict of interest. It sells consulting services to corporations, advising them on how to get favorable proxy recommendations from that very same ISS.<sup>5</sup> Imagine the pressure a corporation must feel to buy consulting services from the same firm that passes judgment on its proxies. This is a classic conflict, of the sort regulators have dealt with for bond-ratings agencies, accounting/consulting firms, and investment research/banking firms. Why not for proxy advisors?

Advocates of ESG investing argue that such “socially responsible” investment choices do not have to come at the expense of lower returns. That argument is deeply dubious. By definition, the imposition of an artificial investment constraint — no, say, to oil companies — cannot yield a systematic return higher than a set of options without such constraints. That truism is clear in the evidence; consider, for example, the effects of divestment from fossil-fuel producers. University of Chicago Law School emeritus professor Daniel R. Fischel found in a study<sup>6</sup> that:

[Of the] 10 major industry sectors in the U.S. equity markets, energy has the lowest correlation with all others, followed by utilities — meaning that companies in these sectors provide the largest potential diversification benefit to investors, and that divestment would reduce returns substantially.

In particular, Professor Fischel’s study tracks the performance of two hypothetical investment portfolios over a 50-year period: one that included energy-related stocks, and another that did not. The portfolio which included energy stocks generated average annual returns 0.7 percentage points greater than the portfolio that excluded them on an absolute basis and 0.5 percentage points per year higher on a risk adjusted basis. In other words, the “divested” portfolio lost roughly 50-70 basis points each and every year over the prior 50-years. Professor Fischel’s study also found that ongoing management fees are likely to be

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<sup>3</sup> <https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-closer-look-31-proxy-firms-voting-recommendations.pdf>

<sup>4</sup> <https://www.forbes.com/sites/georgkell/2018/07/11/the-remarkable-rise-of-esg/#1e1719201695>

<sup>5</sup> <https://pubsonline.informs.org/doi/abs/10.1287/mnsc.2016.2652>

<sup>6</sup> [http://divestmentfacts.com/pdf/Fischel\\_Report.pdf](http://divestmentfacts.com/pdf/Fischel_Report.pdf)

as much as three times higher for a portfolio divested of fossil fuel stocks.<sup>7</sup>

There has been extensive research on the question of the returns of ESG portfolios vs. broad index portfolios. For example, Adler and Kirtzman concluded in the *Journal of Portfolio Management* that “the cost of socially responsible investing is substantial for even moderately skilled investors.”<sup>8</sup> A comparison published by the research firm MSCI found that \$100 invested in the MSCI KLD 400 Social Index, a popular ESG index, grew to \$338.08 for the 15 years ending Nov. 30, 2018. By comparison, \$100 invested in the MSCI USA Investable Market Index, comprising approximately 3,000 stocks across all market capitalizations (a proxy for the entire U.S. market), grew to \$369.84 – or 9.4% more.<sup>9</sup>

The danger of ESG investing is evident. Trustees of public-pension plans, for example, explicitly have ignored the advice of financial advisors that the plans themselves have hired in order to adopt ESG policies that reduce returns for millions of investors.

In May 2017, for example, some members of the board of the \$25 billion San Francisco Employees Retirement System (SFERS) proposed divesting its portfolio of holdings of the 200 largest fossil fuel companies that comprise the Carbon Underground 200 stocks.<sup>10</sup> The board then asked its general investment consultant, NEPC, to analyze the consequences of such a divestment. SFERS staff examined NEPC’s work and stated:

Retirement staff concurs with NEPC’s conclusion that divestment from Carbon Underground 200 fossil fuel companies will materially reduce the potential risk-adjusted returns from the SFERS public markets portfolio.

Accordingly, the staff recommended against divestment.

In 2016, the California Public Employees Retirement System (CalPERS), the largest public-pension system in the U.S. with about 2 million members, similarly examined whether to continue a policy of blacklisting tobacco companies. Its financial advisor, Wilshire Associates, estimated that the policy had cost the system’s members \$3 billion.<sup>11</sup> In the end, the CalPERS board decided not merely to retain the ban on tobacco stocks but to broaden it.<sup>12</sup>

The Department of Labor (DOL) earlier this year made clear the fiduciary responsibility of fund managers to their investors for private funds governed by the Employee Retirement Income Security Act of 1974 (ERISA). The department cited its “longstanding view that, because every investment necessarily causes a plan to forego (*sic*) other investment opportunities, plan fiduciaries are not permitted to sacrifice investment return or take on additional investment risk as a means of using plan investments to promote collateral social policy goals.”<sup>13</sup>

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<sup>7</sup> <https://www.compasslexecon.com/compass-lexecon-releases-fischel-study-on-effect-of-fossil-fuel-divestment-proposals-on-university-endowments/>

<sup>8</sup> <http://jpm.ijournals.com/content/35/1/52>

<sup>9</sup> <https://www.msci.com/documents/10199/904492e6-527e-4d64-9904-c710bf1533c6>

<sup>10</sup> <https://mysfers.org/wp-content/uploads/08092017-board-meeting-07-fossil-fuel-A.pdf>

<sup>11</sup> <https://www.ft.com/content/e87a9b3c-0708-11e6-9b51-0fb5e65703ce>

<sup>12</sup> <https://www.calpers.ca.gov/page/newsroom/calpers-news/2016/votes-expand-tobacco-investment-ban>

<sup>13</sup> <https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-01>

In Field Assistance Bulletin 2018-01, the department stated:

Fiduciaries must not too readily treat ESG factors as economically relevant to the particular investment choices at issue when making a decision. . . . ERISA fiduciaries must always put first the economic interests of the plan in providing retirement benefits. A fiduciary’s evaluation of the economics of an investment should be focused on financial factors that have a material effect on the return and risk of an investment based on appropriate investment horizons consistent with the plan’s articulated funding and investment objectives.

Public-employee pension funds such as SFERS and CalPERS are subject to state laws and regulations instead of Labor Department-administered ERISA requirements. Public employees cannot exit their pension plans whether they approve of ESG policies or not. As SEC Commissioner Hester M. Peirce stated in a speech in September:

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.<sup>14</sup>

And so it is not surprising that ESG investing by public pension funds has yielded penalties for investment returns. (In many cases, it is taxpayers who would have to finance the unfunded pension liabilities of the funds.) A study by James Copland of the Manhattan Institute and David Larcker and Bryan Tayan of Stanford found “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.”<sup>15</sup> As an important example, for the 10-year period ending June 30, the annual average return for CalPERS was 5.6%,<sup>16</sup> while the Vanguard Balanced Index Fund, with holdings roughly divided three-fifths stocks and two-fifths bonds and cash, earned 7.8%.<sup>17</sup>

After a campaign that highlighted CalPERS’s poor returns, Jason Perez, a police officer, defeated Priya Mathur, who had been a member of the board since 2002, its newly installed president, and an impassioned advocate of ESG investing. Perez, the Calpensions website noted, “wants to shift the \$360 billion investment fund toward higher yields that secure pensions with less focus on social issues.”<sup>18</sup>

Said Sergeant Perez:

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

<sup>14</sup> <https://www.sec.gov/news/speech/speech-peirce-092118>

<sup>15</sup> <https://www.manhattan-institute.org/html/proxy-advisory-firms-empirical-evidence-and-case-reform-11253.html>

<sup>16</sup> <https://www.calpers.ca.gov/page/newsroom/calpers-news/2018/preliminary-fiscal-year-investment-returns>

<sup>17</sup> Calculation through Bloomberg database.

<sup>18</sup> <https://calpensions.com/2018/10/05/calpers-president-loses-board-seat-to-policeman/>

only the manufacturers, but also large retail stores such as Walmart, Big 5 Sporting Goods, Cabela's, and Outdoorsman. Thankfully, the Board did not even have a member second the motion due, in large part, to the testimony of more reasonable people. This example clearly shows how CalPERS is being used as a Political Action Committee as opposed to a retirement fund.

That statement says it all: The SEC should ensure that managers and advisors do not play political games with other people's money. That gamesmanship is the very essence of ESG investing, with all of the self-dealing and other perversities that politicized investment choices offer.

It is time for the SEC to reconsider the 2003 regulation on proxy disclosures, and, especially given that taxpayers must make up the unfunded liabilities of the public pension funds, it is unacceptable that their managers be allowed to ignore the normal fiduciary responsibility to maximize risk-adjusted returns.

Therefore, let me offer the following recommendations to the Commission:

First, the SEC should clarify that funds are the sole arbiters of whether to vote on proxy questions. The single test is whether the vote enhances the value of their clients' investment, with all costs taken into consideration. The funds must be transparent as to their policies. For example, a policy might be: "We will never vote shares because the costs outweigh the benefits," or, "We will vote as recommended by management," or "We will vote only in rare cases where we believe a proposal will substantially enhance shareholder value." Funds may also choose to vote shares proportionally, based on the expressed wishes of retail investors.

Second, the SEC should affirm that funds are breaching their fiduciary duty when they vote to impose criteria other than clear value-enhancement on companies whose shares they own. This is essentially the Department of Labor position for ERISA funds. In a 2016 paper, Alicia Munnell, a former Treasury Department official under President Clinton and now director of the Center for Retirement Research at Boston College, and her colleague Anqi Chen, concluded:

While social investing raises complex issues, public pension funds are not suited for this activity. The effectiveness of social investing is limited, and it distracts plan sponsors from the primary purpose of pension funds – providing retirement security for their employment.<sup>19</sup>

The SEC has an opportunity to deal not merely with the mechanics of proxy advisory regulation but also with the growing threat to retirees of politically biased investment recommendations. I urge the Commission to adopt these reforms in its current examination.

Thank you for allowing me to offer my views on this important matter.

Sincerely,

Benjamin Zycher, PhD

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<sup>19</sup> [http://crr.bc.edu/wp-content/uploads/2016/11/slp\\_53.pdf](http://crr.bc.edu/wp-content/uploads/2016/11/slp_53.pdf)