Mr. Brent J. Fields
Secretary, Securities and Exchange Commission
100 F St NE
Washington, D.C. 20549-1090

Re: File No. 4-725

Dear Mr. Fields:

February 28, 2019

Individual Investors' Role in the Proxy Process

Investors are given the opportunity to affect corporate governance through the shareholder process. Because investors have a financial stake in the company, they are given the opportunity to elect a board of directors and have a say on a number of different issues that directly affect the management of the company. The idea is that with a direct financial interest, shareholders are given the opportunity to increase their value in the company. The company will announce its annual shareholders meeting and invite all owners to the meeting where ballots will be cast.

Since most shareholders have a very small percentage of shares, they are unlikely to attend a shareholders meeting and actually cast their ballots. For example, there are in excess of 1.4 billion shares of General Motors Corporation outstanding.[1] Even if you held 5,000 shares of GM stock, it is very unlikely that your vote would be a deciding factor. Thus you have little or no incentive to cast your ballot in person.

In response to this situation, stockholders are sent a proxy statement, where they may vote by mail, on-line, or another method rather than cast their vote at the meeting. Even with the elimination of the cost of attending a meeting, the opportunity cost for any shareholder to analyze a shareholder resolution and determine how to vote is quite large. Therefore, the shareholder is allowed to assign his or her vote to someone else, such as a broker, who is likely more knowledgeable about the nuances of specific shareholder resolutions than is the shareholder.

Institutional investors, such as pension funds or investment management companies (mutual funds) have large numbers of shares and are much more likely to vote their proxies. In 2003 the SEC implemented a regulation that required investment management companies to disclose how they voted their proxies.[2] This regulation eventually was interpreted to require all mutual funds to vote on all proxy issues. It also limited the liability of proxy advisor firms.[3]

---

[1] https://www.nasdaq.com/symbol/gm/stock-report

[2] https://www.sec.gov/rules/final/33-8188.htm

[3] Benjamin Zycher, American Enterprise Institute, "Other people's money: ESG investing and the conflicts of the consultant class; Doing well while pretending to do good, " December 17, 2018, https://www.aei.org/publication/other-peoples-money-esg-investing-and-the-conflicts-of-the-consultant-class/

The Evolution of Proxy Advisory Firms

As a consequence, fund managers have felt that hiring an outside advisory firm to decide how to vote the proxies will reduce the chance of a lawsuit alleging improprieties. If the advisory firms were to decide the best way to vote proxies to maximize the value of an investment or the pension fund, then maximizing the return to the mutual fund, pension fund or other institutional advisor would be consistent with the inclination to hire firms to avoid litigation.

However, there is a principal-agent problem, in that what is in the best interest of the holders of the mutual fund or pension fund may not be what the proxy advisor firm believes is in its best interest. This is often a consequence of asymmetric information, where one party has more information about an issue than another.[4] Since the institutional investor probably has less information about the effects of voting proxies for the various companies owned by the institution than does the advisory firm, the institutional investor may find it difficult to know whether the proxy vote suggested by the advisor is actually going to maximize the value of the stocks owned by the institution. Unfortunately, proxy advisors develop a one-size fits all recommendation as opposed to tailoring their advice to specific clients.

Clearly the individual investor in a mutual fund, such as Vanguard Explorer Fund, has no idea what the effect of management's voting on a particular proxy will be. Therefore, it may be difficult for the investor or the investment manager to know if the proxy advisor is giving advice that will maximize the return to the investor or whether the advisor is giving advice that conforms to what the advisor feels in the best interest of the advisory firm.

The Outsized Influence of Institutional Shareholder Services (ISS) and Glass Lewis (GL)

In the case of private mutual funds and other investment firms, the managers of the funds may over time come to discover that one advisory firm's advice is better than another's in terms of maximizing the value of investments. However, in reality two proxy advisory firms dominate the industry. Institutional Shareholder Services (ISS) and Glass Lewis (GL), combined, control 97% of the advisory market.[5] This has enabled them to have substantial effect on voting outcomes, as noted in a recent Stanford University study. It concluded that "most research finds that ISS and Glass Lewis can swing up to 20% of the vote, depending upon the proposal."[6] A Harvard University study pointed out that "newly-published empirical evidence makes clear that, while the recommendations of ISS are not followed by their clients 100% of the time, they are followed *nearly* 100% of the time by many of the largest fund managers in the country."[7] The American Council for Capital Formation found that:

---

[4] The early examination of the principal-agent problem is most often cited as due to the work of Jensen and Meckling in October 1976 *Journal of Financial Economics*. The seminal article in asymmetric information is George Akerlof's "The Market for Lemons," *QJE* 1970.

[5] http://accfcorpgov.org/

[6] https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-research-spotlight-10-proxy-advisors.pdf, 12

[7] https://corpgov.law.harvard.edu/2018/11/07/are-proxy-advisors-really-a-problem/

- 175 asset managers managing over $5.0 trillion in assets have historically voted consistently with ISS's recommendations 95% of the time, whether the matter at issue was a management proposal or a shareholder proposal, and

- 82 of the asset managers with over $1.3 trillion of assets under management voted consistently with ISS' recommendations 99% of the time, whether the matter in question was a management proposal or a shareholder proposal.[8]

Due to the rational ignorance of individual investors and fund managers of the effect of any proxy vote for any individual firm, it is quite possible that the proxy advisory firms will fall under the principal-agent situation discussed above. It is likely that proxy advisory firms will advise clients to vote their proxies in a way that is consistent with the desired policy objectives of the advisory firms not in a way that maximizes the return to the investor.

Environmental, Social, and Corporate Governance (ESG) and the Proxy Process

Dr. Wayne Winegarden of the Pacific Research Institute, in a filing with the SEC, argues that the two advisory firms are biased towards making recommendations based on environmental, social, and corporate governance (ESG) principles.[9] He notes that both of the major proxy firms consider ESG as central in their analysis and make recommendations that support those principles.

As Adam Seessel pointed out in a recent *Barron's* feature, as in any situation, restrictions on choice limit the ability to perform. In the case of investing, restrictions on what firms may be invested in will reduce the ability of any investor to maximize the value of their portfolio. Thus ESG investing will generally inhibit the performance of any portfolio because investments that do not fit ESG principles are off limits despite that fact that they are sometimes the most profitable.[10] Private pension funds generally are not engaged in ESG investing. This is likely due to the fiduciary responsibility requirements of the Employee Retirement Income Security Act of 1974 (ERISA), which limit the ability of private pensions to undertake policies that limit a pension fund's investment options in a way that would reduce the fund's returns.[11]

ESG criteria is clearly inappropriate for public pension funds. First, the managers of a public pension fund should have a fiduciary responsibility to the investors. Second, the individual pensioners are unable to move their investment to another pension fund if they are dissatisfied with the performance or public policy desires of the fund's management. Unfortunately, the reliance of some public pension funds on ISS and Glass Lewis will fail to result in maximizing the value of their portfolio.

---

[8] http://accfcorpgov.org/numerous-asset-managers-voting-in-lockstep-with-proxy-advisor-recommendations/

[9] https://www.sec.gov/comments/4-725/4725-4644756-176461.pdf

[10] Does Sustainable Investing Lead to Lower Returns?, *Barron's*, June 23, 2018: https://www.barrons.com/articles/does-sustainable-investing-lead-to-lower-returns-1529712000

[11] Ibid.

Public pensions are beset by large unfunded liabilities. Moody's recently estimated the unfunded liabilities of the fifty state pension funds as in excess of $1.6 trillion.[12] This is nearly 150% of the annual revenue of the states. Clearly, it is important for public pension funds to choose investments and direct the leadership of the companies whose stock is owned by the pension in a way that maximizes the return to the pension fund. Unfortunately, the use of proxy advisory firms that are biased towards limiting the range of investments to ESG will not accomplish this.

Proxy Advisory Reform is Needed by the SEC

Reform is needed in order to diminish these firms' outsized role and influence over the proxy process. Very clear conflicts of interest exist that fail to be disclosed and these can steer recommendations for the benefit of the proxy advisory firm rather than for the benefit of the public pensions. Proxy advisors are not required to provide advice through the lens of what will generate the greatest returns. And ISS and Glass Lewis' outsized influence over the proxy process, by recommending resolutions, advising how to vote on those resolutions, and providing the service to vote proxies for clients, is detrimental to the public employee pensions and the economy as a whole. The SEC should change this system and provide greater oversight.

Sincerely,

Gary Wolfram, Ph.D.
William Simon Professor of Economics and Public Policy
Hillsdale College
Hillsdale, Michigan

[12] https://www.moodys.com/research/Moodys-Unfunded-US-state-pension-liabilities-surge-in-fiscal-2017--PBM_1139183