Ms. Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

By email: rule-comments@sec.gov

Re: File No. S7-22-19
SEC Proposed Rule: Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice

January 17, 2020

Dear Ms. Countryman,

I write in response to a request by the Securities and Exchange Commission (SEC) for comments on its proposed rule "Amendments to Exemptions From the Proxy Rules for Proxy Voting Advice," published in the Federal Register on December 4, 2019.[1] 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 that I express in this letter are my own and do not purport to represent those of any institution with which I am affiliated.

I previously submitted to the SEC a formal comment on the SEC Staff Roundtable on the Proxy Process (File No. 4-725).[2] I organized and moderated a panel discussion on "Environmental, Social, and Governance Investing: The Proxy Advisory Process and the Interests of Investors," held June 18, 2019 at the American Enterprise Institute, at which SEC Commissioner Hester Peirce delivered the keynote address.[3]

In context of SEC policy generally and this proposed rule in particular, it is important to specify the appropriate policy objective: provision of incentives to company managers and officials, proxy advisors, and other relevant decisionmakers to maximize the economic value of the assets owned by shareholders, participants in pension and retirement funds, and other parties with a direct financial interest in the performance of businesses subject to SEC rules and oversight. This policy objective is consistent with---indeed, it would strengthen---the fiduciary responsibility of those making or influencing business decisions to maximize that economic value. It would effect that outcome by minimizing the scope and opportunity for business decisions driven by considerations reflecting the personal preferences of managers, proxy advisors, and others in place of the fiduciary interests of the shareholders, participants in pension and retirement funds, and the other parties alluded to immediately above. This consideration is particularly important in the case of public pension portfolios, for a straightforward reason summarized by Commissioner Peirce in 2018:

---

[1] The proposed rule is available at https://www.federalregister.gov/documents/2019/12/04/2019-24475/amendments-to-exemptions-from-the-proxy-rules-for-proxy-voting-advice.
[2] December 21, 2018, available at https://www.sec.gov/comments/4-725/4725-4827804-177047.pdf.
[3] A summary and podcast of the event are available at https://www.aei.org/events/mutual-funds-public-employees-public-pensions-securities-social-justice-environmental-policy/.

> The problems arise when those making the investment decisions are doing so on behalf of others who do not share their [policy or political] 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.[4]

SEC Chairman Jay Clayton emphasized this reality last November:

> A common theme in [Main Street investors'] letters was the concern that their financial investments---including their retirement funds---were being steered by third parties to promote individual agendas, rather than to further their primary goals of being able to have enough money to lessen the fear of 'running out' in retirement or to leave money to their children and grandchildren.[5]

In 2003, the Securities and Exchange Commission promulgated a regulation[6] that appeared benign but that has engendered effects unintended and adverse. It has resulted in a duopoly of two firms enjoying a position as 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 services. Because of subsequent staff interventions and interpretations, 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, that the funds could avoid liability by retaining proxy advisors, and that the proxy advisors would bear liability only in extreme cases. Commissioner Peirce summarized the resulting problems well last November:

> Much of the mischief in this area has arisen from the misperception—perpetuated in part by the SEC—that the fiduciary duty included an obligation to vote each and every proxy. Advisors, particularly small ones, overwhelmed with the number of proxies to be voted each season, reasonably sought third party assistance in wading through the workload. Indeed, this agency, through staff no-action letters, encouraged them to do just that.
>
> Hiring assistance in researching and analyzing proxies of course does not relieve the adviser of its fiduciary duty; the adviser must still weigh the advice and vote according to its clients' interests, which might be inconsistent with its own. Yet our staff guidance seemed to encourage carefree outsourcing of the voting function without much thought about

[4] https://www.sec.gov/news/speech/speech-peirce-092118

[5] "Statement of Chairman Jay Clayton on Proposals to Enhance the Accuracy, Transparency and Effectiveness of Our Proxy Voting System," November 5, 2019, at https://www.sec.gov/news/public-statement/statement-clayton-2019-11-05-open-meeting#_ftn8.

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

> how those third-party voting advisors were coming up with their recommendations.[7]

The ”extreme cases” limitation on the potential liability of proxy advisors means that in practice the proxy advisors are constrained by fiduciary responsibility considerations only weakly; and that the personal preferences of the proxy advisors, often oriented toward specific policy or political goals, can carry substantial weight in terms of decisions on proxy matters. Such matters include executive compensation and corporate policies on a range of social and environmental questions. In short, the voting recommendations flowing from the proxy advisory services have been shaped by incentives very different from enhancing value for the shareholders and future retirees and pensioners who participate in the funds. Nor can it be assumed that this effect is small: Recent research focusing on ISS finds that a negative recommendation results in a 25 percent reduction in support for the given proxy proposal.[8]

One argument commonly offered in support of the use of proxy advisors is straightforward: Such employment of proxy advisors purportedly reduces the costs of evaluating proxy proposals confronted by fund managers required to vote shares in ways consistent with their fiduciary responsibilities to the owners of the funds and current and future pensioners.[9] This argument is almost certainly incorrect. After all, the proxy advisors do not offer their services at a subsidized price. *Someone* must evaluate the proxy proposals on behalf of fund managers; that is, someone must hire the analysts and pay the costs of constructing and operating a more-or-less permanent analytic effort. There is little reason to believe that the proxy advisors have a comparative advantage (lower marginal costs) in terms of doing so. In principle, there might be high fixed costs (and thus scale economies, that is, declining average costs) for such analytic efforts; but that does not seem very plausible, since the costs of hiring analysts and constructing and operating an analytic shop ought to be roughly proportional to the analytic effort.

Only the regulatory environment yielded by the SEC staff interpretations noted above has created such a comparative "advantage," one that is wholly artificial, in that, again, there is no reason to believe that the costs of employing analysts, acquiring information, and doing the requisite analyses of proxy proposals would be reduced by moving such activities outside the organizational boundaries of the funds themselves. If a given proposal is submitted to more than one fund, there might exist in principle a potential scale economy attendant upon an analytic effort conducted by one proxy advisor rather than by multiple funds in a duplicative fashion. Any such scale economy is very unlikely to be available in practice, because the fund managers are certain to understand better than outsiders (i.e., the proxy advisors) the prospective impacts of given proposals on their funds. Accordingly, this scale economy effect, even if it exists, would be outweighed by the costs of evaluating the effects of given proxy proposals on funds with differing characteristics. And this reality exists even apart from the incentives created by the current regulatory environment for proxy advisors to substitute their personal political, social, and policy preferences in place of fiduciary considerations alone.

---

[7] Commissioner Hester M. Peirce, "Statement at Open Meeting on Proposed Amendments to Improve Accuracy and Transparency of Proxy Voting Advice," November 5, 2019, at https://www.sec.gov/news/public-statement/statement-peirce-2019-11-05-proxy-voting-advice.

[8] See Nadya Malenko and Yao Shen, "The Role of Proxy Advisory Firms: Evidence From a Regression-Discontinuity Design," *Review of Financial Studies*, Vol. 29, Issue 12 (December 1, 2016), pp. 3394-3427, at https://academic.oup.com/rfs/article-abstract/29/12/3394/2418027?redirectedFrom=fulltext.

[9] See for example the comment letter to the SEC of Professor Paul Rose, "Re: File Number S7-22-19, Amendments to Exemptions From the Proxy Rules for Proxy Voting Advice," at https://www.sec.gov/comments/s7-22-19/s72219-6429308-198569.pdf. Notwithstanding this narrow issue, note that Professor Rose's comment letter is very useful.

In any event, the SEC issued last summer "an interpretation that proxy voting advice provided by proxy advisory firms generally constitutes a 'solicitation' under the federal proxy rules and provided related guidance about the application of the proxy antifraud rule to proxy voting advice."[10] Commissioner Elad Roisman noted that "Advisers who vote proxies must do so in a manner consistent with their fiduciary obligations and, to the extent they rely on voting advice from proxy advisory firms they must take reasonable steps to ensure the use of that advice is consistent with their fiduciary duties."[11] This guidance may help to constrain the ability of the proxy advisory services to make recommendations not driven by shareholder value maximization objectives generally; a general example is a substitution to some substantial degree of environmental, social, and governance (ESG) objectives in place of fiduciary considerations. A shift away from value maximization is particularly perverse in the case of public pension management, for the reasons summarized by Chairman Clayton and by Commissioner Peirce in 2018. This adverse set of incentives is shaped by several factors underlying the relationship between proxy advisors and fund decisionmakers.

This comment letter focuses specifically on two issues cited in the SEC proposed new rule on proxy voting: automatic voting and specialty reports, in the specific context of the fiduciary responsibility to maximize the value of pension investments.

Automatic voting. Consider again the staff interpretations of the 2003 regulation, as noted above, that funds must vote on all proxy issues, that the funds could avoid liability by retaining proxy advisors, and that the proxy advisors would bear liability only in extreme cases. It cannot be a surprise that this regulatory environment provides powerful incentives for fund managers to adopt the recommendations of their proxy advisors, that this incentive structure would engender a bias toward such deference, and that one result would be "automatic voting"---a blanket acceptance of the proxy advisors' recommendations---by fund managers. Even in the case of funds that evaluate proxy advisors' recommendations independently, it is no surprise that acceptance of those recommendations has evolved into the default option in many cases, while rejection of the recommendations is the exception.[12] This incentive yielding an increase in automatic voting has been confirmed empirically; one recent study concludes that "this research makes clear that many institutional investors vote by default in a manner recommended by their proxy advisors.[13] Another study found that "175 asset managers with more than $5 trillion in assets under management have historically voted with ISS on both management and shareholder proposals more than 95% of the time.[14] Rose cites data "on investors who have voted in line with ISS over 99.5 percent of the time, on at least 5,000 management resolutions, presenting a *prima facie* case of overreliance on ISS' recommendations."[15]

Three central problems result from the current incentives for such automatic voting. First: Automatic voting literally outsources the evaluation of proxy proposals to the proxy advisors, an outcome that obviously disenfranchises pensioners in particular and shareholders more generally, again for the reasons summarized by Chairman Clayton and Commissioner Peirce as referenced above. This is a literal silencing of pensioners' voices on proxy proposals. Second: This outsourcing, by inserting an artificial external actor between the fund management and those to whom that management has a fiduciary

---

[10] See https://www.sec.gov/news/press-release/2019-158.

[11] *Ibid.*

[12] For several examples of this dynamic, see Rose, *op. cit.*, fn. 9 *supra.* See also James R. Copland, David F. Larcker, and Brian Tayan, "Proxy Advisory Firms: Empirical Evidence and the Case for Reform," Manhattan Institute, May 2018, at https://media4.manhattan-institute.org/sites/default/files/R-JC-0518-v2.pdf.

[13] See Frank M. Placenti, "Are Proxy Advisors Really A Problem?" American Council for Capital Formation, October 2018, at https://accfcorpgov.org/wp-content/uploads/2018/10/ACCF_ProxyProblemReport_FINAL.pdf.

[14] See Timothy M. Doyle, "The Realities of Robo-Voting," American Council for Capital Formation, November 2018, at http://accf.org/wp-content/uploads/2018/11/ACCF-RoboVoting-Report_11_8_FINAL.pdf.

[15] Rose, *op. cit.*, fn. 9 *supra.*

responsibility, must reduce the transparency of decisions on proxy proposals, exacerbating the disenfranchisement just noted. The proxy advisors have no obvious responsibility or incentives to respond to inquiries from pensioners, and communications between pensioners, fund managers, and proxy advisors are hardly frictionless. Third: Such systematic deference manifesting itself in automatic voting yields an incentive on the part of the proxy advisors that is equally powerful even if more subtle. Proxy advice more easily can reflect the personal policy and political preferences of the proxy advisors as distinct from parameters driven by fiduciary responsibilities to fund owners and pensioners, than would be the case were fund managers to evaluate the proxy advisors' recommendations in an independent fashion. In its proposed rule, the SEC calls attention to automatic voting as an issue, seeking public comment on the possibility of disabling of automatic voting mechanisms.[16] This recommendation would be useful, and should be adopted by the SEC in the final rule. It is essential that the SEC require that proxy advisors' recommendations be justified specifically in terms of the fiduciary responsibility to maximize returns, and not on any other grounds. Note that such investment objectives as ESG and others obviously not consistent with value maximization can be "justified" as consistent with those fiduciary responsibilities, on grounds imaginative but analytically flawed. Fund managers must be required to examine such arguments critically, a topic outside the focus of this comment letter.

Specialty reports. Specialty reports by proxy advisors typically are prepared in response to requests from specific investors, and thus are likely to reflect preferences on matters not driven by fiduciary considerations of interest to all investors. ESG considerations are represented heavily among such specialty reports; for example, ISS offers customized reports on "Socially Responsible Policy" and "Sustainability Policy."[17] It is far from clear as to why the ISS opinions on "socially responsible policy" should be taken more seriously than those of anyone else; and "sustainability" as an environmental goal is empty analytically.[18] In any event, this practice allows fund managers facing political pressures from a subset of investors to pay its proxy advisor to ratify voting decisions driven by ESG and other objectives, while maintaining the illusion of an "independent" supporting analysis. The SEC proposed rule touches on the problem of specialty reports; as with the issue of automatic voting, the SEC should require that the preparation and use of such specialty reports be justified specifically in terms of the fiduciary responsibility to maximize returns, and not on any other grounds.[19]

****

The dangers of automatic voting and specialty reports, by their very nature driven by ESG and other objectives not consistent with the fiduciary responsibility to maximize returns for investors, are not merely theoretical. Advocates of ESG investing often 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---as an example, divestment from fossil fuel producers---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 such divestment from fossil-fuel producers. University of Chicago Law School emeritus professor Daniel R. Fischel found in a study[20] that:

---

[16] See the proposed rule, *op. cit.*, fn 1 *supra.*, at printed pages 66551-66552,

[17] See the proposed rule, *op. cit.*, fn 1 *supra.*, at printed page 66522; and the ISS listing of "Multiple Policy Choices" at https://www.issgovernance.com/solutions/governance-advisory-services/custom-policy-research/. See also the comment letter from Mr. Ken Blackwell, at https://www.sec.gov/comments/s7-22-19/s72219-6510613-200227.pdf.

[18] See Benjamin Zycher, "Four Decades of Subsidy Rationales for Uncompetitive Energy," Prepared Statement Before the U.S. Senate Committee on Finance, Hearing on *Energy Tax Policy in 2016 and Beyond*, June 14, 2016, at https://www.finance.senate.gov/imo/media/doc/14jun2016Zycher.pdf.

[19] See the proposed rule, *op. cit.*, fn 1 *supra.*, at printed page 66536.

[20] See Daniel R. Fischel, "Fossil Fuel Divestment: A Costly and Ineffective Investment Strategy," at http://divestmentfacts.com/pdf/Fischel_Report.pdf.

> [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 as much as three times higher for a portfolio divested of fossil fuel stocks.[21]

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."[22] 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.[23]

In the context of this proposed rule, it is essential that the SEC make explicit a requirement that proxy advice generally, and automatic voting practices and the preparation of specialty reports in particular, be justified explicitly on value maximization grounds. This will help to reverse the perverse incentives flowing from the 2003 rule and the staff interpretations that followed it.

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

Sincerely,

Benjamin Zycher, Ph.D.

---

[21] See Compass Lexecon, "Compass Lexecon Releases Fischel Study on effect of Fossil Fuel Divestment Proposals on University Endowments," February 13, 2015, at https://www.compasslexecon.com/compass-lexecon-releases-fischel-study-on-effect-of-fossil-fuel-divestment-proposals-on-university-endowments/.

[22] See Timothy Adler and Mark Kritzman, "The Cost of Socially Responsible Investing," *Journal of Portfolio Management*, Vol. 35, No. 1 (Fall 2008), pp. 52-56, at http://jpm.iijournals.com/content/35/1/52.

[23] See https://www.msci.com/documents/10199/904492e6-527e-4d64-9904-c710bf1533c6.