September 29, 2020

Office of Regulations and Interpretations, Employee Benefits
Security Administration, Room N–5655
U.S. Department of Labor
200 Constitution Avenue NW, Washington, DC 20210

Attention: Proxy Voting and Shareholder Rights NPRM

Re: RIN 1210-AB91

I am a senior 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.

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The Department of Labor has proposed amendments to the investment duties regulation under Title I of the Employee Retirement Income Security Act of 1974 (ERISA) with the intention of confirming the fiduciary responsibilities of plan sponsors regarding "proxy voting and other exercises of shareholder rights."

The clarifications ensure that when fiduciaries vote on proxy measures, their positions are solely based on the measures' financial impacts and cannot be based on other "unrelated objectives". Fiduciaries would still be obligated to vote on measures that have a financial impact, but are also obligated not to vote if the managers cannot demonstrate that the expenses required to analyze the measure's impact will financially benefit the plan.

These clarifications will help ensure that the managers of private pension funds, who invest $10.7 trillion on behalf of nearly 140 million Americans, adhere to their fiduciary responsibilities when voting on proxy measures.

The clarifications are appropriate and necessary because of the expansion in the number of Environmental, Social, and Governance (ESG) proxy proposals that are considered under the proxy process.

ESG proxy initiatives address social, environmental, or governance issues that are related to a corporation's activities. Typically, companies implement ESG programs to demonstrate their commitment to social responsibility. Corporate ESG programs can be profit-enhancing, but they can also be financially destructive.

Corporate ESG programs will enhance shareholder value when aligned with corporate actions desired by consumers demanding that products are produced consistent with ESG criteria. By doing so, the company is providing customers with the products they desire in the manner they want it produced. When these criteria are met, the ESG proxy measures warrant support.

Here, proxy statements demanding that the company comply with specific ESG criteria are consistent with profit-maximizing behavior. No other guiding investment principle is necessary because the ESG criteria are value enhancing.

Voting in favor of specific ESG programs can also make sense from an individual investor's perspective. Even if an ESG program does not enhance returns, and the investor's support of ESG programs harmed the company's financial performance, they knew the constraints they were imposing, and bear the consequences from their actions. Perhaps investors are content with the trade-off, perhaps not. Either way their decisions reflect their values and they bear the costs of their own actions.

ESG considerations do not replace fiduciary responsibilities

While ESG programs will sometimes enhance operations, they can also be financially harmful. In these instances, serious ERISA concerns arise when pension funds support ESG programs because fund managers' actions are detrimental to the fund's financial performance. Several studies examining ESG's impact on corporate profitability document that ESG-related proxy measures often harm financial returns.

A 2002 study by Tracie Woidtke in the *Journal of Financial Economics* examined the impact from activist public pension funds on the market values of a sample of Fortune 500 companies.[1] Her results illustrate that increased shareholder activism by public pension funds is negatively correlated with stock returns. Particularly noteworthy, the firms receiving proposals from activist public pension funds promoting social agendas were valued 14 percent lower than similar companies without such agendas.

Munnell and Chen (2016) reviewed the impacts from ESG by 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?"[2] 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."[3]

These results make sense because, unlike the individual investor, pension funds represent thousands of individual investors who cannot choose the pension fund manager investing on

[1] Woidtke T "Agents watching agents?: evidence from pension fund ownership and firm value" *Journal of Financial Economics* Vol. 63, Issue 1 (2002) January.
[2] Munnell AH and Chen A "New Developments in Social Investing by Public Pensions" *Center for Retirement Research at Boston College* Number 53, November 2016.
[3] Ibid.

their behalf. If you work for a specific employer, then your retirement savings will be invested on your behalf by the investment managers chosen by your employer. You have no choice.

Some workers will agree with specific ESG policies that a pension fund is supporting, while others will not. But the beneficiaries who do not agree with the ESG policies cannot self-select themselves out of the investment fund. As a result, pension funds that support ESG programs are supporting political policies that violate the principles of some of its members, while possibly hurting returns for beneficiaries as a whole.

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.
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> ***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.***[4] (emphasis added)

Munnell and Chen (2016) also noted that the Department of Labor (DOL) has recognized these risks for many years. According to their article, "***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*** (emphasis added)."[5] As this opinion correctly notes, options have value. Limiting the investment opportunities based on ESG criteria eliminates options and, therefore, imposes costs on pension funds. What is true for investing is also true for corporate operations. ESG programs that limit companies' operating options beyond what is

[4] "Peirce HM "My Beef with Stakeholders: Remarks at the 17th Annual SEC Conference, Center for Corporate Reporting and Governance" *U.S. Securities and Exchange Commission*, September 21, 2018; https://www.sec.gov/news/speech/speech-peirce-092118. (emphasis added)

[5] 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)

valued by employees and customers creates financial risks. Supporting such measures will, consequently, contradict the fiduciary responsibility of fund managers.

Proxy advisory firms promote ESG shareholder resolutions, often against pensioners' best interests

Pension fund managers must comprehensively analyze the costs and benefits of proposed ESG proxy measures before determining whether the proposal should be supported. Pension fund managers have a fiduciary responsibility to take positions based on whether the proposal enhances shareholder value.

Private pension funds are currently required (or believe they are required) to vote on all proxy measures. They rely on proxy advisory firms to manage this herculean task. The two largest firms (ISS and Glass Lewis) control 97 percent of the proxy advisory market and also provide ESG advisory services to corporations. This combination creates a meaningful conflict of interest with respect to ESG programs that could be biasing the advice many pension managers receive on shareholder resolutions.

These biases are problematic because they appear to be harming financial returns. For instance, 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)."[6]

Moreover, the two major proxy advisory firms establish their position on ESG without adequate transparency and without considering how the programs can impact different investors (the advisory firms generally employ a one-sized fits all approach to deciding issues). For instance, when examining the influence of the proxy advisory firms, the American Council for Capital Formation concluded 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."
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> ***As a result, proxy advisory firms have emerged as "quasi-regulators," wielding their influence to require additional disclosure from public companies without any statutory authority, particularly around environmental or social issues*** (emphasis added). These recommendations, which are drawn from unaudited data sources, create new disclosure requirements that ultimately encumber companies with additional costs and burdens. This type of quasi-regulatory

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[6] Copland JR, Larcker DF, and Tayan B "Proxy Advisory Firms: Empirical Evidence and the Case for Reform" *the Manhattan Institute*, May 2018.

process especially disadvantages small and mid-sized companies, in favor of larger companies that have the resources to comply.[7]

It is unclear whether ISS or Glass Lewis accounts for the specific needs of the specific company considering the proxy measure when advising institutional investors about ESG proxy statements. Based on their own ESG programs, it can be reasonably concluded that both firms are biased toward supporting ESG programs despite the negative impact they can have. As a result, institutional investors may be violating their fiduciary responsibilities when adopting the ESG voting positions suggested by these proxy advisory firms.

The proposed rule clarifications help address these issues

Due to the problems outlined in the previous two sections, it is currently unclear whether fund managers are fulfilling their fiduciary responsibilities to shareholders when voting on proxy measures. The proposed clarifications will help improve the ability of managers to faithfully execute their fiduciary responsibilities.

Clarifying that there is no requirement for institutional investors to vote on all items on corporate proxy statements, and that managers should abstain from voting if the costs from discovering whether the proxy measure will enhance profits exceeds the expected financial benefit, will create several benefits. This clarification would,

- Help managers better control the fund's expenses, which is an important goal for maximizing return for beneficiaries.
- Enable institutional investors to focus on the financially important corporate proxy measures, which will improve the funds' investment efficiencies.
- Reduce the inflated demand for the proxy advisory services, which would improve the efficiency of the proxy advisory services market. Fund managers would, consequently, be better informed regarding the potential costs and benefits of proxy proposals.

The clarification that fund managers can only support proxy measures for financial reasons is an explicit recognition that pension funds' social responsibility is to help secure the retirement of its beneficiaries. This role creates great value for beneficiaries, yet it is widely recognized that achieving strong risk-adjusted investment returns over the long-term is difficult to achieve. Additionally, the financial performance of the fund is often the only nexus between the diverse group of beneficiaries on whose behalf pension funds are investing. Pension funds that support proxy measures for other non-financial reasons are making it more difficult to fulfill their primary social responsibility, and in the extreme could be violating these obligations. The clarification will, consequently, help ensure that private pension fund managers are not supporting proxy proposals that create additional, and unnecessary, risks for investors.

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[7] Doyle TM "New Report: Proxy Advisory Firms Operate with Unchecked Power" *American Council for Capital Formation*, May 1, 2018; http://accf.org/2018/05/01/outsized-influence-minimal-oversight-new-accf-report-finds-that-proxy-advisory-firms-operate-with-unchecked-power/.

Additional clarifications should promote greater transparency in the proxy process

In addition to the proposed reforms, the DOL could further improve the proxy process by requiring private pension funds to receive more transparent information from the proxy advisory services firms. As mentioned above, the methodology that proxy advisory firms use when developing their voting recommendations is currently opaque. However, pension fund managers should understand how the advisory firms developed their recommendations and have access to the financial analyses used to develop these positions. Without this information, pension fund managers will not know whether the proper due diligence has been performed.

Greater transparency is also required to disclose specific conflicts of interests that a proxy advisory firm may have. Such conflicts of interests likely exist because the major proxy advisory firms provide ESG advisory consulting services. Instead of allowing proxy advisory firms to rely on their "general conflict of interest" statements as an adequate disclosure, the DOL should consider requiring fund managers to obtain conflict of interest disclosures that are specific to the issue under evaluation. More relevant conflict of interest disclosures will ensure that investors relying on the proxy firms' recommendations are aware of the proxy firm's specific biases and potential conflicts of interest related to the specific issue under consideration.

By nature of the cost-benefit analysis requirement, the proposed reforms would make robo-voting an impractical option for most proxy measures. However, should robo-voting still occur for certain proxy measures, the practice of robo-voting should only be allowed if the company that is the subject of the proxy advisory firm's advice has not submitted a written response to the recommendation. When a company has not responded to the proxy firm's advice, this could be taken as a signal that the firm either agrees with the proxy advisor's recommendation, or does not believe the recommendation will meaningfully harm the company's operations. Either way, this lack of response could signify that robo-voting on these measures is not inappropriate. For those measures where the company position diverges from the proxy advisory firm, DOL should prohibit proxy firms from automatically voting on behalf of their clients.

Conclusion

The proposed clarifications will improve several of the flaws in the current proxy process and reduce costs for plan participants. Just as important, this clarification will help plan fiduciaries focus their scarce resources on the proxy votes that they judge will materially impactful financial results. The clarifications are necessary because the prevalence of ESG proposals increases the risk that private pension funds are supporting proxy measures that harm companies' profitability and, consequently, distracts from their primary social responsibility of securing the retirement for millions of beneficiaries.

The proposed clarifications provide important guidance for these fund managers that this primary social responsibility must guide their actions and provides the flexibility required to execute on these goals more efficiently. Pension funds are able to support ESG measures where it can be demonstrated that these proxy proposals will improve the profitability of the company, and are required to oppose those measures that will harm profitability and thus reduce their ability to fulfill their social responsibilities.

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

Sincerely,

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