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Comment Letter on Rule Proposed by the Employee Benefits Security Administration, U.S. Department of Labor: "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights," September 4, 2020

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Comment Letter Re RIN 1210-AB91, Department of Labor, Employee Benefits Security Administration.

By electronic submission:
https://www.federalregister.gov/documents/2020/09/04/2020-19472/fiduciary-duties-regarding-proxy-voting-and-shareholder-rights#open-comment.

Summary

The "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights" rule proposed by the Department of Labor represents an important step forward in terms of the protection of the fiduciary interests of participants in pension and retirement plans governed under the Employee Retirement Income Security Act of 1974. In particular: the proposed rule makes it clear that funds are not required to vote on every proxy proposal that they confront. Instead: "A fiduciary's duty is only to vote those proxies that are prudently determined to have an economic impact on the plan after the costs of research and voting are taken into account." And: Fiduciaries are required to "act solely in accordance with the economic interest of the plan considering only factors that they prudently determine will affect the economic value of the plan's investment based on a determination of risk and return over an appropriate investment horizon consistent with the plan's investment objectives and the funding policy of the plan."

These newly proposed requirements represent a crucial constraint on the ability of the proponents of proxy proposals and proxy advisory firms to substitute their own preferences, whether political or otherwise inconsistent with the fiduciary interests of plan participants, upon the decisions of fund managers. The Department is to be applauded for these steps to strengthen such protections.

But the proposed rule must be strengthened so as to prohibit or at a minimum to constrain sharply the practice of automatic voting by fund managers in accordance with the recommendations of proxy advisory firms. The rule as proposed barely mentions automatic

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voting---once in a footnote, and obliquely in one paragraph---despite the reality that automatic voting is deeply perverse in the context of the fiduciary interests of plan participants. Accordingly, the proposed rule should be strengthened as follows:

- The definition and constraints to be imposed upon automatic voting should be made explicit and strengthened. At a minimum, the definition from the SEC guidance document---or a fuller definition to be determined by the Department---should be incorporated explicitly into the body of the rule. Whatever definition that the Department chooses, automatic voting should be proscribed, as it is inconsistent with the fiduciary interests of plan participants protected by ERISA, as the Department recognizes explicitly. The requirement for explicit analytic justification for specific votes on proxy proposals should be preserved.
- The Department should proscribe automatic voting when a given recommendation from a proxy advisory firm is contested, in particular by the given company investments in which are at issue. Given a response by the company, the managers of the fund should be required to publish a detailed analysis of the proxy recommendation and the response, and an explanation of the fund voting decision if the fund chooses to vote.
- If automatic voting is not proscribed, the Department should strengthen the due diligence requirements attendant upon acceptance of proxy advisors' recommendations, just as is the case with all decisions by fund managers that affect the interests of the plan participants.
- Similarly, the due diligence requirements must be preserved in the context of any acceptance by the fund managers of the automatic vote submission or pre-population services. Fund managers should be required to publish issuer responses to proxy recommendations and all other relevant information before casting a vote on a proxy proposal.
- The Department should make it clear that automatic voting is presumed to be inconsistent with the fiduciary responsibilities of the fund managers precisely because the proxy firms have no obvious incentives or responsibilities to shape their recommendations so as to further those fiduciary interests. Only explicit cost-benefit analysis by fund managers can be consistent with them. The Department's proposed rule directly implies a cost-benefit test for proposals facing proxy votes: "A fiduciary's duty is only to vote those proxies that are prudently determined to have an economic impact on the plan after the costs of research and voting are taken into account." If that is the Department's objective---as it should be---a continuation of automatic voting would not comply with the cost-benefit analysis consistent with due diligence. The final rule should make this point explicit.

Introduction

This comment letter responds to a request from the Employee Benefits Security Administration, U.S. Department of Labor, for comments on its proposed rule "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights" (hereinafter referenced here as the "Fiduciary Duties/Proxy Voting" rule), focusing on "the prudence and exclusive purpose duties under the Employee Retirement Income Security Act of 1974 (ERISA) to the exercise of shareholder rights, including proxy voting, the use of written proxy voting policies and guidelines, and the selection and monitoring of proxy advisory firms."[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 am a former member of the Board of Directors of the Western Economics Association International, and I now am a member of the Board of Trustees of the Foundation for Research in Economics Education. 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.

Some recent related activities on my part are as follows. I submitted a comment letter to the Securities and Exchange Commission 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 (ESG) 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] Subsequent to that I submitted to the SEC a formal comment on the SEC Proposed Rule: Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice (File No. S7-22-19).[4] And I submitted last July a comment letter to the Department of Labor on its proposed rule "Financial Factors in Selecting Plan Investments (RIN 1210-AB95)."[5]

The new Fiduciary Duties/Proxy Voting rule proposed by the Department of Labor is timely and needed, and the central purpose of this comment letter is the presentation of analysis in support of the adoption of the proposed rule as a final rule, but with a needed clarification of the constraints to be placed upon automatic (or "robo-") voting by fund managers in accordance with the recommendations of proxy advisors. This proposed rule is particularly important given (1) the growing number and complexity of proxy proposals confronted by corporate and fund managers, (2) the growing trend among such proposals to force Environmental, Social, and Governance (ESG) considerations into management decisions in place of narrow fiduciary considerations, (3) the growing trend on the part of managers governed by ERISA to rely on the advice of proxy advisor firms for recommendation decisions on proxy proposals, and in particular (4) the growing trend of such managers simply to accept such recommendations virtually wholesale, as manifested in automatic voting in accordance with those recommendations.

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[1] The proposed rule can be found at https://www.federalregister.gov/documents/2020/09/04/2020-19472/fiduciary-duties-regarding-proxy-voting-and-shareholder-rights.

[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/.

[4] January 17, 2020, available at https://www.sec.gov/comments/s7-22-19/s72219-6668654-203966.pdf.

[5] July 21, 2020, available at https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB95/00139.pdf.

The net effect of the growing importance of proxy proposals, the recommendations of proxy advisors, and automatic voting is a sharp increase in the pressures for incorporation of ESG considerations in investment decisions. Because such considerations by definition move decisions away from narrow fiduciary criteria, they inexorably become heavily political. In part this is because choices among alternative ESG goals inevitably are arbitrary; and in part it is because of the inevitable conflicts among them. Should a firm invest in additional workforce training or "climate" activism? The answer cannot be "both" because resources are limited, always and everywhere.

Because ESG considerations are inherently political, they must impose an artificial constraint on investment choices. Accordingly, they are inconsistent with the traditional and appropriate goal of value maximization on behalf of the investors the retirement and other assets of whom are the object of investment choices.[6] The reliance on the recommendations of proxy advisors combined with automatic voting in accordance with them allow for no straightforward constraint on the substitution of ESG factors in place of fiduciary factors. Nor does the current system provide any straightforward constraint on the ability of proxy advisors to substitute their own priorities among conflicting ESG factors so as to advance their own priorities and to satisfy their own political biases. Thus does ESG investing conflict sharply with the interests of current and future retirees. Accordingly, investment decisions influenced by ESG considerations must carry with them serious adverse implications for the investment returns earned by current and future pensioners, that is, for their pecuniary interests.

Some Background

In 2003, the Securities and Exchange Commission promulgated a regulation that appeared benign but that has engendered an outcome unintended and adverse: a duopoly of two firms enjoying a position as the most powerful arbiters of corporate governance in America.[7] Those firms, Institutional Shareholder Services (ISS) and Glass Lewis (GL), provide recommendations to investors and asset managers on how they should vote their shares in the many companies that they own. The two account for 97 percent of the market for proxy advisory services. In short, despite lacking any statutory authority, they have become the de-facto regulators of America's public companies.

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.

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

[7] See Securities and Exchange Commission, "Final Rule: Disclosure of Proxy Voting Policies and Proxy Voting Records by registered Management Investment Companies," RIN 3235-AI64, April 14, 2003, at https://www.sec.gov/rules/final/33-8188.htm.

The "extreme cases" limitation on the potential liability of proxy advisors means that in practice they effectively are unconstrained by fiduciary responsibility considerations. So the personal preferences of the proxy advisors---or their staffs---often oriented toward specific policy or political goals, can carry substantial weight in terms of decisions on proxy matters, including executive compensation and corporate policies on a range of social and environmental questions. The climate "crisis" and the pursuit of "sustainability" are popular ones, and it is no surprise that many of the proxy advisors' staff bureaucrats are enamored with them. Put aside the very large substantial *climate* uncertainties discussed in the scientific literature, including those outlined by the IPCC itself.[8] The resulting impacts on *business* risks extending far into the future would be deeply speculative; and the definition of "sustainability" is vastly more ambiguous than commonly asserted.[9]

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. This effect is very unlikely to be small: Recent research focusing on ISS finds that a negative recommendation results in a 25 percent reduction in support for the given proxy proposal.

Because the managers avoid liability by retaining proxy advisors, it is unsurprising that they have been induced to defer wholesale to their recommendations. And so the funds continue to vote on all proxy issues in accordance with those recommendations, an approach described accurately as automatic voting. Even in the case of funds that evaluate proxy advisors' recommendations independently, acceptance of those recommendations has evolved into the default option in many cases, while rejection of the recommendations is the exception, a dynamic that research has confirmed empirically.[10] 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.[11]

Automatic voting literally outsources the evaluation of proxy proposals to the proxy advisors, an outcome that disenfranchises pensioners in particular and shareholders more generally. This outsourcing inserts an external decisionmaker between the fund

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[8] For detailed discussions and debates on the scientific uncertainties, see, e.g., https://judithcurry.com/. The various reports and analyses reported in the Fifth Assessment Report of the Intergovernmental Panel on Climate Change are available at https://www.ipcc.ch/report/ar5/syr/.

[9] See, e.g., Benjamin Zycher, "The Incoherence of Sustainability," *U.S. News & World Report*, May 25, 2016, at https://www.usnews.com/opinion/articles/2016-05-25/future-generations-resources-dont-depend-on-investment-in-sustainability.

[10] See James R. Copland, *et. al.*, "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; and 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.

[11] 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.

management and those to whom that management has a fiduciary responsibility, thus reducing the transparency of decisions on proxy proposals. The proxy advisors have no straightforward responsibility or incentives to respond to inquiries from investors, and communications between investors, managers, and proxy advisors are hardly frictionless. The systematic deference manifesting itself in automatic voting yields an incentive for proxy advisors to adopt stances reflecting their own personal policy and political preferences, as distinct from parameters driven by fiduciary responsibilities to the business and fund owners.

Central Observations

This proposed Fiduciary Duties/Proxy Voting rule is a companion to the Department of Labor proposed rule "Financial Factors in Selecting Plan Investments" (RIN 1210-AB95), June 30, 2020, which essentially is a rule proposing to impose constraints upon ESG investing by funds governed under ERISA.[12] The central importance of that previous "Financial Factors" proposed rule is captured well in section B summarizing the earlier rule's provisions:

> Paragraph (c)(1) directly provides that a fiduciary's evaluation of an investment must be focused only on pecuniary factors. The paragraph explains that it is unlawful for a fiduciary to sacrifice return or accept additional risk to promote a public policy, political, or any other non-pecuniary goal.
>
> The Department is concerned that the growing emphasis on ESG investing, and other non-pecuniary factors, may be prompting ERISA plan fiduciaries to make investment decisions for purposes distinct from their responsibility to provide benefits to participants and beneficiaries and defraying reasonable plan administration expenses. The Department is also concerned that some investment products may be marketed to ERISA fiduciaries on the basis of purported benefits and goals unrelated to financial performance.

The newer companion Fiduciary Duties/Proxy Voting proposed rule reiterates this concern (printed page 55222):

> The Department is now concerned that some fiduciaries and proxy advisory firms… may be acting in ways that unwittingly allow plan assets to be used to support or pursue proxy proposals for environmental, social, or public policy agendas that have no connection to increasing the value of

[12] See fn. 5 *supra*.

> investments used for the payment of benefits or plan administrative expenses, and in fact may have unnecessarily increased plan expenses.

The central objective of the new proposed rule is stated clearly (printed page 55220, A. Background, Supplementary Information section):

> The Department has tried to convey in its sub-regulatory guidance that *fiduciaries need not vote all proxies. A fiduciary's duty is only to vote those proxies that are prudently determined to have an economic impact on the plan after the costs of research and voting are taken into account.* Nevertheless, a misunderstanding that fiduciaries must research and vote all proxies continues to persist, causing some plans to expend their assets unnecessarily on matters not economically relevant to the plan. As discussed below, this problem has been exacerbated by the fact that since 1988 the amount and types of shareholder proposals have increased substantially. *Therefore, the Department has decided to propose rule amendments that expressly state that fiduciaries must not vote in circumstances where plan assets would be expended on shareholder engagement activities that do not have an economic impact on the plan, whether by themselves or after the costs of engagement are taken into account.* (Italics added.)

In short: Plans may choose to vote on proxy proposals that are "prudently determined" to have an economic impact on the plan; or they may choose not to vote on given proxy proposals at all. The latter option would reverse the historical SEC policy, noted above, that the 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. At a minimum, therefore, the Fiduciary Duties/Proxy Voting proposed rule will serve to impose substantial limits on the ability of the two dominant proxy advisory firms to drive investment decisions by funds governed under ERISA in ways inconsistent with the fiduciary interests of the investors, but furthering the political goals of the proxy advisors. In this fundamental context, the newly-specified option not to vote on any given proxy proposal is by far the more important dimension of this proposed rule, in that it is unlikely to prove difficult to find analytics (or "experts") in support of a choice to vote on a given proxy proposal.

But that observation understates the importance of the new proposed rule, which states (printed page 55225):

> Paragraph (e)(3) sets forth certain proposed requirements and limitations pertaining to proxy voting. The proposed rule provides in paragraph (e)(3)(i) that a plan fiduciary must

> vote any proxy where the fiduciary prudently determines that the matter being voted upon would have an economic impact on the plan after considering those factors described in paragraph (e)(2)(ii) and taking into account the costs involved (including the cost of research, if necessary, to determine how to vote). As a corollary, paragraph (e)(3)(ii) provides that *a plan fiduciary must not vote any proxy unless the fiduciary prudently determines that the matter being voted upon would have an economic impact on the plan after considering those factors described in paragraph (e)(2)(ii) and taking into account the costs involved*. (Italics added.)

Note that this requirement applies to plan fiduciaries, investment advisers, and to proxy advisors. Moreover, plan fiduciaries are required to (printed page 55224):

> [A]ct solely in accordance with the economic interest of the plan considering only factors that they prudently determine will affect the economic value of the plan's investment based on a determination of risk and return over an appropriate investment horizon consistent with the plan's investment objectives and the funding policy of the plan.
>
> [N]ot subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to any non-pecuniary objective, or sacrifice investment return or take on additional investment risk to promote goals unrelated to these financial interests of the plan's participants and beneficiaries or the purposes of the plan.

And in a possible regulatory constraint on automatic voting, the proposed rule (printed page 55224) requires plan fiduciaries to

> [I]nvestigate material facts that form the basis for any particular proxy vote or other exercise of shareholder rights (e.g., the fiduciary may not adopt a practice of following the recommendations of a proxy advisory firm or other service provider without appropriate supervision and a determination that the service provider's proxy voting guidelines are consistent with the economic interests of the plan and its participants and beneficiaries).
>
> [F]iduciaries must be prepared to articulate the anticipated economic benefit of proxy-vote decisions in the event they decide to vote.

However, it is unfortunate that the proposed rule refers only once explicitly to automatic voting (footnote 54): "… research has shown that a significant number of asset managers automatically vote in accordance with the recommendations of proxy advisory firms." Accordingly, the proposed rule fails to define automatic voting, instead merely referring (footnote 50) to a supplement to SEC guidance on proxy voting, which delineates automatic voting as

> circumstances where the investment adviser utilizes a proxy advisory firm's electronic vote management system that "pre-populates" the adviser's proxies with suggested voting recommendations and/or for voting execution services.[13]

The proposed rule goes on to state (printed page 55223) that "The Department believes that activities of proxy advisory firms have similar relevance for fiduciaries under ERISA." It is reasonable therefore to infer that the Department of Labor intends to apply that definition to plans and fiduciaries covered under this proposed rule.

But greater clarity is needed. The proposed Fiduciary Duties/Proxy Voting rule should be strengthened as follows:

- The definition and constraints to be imposed upon automatic voting should be made explicit and strengthened. At a minimum, the definition from the SEC guidance document---or a fuller definition to be determined by the Department---should be incorporated explicitly into the body of the rule. Whatever definition that the Department chooses, automatic voting should be proscribed, as it is inconsistent with the fiduciary interests of plan participants protected by ERISA, as the Department recognizes explicitly. The requirement for explicit analytic justification for specific votes on proxy proposals should be preserved.
- The Department should proscribe automatic voting when a given recommendation from a proxy advisory firm is contested, in particular by the given company investments in which are at issue. Given a response by the company, the managers of the fund should be required to publish a detailed analysis of the proxy recommendation and the response, and an explanation of the fund voting decision if the fund chooses to vote.
- If automatic voting is not proscribed, the Department should strengthen the due diligence requirements attendant upon acceptance of proxy advisors' recommendations, just as is the case with all decisions by fund managers that affect the interests of the plan participants.
- Similarly, the due diligence requirements must be preserved in the context of any acceptance by the fund managers of the automatic vote submission or pre-population services. Fund managers should be required to publish issuer responses to proxy recommendations and all other relevant information before casting a vote on a proxy proposal.

[13] See Securities and Exchange Commission, "Supplement to Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisors," 17 CFR Part 276, Release No. IA-5547, July 22, 2020, page 3, at https://www.sec.gov/rules/policy/2020/ia-5547.pdf.

- The Department should make it clear that automatic voting is presumed to be inconsistent with the fiduciary responsibilities of the fund managers precisely because the proxy firms have no obvious incentives or responsibilities to shape their recommendations so as to further those fiduciary interests. Only explicit cost-benefit analysis by fund managers can be consistent with them. The Department's proposed rule directly implies a cost-benefit test for proposals facing proxy votes: "A fiduciary's duty is only to vote those proxies that are prudently determined to have an economic impact on the plan after the costs of research and voting are taken into account." If that is the Department's objective---as it should be---a continuation of automatic voting would not comply with the cost-benefit analysis consistent with due diligence. The final rule should make this point explicit.

Observations on Four of the Department's Solicited Inquiries

Page 27: Rule Mechanics. "The Department also believes that determining materiality based on a percentage of plan assets could be a straightforward way for fiduciaries to apply such a cap, and specifically solicits comments on whether in setting this upper limit, the Department should look to financial practices and existing regulations regarding quantitative measures of materiality."

Given the implementation of the requirement for rigorous cost/benefit analysis already discussed above, it is unlikely to prove to be the case that quantified limitations would prove necessary to protect the interests of plan participants. With no duty to vote on any given proxy proposal, a market in such proposals---"supply" by those making such proposals and "demand" by plan managers evaluating them---will emerge, and any such market can be predicted to optimize the resources used to produce proposals and to evaluate them.

Page 40: Cost/Benefit Analysis. "The Department invites comments on whether, to what extent, and under what circumstances plans' proxy votes are likely or unlikely to increase the value of their shares or otherwise advance their participants' economic interest."

Given a rigorous application of cost/benefit analysis to proxy proposals, it is straightforward to predict that such proposals will tend to be those that can be predicted to satisfy such a cost/benefit test, a condition very different from that observed under the current system in which there exists no such constraint and in which proxy advisors have no obvious incentives to allow the fiduciary interests of plan participants to constrain their recommendations. Given the requirement that cost/benefit analysis be applied to both the decision to vote on a given proxy proposal and the decision on how to vote on that given proposal, it is obvious that this rule would protect the value of the participants' economic interests.

Page 51: Cost/Benefit Analysis. "The Department also invites comments on whether the proposed rule, if finalized, would enable plans to retain proxy advisory firms at lower cost or with more attractive fee arrangements, since a much narrower range of responsibilities might be encompassed, and on whether the proposed rule would lead to new, narrower advisory engagements or new services."

The proposed rule combined with the required cost/benefit analysis specified above would change the nature of the services demanded of proxy advisors. On the one hand, it would reduce the range of advisory services demanded by eliminating the need to vote every proxy proposal. On the other hand, it may be the case that some cost/benefit analyses of such proposals would be conducted more efficiently by outside advisors, although that is not an obvious outcome. It is likely to be true in some cases and not true in others, a dynamic that cannot be predicted in advance. Because it is difficult to believe that there are important scale economies (declining average costs) in the conduct of such analyses, it is likely to be the case that the current duopoly will end, with new entrants offering analytic services; at a minimum, one possible result would be a competitive decline in the cost of such services. Whether the prices of advisory services fall or rise, it is clear that the *value* of such services will rise given the new incentive to evaluate proxy proposals on their respective merits defined in terms of the fiduciary interests of plan participants rather than the personal or political preferences of the proxy advisors.

<u>Page 64: Cost/Benefit Analysis.</u> "The Department believes that the benefits of the proposal would justify its costs, but also invites comments on this question."

Unless there is a reason to believe that cost/benefit analysis by the plan fiduciaries applied to proxy proposals systematically would be biased, it is clear that the benefits of the proposed rule would exceed its costs. There is no reason *ex ante* to predict such bias, in particular because market forces tend to force corrections to consistent errors made by managers. Required cost/benefit analysis of proxy proposals, with no requirement to vote a given proposal, will end automatic voting and the costs of proxy proposals inconsistent with the fiduciary interests of plan participants, and will serve to impose sharp constraints on the power of the proxy advisors to direct fund resources, and thus on the ability of those advisors to command significant fees.