Comment Submitted on Rule Proposed by the Securities and Exchange Commission: Amendments to Federal Proxy Rules Governing Proxy Voting Advice October 14, 2021

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The Securities and Exchange Commission has proposed amendments to the "Exemptions From the Proxy Rules for Proxy Voting Advice" rule finalized on July 22, 2020. These proposed amendments should not be finalized, as they are devoid of an analytic basis justifying a rejection of the transparency provisions of the existing final rule, they would reduce the availability of relevant information available to investors receiving voting advice from proxy advisors, and in general are inconsistent with the objective of maximizing the economic value of assets owned by shareholders, fund participants, and others with a direct financial interest in the performance of businesses subject to SEC rules and oversight. The process with which the proposed rule has been promulgated would erode the stability and predictability that are important components among the appropriate goals of any rational regulatory system. Moreover, the proposed rule would increase the scope of proxy advice driven by the personal political preferences of proxy advisors, and thus is inconsistent with the fiduciary responsibilities of those making business decisions to maximize the economic value of businesses and funds, the appropriate policy objective in this context.

This comment responds to a request from the Securities and Exchange Commission for comments on its rule proposed on November 17, 2021 that would amend "the Federal proxy rules governing proxy voting advice."[1] The proposed rule would revise the final "Exemptions From the Proxy Rules for Proxy Voting Advice" rule finalized July 22, 2020, published September 3, 2020, and which took effect November 2, 2020.[2] The proposed rule offers no new data or analysis in

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[1] See https://www.sec.gov/rules/proposed/2021/34-93595.pdf.

[2] See https://www.federalregister.gov/documents/2020/09/03/2020-16337/exemptions-from-the-proxy-rules-for-proxy-voting-advice.

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support of a reversal of important provisions of the existing final rule, and thus is inconsistent with the central stability and predictability objectives of regulatory policymaking. The proposed rule would weaken the constraints imposed upon proxy advisors by the existing final rule in terms of justifying their recommendations given business and fund managers, and thus would erode the appropriate policy objective of maximizing the economic value of assets owned by shareholders, fund participants, and those with direct financial interests in the performance of businesses subject to SEC rules and oversight. By reducing the transparency of voting recommendations offered by proxy advisors, the proposed rule would allow for an increase in the relative weight of the personal political preferences of the proxy advisors — the introduction of "Environmental, Social, and Governance" (ESG) objectives is an obvious example — and thus would be inconsistent with the appropriate policy objective of protecting the fiduciary interests of the business owners and fund participants.

The rule finalized in 2020 required proxy advisors to disclose their recommendations simultaneously to the clients to whom the proxy recommendations are directed as well as to the issuers and others whose actions are the subject of the proxy advice. The final rule imposed also a constraint to the effect that a failure by proxy advisors to disclose conflicts of interest and other important dimensions of their analyses might represent a statement deemed "misleading" under SEC protocols.

The proposed rule eliminates those provisions, but offers little analysis or data in support of that action, other than some comments received on the earlier rule before finalization. The SEC had received numerous comments in support of those provisions as well, but now has failed to explain why the earlier comments in opposition carry greater weight. In short, the proposed rule offers no analysis or data justifying a rejection of the transparency provisions of the existing final rule only about a year after it took effect. Given that the formulation of such rules is complex as an economic and regulatory matter, requiring substantial staff time, oversight and review by the SEC commissioners and their respective staffs, the effort to revise the existing final rule began in June 2021, shortly after Mr. Gary Gensler became the SEC chairman in April. Accordingly, it is impossible that new data or observations or problems have emerged after the final rule took effect; the new proposed rule legitimately can be viewed as arbitrary, and thus political. This clearly is why Commissioner Hester M. Peirce in her dissent argued as follows:

> The Commission lacks a sound basis for seeking to amend a brand new rule. Nothing has changed since we adopted the rule, and we have not learned anything new. The release takes a stab at justifying the rewrite, but we might as well simply acknowledge that the political winds have shifted.[3]

Similarly, Commissioner Elad L. Roisman notes that:

> Whereas the Final Rules were developed based on years' worth of information and deliberation, and support for their requirements was clearly delineated in a transparent administrative process, this proposal's rationale is not so well-supported and the process through which it was developed raises questions about its thoroughness. Offering such little transparency into our

[3] November 17, 2021, at https://www.sec.gov/news/statement/peirce-proxy-advice-20211117.

> process or reasoning for considering dramatic changes to recently adopted rules can lead people to worry about the efficacy and longevity of our rulemakings. This is poor precedent for our Commission to overturn thoughtfully developed regulation so lightly.[4]

For reasons similar to those supporting the goal of predictability in judicial decisionmaking — the importance of precedent — stability and predictability are necessary attributes of a system of regulatory policymaking one central goal of which is the strengthening of efficiency and productivity of resource use. But it is obvious that the process with which the proposed rule has been promulgated — again, it is based upon no new data or analysis — is inconsistent with those objectives. It would erode the stability and predictability that are the appropriate goals of any rational regulatory system.

By eliminating or eroding sharply the openness (or "engagement") requirements of the existing final rule, the proposed rule would reduce the availability of relevant information available to investors receiving voting advice from proxy advisors. This reduction in relevant information clearly can be predicted to weaken the constraints imposed upon proxy advisors by the existing final rule in terms of justifying their recommendations given business and fund managers, and thus would erode the appropriate policy objective of maximizing the economic value of assets owned by shareholders, fund participants, and those with direct financial interests in the performance of businesses subject to SEC rules and oversight.

One objection — perhaps the central one — is the cost to be borne at least nominally by proxy advisors forced to expand their engagement activities and other such outreach and interactions with issuers and clients; such information provision and interactions might be complex, continual, the source of disagreement and demands for revisions and the like. Roisman notes that "The [proposed regulation] does go on to cite a closed-door meeting that a group of 16 asset managers and five advocacy groups held with the Chair this past June, where those present 'expressed concerns about the costs associated with the [Final Rules], including the Rule 14a-2(b)(9)(ii) conditions…'"[5]

That objection is exceedingly weak. Ordinarily we would expect competitive markets to use resources in ways that justify the attendant costs, so that the absence of such engagement as mandated in the final rule might suggest that such engagement is more costly that it is worth. In this context, however, that conclusion is not warranted: Two proxy advisor firms — Glass Lewis and Institutional Shareholder Services — serve 97 percent of the market for proxy advisory services, for wholly artificial reasons discussed below. Accordingly, no such efficiency conclusion follows; and this cost argument simply shunts aside the adverse effects of recommendations from proxy advisors, that is, real economic costs borne by clients, resulting from proxy recommendations based upon poor analysis, poor data, mistakes, and other inevitable problems inherent in a world in which information is costly.

Moreover, it is not merely the cost of information that is the central problem. By removing the mandate for the engagement allowing clients and issuers to correct errors and the like, the proposed rule would increase the scope of proxy advice driven by the personal political preferences of proxy advisors. It is thus inconsistent with the fiduciary responsibilities of those making

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[4] November 17, 2021 at https://www.sec.gov/news/statement/roisman-proxy-advice-20211117.

[5] See section IIIA in the Roisman dissent, *Ibid*.

business decisions to maximize economic value, the only appropriate policy objective. By reducing the transparency of voting recommendations offered by proxy advisors, the proposed rule would allow for an increase in the relative weight of the personal political preferences of the proxy advisors — the introduction of Environmental, Social, and Governance objectives is an obvious example — and thus would be inconsistent with the appropriate policy objective of protecting the fiduciary interests of the business owners and fund participants.

The appropriate policy objective of SEC rulemaking is straightforward: the provision of incentives stronger rather than weaker 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 relevant parties. This consideration is particularly important in the case of public pension portfolios, for a straightforward reason summarized by Commissioner Peirce in 2018:

> 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.[6]

Then-Chairman of the SEC Jay Clayton emphasized this reality in November of 2019:

> 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.[7]

In 2003, the Securities and Exchange Commission promulgated a regulation[8] 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

[6] See https://www.sec.gov/news/speech/speech-peirce-092118.
[7] "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.
[8] https://www.sec.gov/rules/final/33-8188.htm.

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 in late 2019:

> 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.
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> Hiring assistance in researching and analyzing proxies of course does not relieve the advisor of its fiduciary duty; the advisor 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 how those third-party voting advisors were coming up with their recommendations*.[9] (Emphasis added)

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, an obvious and prominent one now is climate matters and greenhouse gas emissions effects. In short, the voting recommendations flowing from the proxy advisory services have been shaped by incentives very different from the objective of 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.[10]

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 managers of businesses and funds required to vote shares in ways consistent with their fiduciary responsibilities to the shareowners and the owners of the funds and current and future pensioners.[11] This argument is almost certainly incorrect. After all, the proxy advisors do

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[9] 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.

[10] 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.

[11] 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-

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 businesses and 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.

In any event, the SEC issued in 2019 "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."[12] Commissioner Elad Roisman noted that "Advisors 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."[13] 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, again, is a substitution to some substantial degree of 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.

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There are powerful reasons to hypothesize that the proposed rule would worsen the information environment confronted by the managers of businesses and funds faced with voting decisions on dozens or hundreds or thousands of proxy proposals. At a minimum the proposed rule

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19/s72219-6429308-198569.pdf. Notwithstanding this narrow issue, note that Professor Rose's comment letter is very useful.

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

[13] *Ibid.*

does not offer justifications for the engagement constraints incorporated in the existing final rule. Accordingly, the proposed rule should not be finalized until a reasonable basis is established for the premise that the proposed rule would improve the ability of managers to vote on proxy proposals in ways consistent with their fiduciary responsibilities.