SB 183 – Pension Systems & Proxy Advisors

Q: Why are insurers concerned about this issue?

A: Many insurers are publicly traded "stock" companies and as such are subject to SEC rules that permit shareholders to make proposals that relate to corporate activity. This process has become politicized and can force publicly traded insurers to be subject to the will of political activists (frequently climate activists who are anti-fossil fuels) who have no real interest in the financial performance of the company. Such proposals often require companies to change their underwriting guidelines (don't insure anything that supports or uses fossil fuels; don't insure municipalities in order to "defund the police"; collect race data contrary to state law to make determinations about discrimination). All of this threatens to replace or undermine the existing laws and regulations that elected officials adopt in our democracy.

Q: What new or additional requirements or obligations are placed on our pension funds by this bill?

A: None. The bill builds upon the comprehensive 2023 legislation by imposing additional transparency on Proxy Advisory firms that do business with our pension funds.

Q: Why the need for more transparency on proxy advisors?

A: After a series of Congressional Hearings, the House Financial Services Staff Report of the ESG Working Group (August 1, 2024) states:

"In recent years, the outsized influence of proxy advisory firms on the proxy voting system has become a growing concern. Proxy advisory firms, such as ISS and Glass Lewis, have gained an unprecedented level of control – commanding 97 percent of the market. Their dominance raises serious questions about bias and accountability, as these firms have the power to sway institutional investors' voting decisions."

This Report also states: "One of the key concerns with proxy advisory firms is their inability to focus on the economic impact of shareholder proposals. By prioritizing social, environmental, and political issues over financial performance, these firms can undermine the fundamental purpose of the proxy voting system. This disregard for economic considerations can have detrimental consequences for retail investors, who rely on the financial success of the companies they invest in. Proxy advisors must be held accountable. They must provide recommendations that consider the long-term economic value of the company, not recommendations driven by non-economic factors or a one-size-fits-all approach."

ALSO: ISS AND GLASS LEWIS ARE FOREIGN-OWNED ENTITIES AND ARE NOT SUBJECT TO THE SAME SET OF RULES AND REGULATIONS THAT INVESTMENT ADVISORS ARE SUBJECT TO.

Q: Why isn't the 2023 law good enough? It states: "The board shall not adopt the recommendations of a proxy adviser or proxy voting service and shall not allow such proxy adviser or proxy voting service to vote on behalf of the system, unless the proxy adviser or proxy voting service acknowledges in writing and accepts under contract its duties under this section and commits to follow the board-adopted proxy voting guidelines when voting the system's shares in order to comply with the board's fiduciary duties and other responsibilities under this section."

A: SB 183 provides an enhanced safeguard that will ensure that proxy advisors will in fact live up to their duty. It requires more than an acknowledgement (or in other words, "a promise" to do the right thing). It holds them to account by requiring them not just to say they are following the board's guidelines and are making recommendations "solely in the interest of the members and beneficiaries" using pecuniary factors, but requires them to "show their work" which formed the basis of their recommendation.

Q: Why only require an economic analysis when the proxy advisor is recommending a vote contrary to the corporation's Board of Directors?

A: It is important to remember that Independent Board members are themselves fiduciaries and there are well established laws that require them to act in the best interest of shareholders. As stated in the House Financial Services Committee ESG report: "Independent directors also play a crucial role in the decision-making of public companies. Independent directors bring expertise, objectivity, and a responsibility to act in the best interest of shareholders. Preserving the integrity of corporate governance requires giving deference to independent directors unless there is a clear justification to oppose their decisions. To achieve a fair and transparent corporate governance landscape that safeguards retail investors' interests, there must be a greater appreciation for the expertise of independent directors. Proxy advisors should be obligated to disclose their economic analysis and provide financial justifications when they recommend votes against the judgment of an independent board of directors. This disclosure empowers shareholders to make informed voting decisions based on an analysis of a company's economic value and long-term prospects, rather than relying solely on the social or political policy preferences of unaccountable proxy advisors.

Proxy Advisory Firms: A Primer

Insight – July 12, 2023
By Thomas Kingsley

<u>Executive Summary</u>
Proxy advisory firms guide investors on how they should vote at corporate shareholder meetings, as institutional investors may not have the resources to vote knowledgeably on the thousands of shares they may own. Proxy advisors have been criticized for a lack of competition in the market, little transparency in the process by which proxy advisory firms make recommendations, and potential conflicts of interest that may arise. Congress, the Securities and Exchange Commission, and industry groups have been pushing for heightened oversight of proxy advisory firms.

<u>What Are Proxy Advisory Firms?</u>
Investors in a publicly traded company are entitled to certain rights regarding the corporate matters of the company they partially own. Any shareholder who owns either at least $2,000 in a company's stock or 1 percent of its total shares may vote or introduce corporate proposals. At a company's annual general meeting, often held in April, shareholders are given the opportunity to vote on the proposals. Topics of discussion usually involve votes on the company's board of directors, executive compensation, and mergers or acquisitions.

Shareholder rights apply not only to retail investors but also to institutional investors such as pension funds, hedge funds, mutual funds, or endowments. Institutional investors typically invest in thousands of shares across thousands of companies, and as a result do not physically (or, as is increasingly common, virtually) attend shareholder meetings or introduce shareholder proposals. Instead, investors contract with proxy advisory firms that exercise the rights of the shareholders on their behalf. Investment managers may rely heavily – if not entirely – on the recommendations of proxy advisors for how they should cast their ballots.

The business of providing proxy advice first sprang into being in the late 1980s and is the product of two agency rulemakings. Critical to the formation of the first proxy advisory firm was the 1988 "Avon Letter," in which the Department of Labor emphasized the fiduciary importance of voting in the interests of pension plan beneficiaries under the Employment Retirement Income Security Act of 1974 (ERISA). Subsequently, in 2003 the Securities and Exchange Commission (SEC) imposed the Proxy Voting by Investment Advisers rule, requiring investment funds to disclose how they vote on behalf of their shareholders. When the SEC later confirmed that relying on third-party proxy advisors was acceptable to comply with this rule, the reliance on proxy advisory firms significantly expanded. A 2017 report conducted by PriceWaterhouseCoopers indicated that institutional investors own 70 percent of all shares publicly traded in the United States, a figure that has not changed significantly since. Institutional investors (or rather the proxy advisors on their behalf) also have significantly higher voter participation rates, casting votes representing 91 percent of all the shares they hold, compared to only 29 percent for retail investors.

Is the Proxy Advisory Process Working?

While proxy advisory firms have served an important role in improving shareholder representation in corporate governance, their business activities and lack of oversight have prompted both lawmakers and regulators to explore opportunities for reform.

Their concerns largely focus on three major issues. First, there exists little to no transparency as to the guidelines and methodologies used by proxy advisory firms when making their recommendations. Second, the proxy advisory firms often face conflicts of interest between their own shareholders and the investment funds and other clients they serve. Third, only two firms dominate the proxy advisory market, leading to significant competition concerns.

Proxy advisory firms do not have to disclose the methodologies used in their research and recommendations, and as a result their clients are left in the dark as to how the proxy firms arrived at a particular conclusion. Firms that believe a proxy advisor's recommendations are flawed are not able to challenge the recommendations. Meanwhile, regulators are similarly ignorant of how to examine proxy advisors' recommendation rationales or ensure they're in compliance with preexisting financial laws.

One report from Squire Patton Boggs looked at these concerns with proxy advisor transparency and analyzed existing data on proxy voting. Of the 107 filings from 94 different companies that made up the research sample, they found "139 significant problems including 90 factual or analytical errors in the three categories that we analyzed." While it's one thing for the firms to keep their proprietary analytical tools private, it's clear that they're flawed to some degree – a cause of concern for investors who rely on their research to make important decisions on matters of corporate governance.

Furthermore, many in the corporate world are unaware of potential conflicts of interest for proxy advisors and instead see the proxy advisory firms as neutral arbiters working on their behalf. That isn't necessarily the case. Institutional investors have a fiduciary duty to their clients, but the proxy advisory firms that act as a third party are not held to the same obligation. Therefore, the proxy advisory firms do not have to act in the best interest of the institutional investors they serve. As a result, if a conflict of interest between a firm and a client were to arise, the firm has no legal obligation to resolve that conflict.

These conflicts of interest have been well-documented, most notably in a case in 2018 which involved the pharmacy Rite Aid. Proxy advisory firm Glass Lewis recommended against a $24 billion merger between Rite Aid and Albertsons, despite Glass Lewis being partially owned by the Alberta Investment Management

Corporation, one of Rite Aid's largest shareholders. Under any other circumstance the SEC or Federal Trade Commission would likely have moved quickly to remove any suspected conflicts of interest, but proxy advisory firms are not currently held to the same standard.

Conflicts of interest may also be ideological. The recommendations of the proxy advisory firms frequently relate to environmental, social, or governance demands that are likely at odds with the firm's prime directive of returning value to shareholders.

Two proxy advisory firms, Glass Lewis and Institutional Shareholder Services (ISS), control an astonishing 97 percent of the proxy advisory market. The proxy advisory business features a high volume / low fee model, which makes it easy for only a handful of companies to dominate the market. In addition, ISS operates a consulting business to ensure that it remains a "one-stop shop" for institutional investors. If this concentration were not troubling enough, it is questionable whether ISS, with a company headcount of only 1,000 people, has the resource capacity to give each firm and recommendation the time it requires, given that ISS has indicated that its clients vote on 8.5 million ballots representing 3.8 trillion shares.

While these questions may feel remote, consider this: The pension funds that manage the pensions of the vast majority of Americans are potentially receiving inadequate – or even incorrect – advice on how to exercise voting rights on behalf of those Americans.

Conclusion

Proxy advisors' lack of transparency and potential conflicts of interest have real-world consequences. At their best they operate as way of streamlining shareholder involvement in the companies they invest in. All too frequently, however, the proxy advisory firms that are assumed to have only the best interests of their shareholders in mind demonstrate that this is far from the case. One study from Stanford concluded that "when boards altered course to implement the compensation policies preferred by proxy advisors, shareholder value was measurably damaged." Assuming that the sole responsibility of a business or investment fund is to increase shareholder profits, the proxy advisory firms hired by these businesses and funds may instead simply be advancing their own agendas at the cost of their clients.

Source: https://www.americanactionforum.org/insight/proxy-advisory-firms-a-primer-2/