Intentional Endowments Network

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Updated Regulatory Guidance on Proxy Voting and Sustainable Investment

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Introduction

On December 29, 2016, the U.S. Department of Labor ("DOL") issued new guidance for ERISA plans regarding proxy voting, statements of investment policy (including proxy voting policies) and other shareholder rights. The new guidance, Interpretive Bulletin ("IB") 2016-1, withdraws previous guidance which had been interpreted to restrict private pension plans governed by the Employee Retirement Income Security Act of 1974 ("ERISA") in voting proxies and exercising shareholder rights unless a cost-benefit analysis had been conducted. The new guidance also confirms that material environmental, governance and social factors are permissible considerations when developing statements of investment policy. Trustees of ERISA plans may wish to review their proxy voting policies, statements of investment policy and investment manager contracts to ensure they reflect the new guidance.

Application to Non-ERISA Investment Fiduciaries:

While the IB applies specifically to private pension funds governed by ERISA, it is persuasive authority for interpretation of obligations applicable to other institutional investor fiduciaries that operate under similar laws. For example, the investment functions of most foundations and endowments are governed by state statutes based on model laws called the Uniform Prudent Management of Institutional Funds Act (UPMIFA), which applies generally to all entities, and the Uniform Prudent Investor Act (UPIA), which applies specifically to trusts. ERISA, UPMIFA and the UPIA are all based on common law trust principles.

The Prefatory Note to UPMIFA confirms that standards for managing and investing institutional funds are and should be the same regardless of whether a charitable organization is organized as a trust, a nonprofit corporation, or some other entity. It cites authority stating that "[t]he modern paradigm of prudence applies to all fiduciaries who are subject to some version of the prudent man rule, whether under ERISA, the private foundation provisions of the Code, UMIFA [the precursor to UPMIFA], other state statutes, or the common law."

Consequently, while not controlling authority for endowments and foundations, the DOL interpretation of proxy voting standards applicable to ERISA fiduciaries provides compelling authority for the same responsibilities of fiduciaries of endowments and foundations.

Previous Guidance Withdrawn:

By way of background, the DOL has issued a series of interpretive bulletins regarding ERISA that focus on proxy voting, investment policy statements and shareholder interactions with management to help fiduciaries understand their duties in managing corporate stock. IB 94-2, issued in 1994, confirmed that fiduciaries may engage with corporate officers and directors either in meetings or though letters in order to monitor the investment and influence corporate management, provided that such communication or monitoring is likely to enhance value.

Subsequent guidance, issued in 2008, emphasized the costs of exercising shareholder rights and cautioned against using plan assets to vote proxies or engage with management. IB 2008-2 stated that "[f]iduciaries must take [costs] into account in determining whether the exercise of rights . . . is expected to have an effect on the economic value of the plan's investment that will outweigh the cost of exercising such rights." This language has been interpreted by many legal advisors to prohibit ERISA plans from exercising shareholder rights, including the voting of proxies, unless the plan has performed a burdensome cost-benefit analysis and concluded the action is more likely than not to result in an increase in the economic value of the plan's investment. This interpretation had the effect of discouraging ERISA plans from voting their proxies and exercising their shareholder rights.[1]

In its most recent bulletin, the DOL has withdrawn its prior interpretive bulletin, stating that a cost-benefit analysis of whether to vote proxies would not be required in most cases. The DOL affirmed that proxy voting is an important tool to communicate with and monitor issuers. IB 2016-1 provides "[p]roxies *should be voted* as part of the process of managing the plan's investment in company stock unless a responsible plan fiduciary determined that the time and costs associated with voting proxies with respect to certain types of proposals or issues may not be in the plan's best interest." (Emphasis added.) The DOL guidance clarifies that investment fiduciaries and their delegates have a fiduciary responsibility to vote proxies, except in special circumstances. [2] Trustees are also encouraged to develop proxy voting guidelines and have a fiduciary obligation to monitor proxy voting activities when they are delegated to external managers.[3]

"The fiduciary obligations of prudence and loyalty to plan participants and beneficiaries require the responsible fiduciary to vote proxies on issues that may affect the value of the plan's investment. This principle applies broadly." IB 2016-1.

The new guidance points out the shortcomings of IB 2008-2, which is out-of-step with current practices.[4] For most institutional investors, voting a proxy can be done without incurring significant costs. Many governing fiduciaries have delegated proxy voting to investment managers, who in turn hire proxy advisors to streamline the process. In addition, the DOL points out that proxy voting may be an investor's only tool to communicate with management regarding the plan's interests. For many funds, including plans that own commingled or index funds, divestment may not be an option.

Long-Term Focus:

One reason institutional investors may not be positioned to simply divest of a holding is because they have adopted index fund investment strategies that expose portfolios to long-term company and systemic risk. The DOL guidance recognizes that voting proxies; engaging with companies and incorporating environmental, social and governance ("ESG") factors into investment decision-making can be important tools in managing that risk and promoting longer-term corporate business strategies. The DOL guidance points out that a growing number of institutional investors are engaging companies on ESG issues,[5] and states that ESG "can be intrinsic to the market value of an investment." IB 2016-1 confirms that investment fiduciaries may consider long-term considerations like material ESG factors when making investment decisions.

ESG:

Another important change in the DOL guidance is that plan fiduciaries may consider ESG considerations. IB 2016-1, as with prior guidance, identifies categories of investment management decisions the investment policy statement may address.[6] In IB 2016-1, the DOL adds ESG factors, recognizing that ESG considerations are appropriate because of the growing number of institutional investors that now recognize the materiality of ESG issues and regularly engage with companies about them. For example, many public pension plans, which include a long-term focus because they must balance the current and future needs of beneficiaries,[7] have been incorporating ESG into their decision-making for years.[8] The DOL also notes that regulators now require ESG disclosures, which are widely used by market participants. In addition, the DOL also observes that ignoring ESG considerations was a contributing factor in causing the financial crises.

Shareholder Engagement:

The new guidance not only permits investment fiduciaries to consider long-term considerations like ESG but also supports engaging with management on ESG issues, provided it is expected to impact shareholder value or risk exposures. While prior guidance had identified some topics that would be appropriate for shareholder engagement (*e.g.*, the election of directors, executive compensation and M&A policy), the list has now been expanded to include governance structures, policies and practices to address material environmental or social factors, transparency and accountability in corporate decision-making, responsiveness to shareholders, plans on climate change preparedness and sustainability, governance and compliance policies, and workplace diversity and equal opportunity. IB 2016-1 notes that shareholder engagement on these topics may be appropriate if there is a reasonable expectation that such efforts are likely to yield financial benefits. [9]

Takeaways for Investment Fiduciaries:

- Investment fiduciaries should consider voting their proxies, if they do not do so already. IB 2016-1 has identified proxy voting as an important fiduciary tool for managing and monitoring investments, and the DOL has recognized the burdens to proxy voting are currently minimal.
- If institutional investment fiduciaries do not currently vote proxies or if they delegate voting to external managers, then they may wish to develop or review their proxy voting policies to ensure the policies reflect recent industry developments and regulatory interpretations
- Fiduciaries can incorporate material ESG factors into decision-making, without concern of violating fiduciary duties. They may also consider incorporating ESG considerations into their statements of investment policy to ensure that material long-term considerations become a part of managers' decision-making processes.
- Investment fiduciaries may engage directly, or ensure their managers are engaging, with companies on a broader range of topics, including climate change, sustainability, diversity and other material ESG factors as long as they are related to corporate performance.
- When proxy voting has been delegated to external managers, governing fiduciaries should have a process in place to monitor voting and ensure its managers are implementing these fiduciary responsibilities appropriately.

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[1]IB 2016-1 notes that this narrow interpretation was inconsistent with long-standing DOL guidance. "IB 94-2 was also intended to make it clear that fiduciary duties associated with voting proxies encompass the monitoring of decisions made and actions taken with regard to proxy voting, and that it was appropriate for a plan fiduciary to incur reasonable expenses in fulfilling those fiduciary obligations. While there may be special circumstances that might warrant a discrete analysis of the cost of the shareholder activity versus the economic benefit associated with the outcome of the activity, the Department did not intend to imply that such an analysis should be conducted in most cases."

[2] IB 2016-1 identifies one special circumstance—voting shares of foreign corporations—in which a fiduciary may reasonably decide not to vote proxies. In these cases, the DOL advises fiduciaries to consider whether the difficulty and expense in voting the shares is reflected in their market price.

[3] The DOL emphasizes named fiduciary oversight responsibilities in IB 2016-1. "Since the fiduciary act of managing plan assets that are shares of corporate stock includes the voting of proxies appurtenant to those shares of stock, a statement of proxy voting policy would be an important part of any comprehensive statement of investment policy. . . . Maintenance of a statement of investment policy by a named fiduciary does not relieve the named fiduciary of its obligations under ERISA section 404(a) with respect to the appointment and monitoring of an investment manager or trustee."

[4] IB-2016 explains, "The Department believes that in the eight years since its publication, the changes made to IB 94-2 by IB 2008-2 have been misunderstood and may have worked to discourage ERISA plan fiduciaries who are responsible for the management of shares of corporate stock from voting proxies and engaging in other prudent exercises of shareholder rights. In particular, the Department is concerned that IB 2008-2 has been read by some stakeholders to articulate a general rule that broadly prohibits ERISA plans from exercising shareholder rights, including voting of proxies, unless the plan has performed a cost-benefit analysis and concluded in the case of each particular proxy vote or exercise of shareholder rights that the action is more likely than not to result in a quantifiable increase in the economic value of the plan's investment."

[5] IB 2016-1 states, "[a] growing number of institutional investors are now engaging companies on ESG issues. According to a 2014 survey by the US SIF Foundation, 202 institutional investors or money managers representing $1.72 trillion in United States-domiciled assets filed or co-filed shareholder resolutions on ESG issues at publicly traded companies from 2012 through 2014. US SIF FOUNDATION, Report on US Sustainable, Responsible and Impact Investing Trends 2014." This trend has only increased in recent years. The most recent report from the SIF Foundation shows even stronger

growth of ESG incorporation and shareholder resolutions on ESG issues, which has increased 33% since 2014. ESG-related strategies account for more than $1.00 out of every $5.00 under professional management in the United States. The total United States-domiciled assets under management using these strategies grew to $8.72 trillion at the start of 2016.

[6] In prior interpretive advice, IB 2015-1, the DOL stated: "An important purpose of this Interpretive Bulletin is to clarify that plan fiduciaries should appropriately consider factors that potentially influence risk and return. Environmental, social, and governance issues may have a direct relationship to the economic value of the plan's investment."

[7] This is referred to as the fiduciary duty of impartiality and was applied to ERISA plans by the US Supreme Court in *Varity v Howe,* 516 U.S. 489 (1996).

[8] Many of the largest institutional investors incorporate ESG factors into decision-making because research shows that it reduces risk and improves returns over the long-term. One such paper is available here.

[9] IB 2016-1 states "the Department believes that IB 2008-2 may be read as discouraging fiduciaries from recognizing the long-term financial benefits that, although difficult to quantify, can result from thoughtful shareholder engagement when voting proxies, establishing a proxy voting policy, or otherwise exercising rights as shareholders."

**This was prepared for the Intentional Endowments Network by Megan Jackson and Keith Johnson at Reinhart Boerner Van Deuren s.c. on February 15, 2017*

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