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Fiduciary Duty Yellow Flags for Proxy Season

Proxy Voting is Integral to the Investment Management Process

Investor fiduciaries have known for decades that proxy voting must be managed in accordance with fiduciary duties. Both the US Department of Labor and Securities and Exchange Commission have issued guidance in the past few years reconfirming that proxy votes are rights which must be exercised as part of the investment management process consistent with the interests of pension plan members or fund investors. Even when named fiduciaries delegate proxy voting responsibilities, fiduciaries have an ongoing responsibility to monitor voting practices.

However, as noted by the Department of Labor in a December 2016 Interpretive Bulletin, domestic and international trends and market developments are changing the facts and circumstances which must be considered when voting proxies. The pace of change has only accelerated since 2016.

Proxy voting and company engagement practices are moving from a mere compliance issue to an integral component of investment and risk management. The old "set it and forget it" approach which relies on off-the-shelf proxy voting processes has become a risky practice. Fiduciaries are well advised to re-evaluate how their legal obligations relate to use of proxy voting in this changing environment.

Proxy Vote Analyses Must Implement Fiduciary Duties

Fiduciary duties govern the processes used in making asset management decisions. In general, investor fiduciaries must (a) act prudently, in a fact-based and forward-looking manner, with reference to the care, skill, diligence and prudence used by similar investors; (b) exercise responsibilities with absolute loyalty to the interests of fund participants and beneficiaries, managing assets to provide promised benefits and cover reasonable administrative expenses; and (c) impartially balance interests of different beneficiary groups, considering issues of cross generational equity and potentially conflicting interests among

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beneficiaries. The duty of prudence includes an obligation to reasonably investigate and verify facts relevant to fund management.

How compliance with these duties of prudence, loyalty and impartiality is influenced by recent developments merits close scrutiny. Like other investment practices, proxy voting policies, analyses and decisions should be explicitly tied to satisfying fiduciary obligations. For example, fiduciaries should ensure their processes:

- Evaluate what is driving peer proxy voting trends;
- Analyze current research findings on issues up for vote;
- Apply forward-looking time horizons appropriate to the interests of fund participants; and
- Take the varying effects that systemic risks can have across participant generations into consideration.

Indeed, many investor fiduciaries and their advisors would be hard pressed to show that proxy votes were based on processes which included up-to-date analyses addressing these basic legal requirements. Asset owner fiduciaries, as well as mutual fund and investment manager boards, should be particularly concerned because of their oversight obligations. Breaches of fiduciary duty can subject fiduciaries to reputation risk, litigation and enforcement actions.

Prudent Practices are Evolving

Investor prudence contemplates use of processes that take practices at similar peers into consideration as a reference point. Copycat adoption is not required, but an understanding of peer practices is. Inflection points, where the relevant knowledge base or industry practices change, require close attention. It appears that we are currently at such a juncture.

For instance, BlackRock's January letter to the world's largest companies highlighted fiduciary duty as requiring a new emphasis on a company's long-term strategic planning, board diversity and understanding of societal impact. BlackRock is doubling the size of its investment stewardship team to implement this obligation. Similar company letters emphasizing long-term value creation and sustainability practices were also sent to companies by State Street Global Advisors and Vanguard.

In December 2016, the US Department of Labor issued an Interpretive Bulletin confirming that environmental, social and governance ("ESG") factors can be

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material to proxy voting decisions and sustainable value creation. In fact, levels of mainstream mutual fund support for ESG and sustainability shareholder resolutions have been increasing.

- According to the 50/50 Climate Project, more than 60 percent of the 30 largest investment managers supported over half of the key votes on climate change last year.
- The Center on Political Accountability reports that mutual fund votes in favor of corporate political expenditure disclosures jumped to 48% in 2017.
- In December, the Financial Times reported that European investment managers are now casting substantially higher negative US company say-on-pay votes than their US peers, citing concerns with the level and structure of US executive compensation.

A prudent proxy voting process should recognize and evaluate applicability of the factors underlying such trend changes in peer practice.

Systemic Issues Raise Duty of Impartiality Concerns

Systemic issues are often unseen by fiduciaries that use only market-relative performance benchmarks. Nevertheless, systemic risks can spread across portfolio companies and compound over time, increasing risk exposures and degrading future returns of fund participants. The potential for inequitable intergenerational treatment in the resulting transfer of risk and value is high.

Climate risk presents perhaps the most obvious systemic risk example. However, other issues like future value destruction from myopic investment practices and company short-term planning horizons also raise concerns. The duty of impartiality requires analysis and a good faith effort to balance fund participant intergenerational equity issues in proxy voting processes. Consideration of systemic issues is critical for younger plan participants.

Conflicts of Interest Implicate the Duty of Loyalty

When adopting proxy voting rules in 2002, the SEC recognized potential for investment manager conflicts of interest in voting proxies and mandated, "To satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interest of its client and must not subrogate client interests to its own." Conflicts of interest can result from service fees received

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from companies on whose proxies votes are being cast, business interests in attracting new public company clients and manager compensation structures that are misaligned with the interests of fund participants.

Managers with delegated proxy voting authority typically disclose to clients their general conflicts arising from business interests and engage independent proxy advisors to apply established voting guidelines. Nevertheless, concern about the effects of conflicts on proxy voting persists.

In 2009 the SEC imposed fines on Intech Investment Management and its Chief Operating Officer for allegedly using a labor-friendly proxy voting policy at non-labor client funds to serve the manager's own business interests in attracting new labor fund clients. The SEC noted that "advisers may use a 'predetermined voting policy,' such as a third-party proxy voting service's platform, to vote proxies provided that the predetermined policy is 'designed to further the interests of clients rather than the adviser.'"(Emphasis added.)

Given that there have been a number of academic studies finding apparent links between mutual fund business interests and their proxy voting patterns, this is an area which merits particular attention by named fiduciaries and other investor oversight boards. Recent public statements from investment managers regarding materiality of ESG factors and systemic risk exposures also present the opportunity for oversight fiduciaries to conduct congruity analyses of proxy votes with those public statements. The results could help fiduciaries identify situations where a manager's proxy voting processes might not be adequate to ensure that votes are being cast in the interests of fund participants rather than the manager's own business interests.

Conclusion

Proxy voting is moving from a mere compliance function to being an integral part of the investment management process. In addition, new data and market developments are changing the facts and circumstances which must be considered when voting proxies. Investor fiduciaries, particularly named fiduciaries and boards with proxy voting oversight duties, should re-evaluate existing policies and processes to ensure their proxy analyses and votes fully satisfy prudence, loyalty and impartiality fiduciary obligations. Reconnection of proxy voting policies and analyses to fiduciary duty would likely have implications for processes and reports of proxy advisors.

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If you have questions about, please contact your Reinhart attorney.

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