PROXY VOTING REFORM: WHAT IS ON THE AGENDA, WHAT IS NOT ON THE AGENDA, AND WHY IT MATTERS FOR ASSET OWNERS

KEITH JOHNSON,∗ CYNTHIA WILLIAMS∗∗ & RUTH AGUILERA∗∗∗

ABSTRACT

Investor proxy voting practices have entered the public spotlight again in 2018 as Congress and the Securities and Exchange Commission (“SEC”) consider changes to the rules which govern proxy voting and regulation of proxy advisors. The focus has largely been on companies’ frustration with an asserted out-sized influence of proxy advisory firms and the corporate community’s long-standing pushback to shareholder proposals, especially those dealing with environmental, social, and governance (“ESG”) issues. However, an accurate recognition of the longstanding principles which underlie institutional investors’ fiduciary duties and provide the legal context for the exercise of proxy voting rights has been largely missing from the debate.

In this Article, we explore current fiduciary duties of institutional investors, asset managers, and proxy advisors and how those legal principles apply to processes for analysis, voting and oversight of proxies on behalf of fund beneficiaries. We also review what current research shows concerning the financial effects of material ESG issues. We conclude that fiduciaries, when voting, monitoring or advising on voting, must apply an up-to-date understanding of fiduciary duties and must correspondingly evaluate how ESG factors and systemic risks can often be material economic issues at individual companies and across industries. We counsel that fundamental fiduciary duty principles require more explicit and forward-looking attention in proxy voting processes to (1) evolution in research on ESG factors and the knowledge base which are driving changes in voting trends, (2) balancing intergenerational

∗ Keith Johnson is the head of the Institutional Investor Services Group at Reinhart Boerner Van Deuren s.c. He formerly served as Chief Legal Officer of the State of Wisconsin Investment Board, President of the National Association of Public Pension Attorneys, and Co-Editor of the Cambridge Handbook of Institutional Investment and Fiduciary Duty.
∗∗ Cynthia Williams is a Professor of Law and holds the Osler Chair in Business Law at Osgoode Hall Law School, York University. She was previously a Professor of Law at the University of Illinois College of Law.
∗∗∗ Ruth Aguilera is a Distinguished Professor of International Business and Strategy at Northeastern University’s D’Amore McKim School of Business.

An earlier version of this analysis appeared as an Industry Voices Commentary in Pensions & Investments. The views expressed herein should not be attributed to the employers, clients, or organizations with which the authors are associated.
short- and long-horizon transfers of risk and return, (3) aggregate influence of systemic risks that can spread across companies and compound over time; (4) improved asset owner oversight of investment manager and proxy advisor business model conflicts of interest, and (5) cost-benefit advantages of collaborative asset owner and investment manager use of proxy and other advisors. Thus, concerns expressed in Congress and at the SEC about integrity of the proxy voting system largely miss the mark because they come from a perspective that is outdated and misguided.
CONTENTS

INTRODUCTION .................................................................................................................. 1350
I. THE TWENTY-FIRST CENTURY FIDUCIARY ............................................................... 1351
   A. Proxy Voting as a Fiduciary Function ................................................................. 1351
   B. The Duty of Prudence ......................................................................................... 1352
   C. The Duty of Loyalty ............................................................................................ 1355
      1. Conflicts of Interest ......................................................................................... 1356
      2. Public Statements and Vote Consistency ....................................................... 1357
   D. Duty of Impartiality ............................................................................................ 1359
   E. The Duty to Manage Costs ................................................................................ 1360
II. THE FINANCIAL MATERIALITY OF ESG .............................................................. 1361
III. IMPLICATIONS FOR PROXY ANALYSES AND POLICIES .............................. 1363
CONCLUSION .................................................................................................................. 1365
INTRODUCTION

Investor proxy voting practices have entered the public spotlight again in 2018 as Congress and the Securities and Exchange Commission (“SEC”) consider changes to the rules which govern proxy voting.¹ On November 15, 2018, the SEC held a Roundtable to consider three issues: (1) the technical issue of proxy “plumbing,” which is how shareholder voting occurs, what to do about problems that regularly arise such as “overvoting,” “undervoting,” “empty voting,” and so forth; (2) whether and how to regulate the two proxy advisory firms, Institutional Shareholder Services (“ISS”) and Glass, Lewis & Co. (“Glass Lewis”), that together advise institutional shareholders on voting their shares; and (3) whether and how to reform the shareholder proposal system, by which shareholders can put items on the agenda for voting at a company’s annual general meeting.²

In holding this Roundtable, the SEC aimed to address companies’ frustration with the asserted out-sized influence of the proxy advisory firms, and the corporate community’s long-standing resistance to shareholder proposals.³ However, an accurate recognition of institutional investors’ fiduciary duties, which provide the legal context for institutional investors’ exercise of proxy voting rights, has largely been missing from the debate.

In this Article, we explore two, seemingly unrelated questions. First, what are the fiduciary duties of institutional investors, asset managers, and proxy advisors when voting on behalf of fund beneficiaries and advising on voting? Second, what does the research show concerning the financial effects of environmental, social, and governance (“ESG”) issues—the issues in shareholder proposals that the Chamber of Commerce and the Roundtable are targeting for reform?

This Article suggests that these are not unrelated questions, but that fiduciaries, when voting or advising on voting, must incorporate a current understanding of the ESG factors that can be material economic issues at many companies and across industries. Thus, concerns expressed at the SEC Roundtable that proxy advisory firms are wrongly advising investors to support


³ See, e.g., Letter from Benjamin Zycher, Resident Scholar, Am. Enter. Inst., to Brent J. Fields, Sec’y, Sec. & Exch. Comm’n (Dec. 21, 2018), https://www.sec.gov/comments/4-725/4725-4827804-177047.pdf [https://perma.cc/QG5C-73LW] (“[R]ecommendations by ISS [Institutional Shareholder Services] and GL [Glass Lewis] are frequently driven by ‘environmental, social, and governance’ (ESG) investing, a concept coined in 2005. ESG substitutes an amorphous range of political goals in place of maximizing the funds’ economic value — that is, the wealth and pension benefits of current investors.”).
shareholder proposals with ESG underpinnings are misplaced. While not every shareholder proposal raising an ESG issue deserves to be supported on economic grounds, many do.

This Article will proceed as follows. In Part I, we explore modern twenty-first century fiduciary principles. In Part II, we discuss emerging research showing the financial materiality of many ESG issues. In Part III, we develop the implications that flow from the prior two sections. Part IV presents our conclusions.

I. THE TWENTY-FIRST CENTURY FIDUCIARY

We argue in this Article that any reform discussions should be anchored to an up-to-date understanding of how fiduciary principles have developed in the twenty-first century. This includes a balanced application of the fiduciary duties of (1) forward-looking prudence (including the obligation to investigate and verify material facts), (2) loyalty to beneficiaries (with its obligation to treat different beneficiary groups impartially), and (3) reasonable management of costs. Those are legal duties which establish expectations for proxy voting processes of asset owners, investment managers, and proxy advisors.

We assert that improved alignment of proxy voting policies and procedures with these fiduciary duty fundamentals could improve company and investor performance over time and reduce exposure of fund beneficiaries to systemic risks. This realignment could be driven by greater investor and proxy service provider focus on (1) the evolving research and knowledge base that leads proxy voting trends; (2) oversight of how proxy voting conflicts of interest at investment managers are managed; (3) explicit attention to balancing short- and long-term effects of aggregated proxy votes; (4) management of systemic risks that can spread across portfolio companies and compound over time; and (5) recognition of the long-term benefits, as well as the costs, associated with opportunities to collaborate on these process improvements.

A. Proxy Voting as a Fiduciary Function

Investor fiduciaries have long known that proxy voting must be managed in accordance with fiduciary duties. Both the U.S. Department of Labor (“DOL”)
and the SEC have issued guidance in the past few years reconfirming that proxy votes are rights which must be prudently exercised consistent with the interests of pension plan members and fund investors.  

For example, in DOL Interpretive Bulletin 2016-01, the DOL noted that “[t]he Department’s longstanding position is that the fiduciary act of managing plan assets which are shares of corporate stock includes decisions on the voting of proxies and other exercises of shareholder rights.”

In Staff Legal Bulletin No. 20, the SEC confirmed: “As a fiduciary, an investment adviser owes each of its clients a duty of care and loyalty with respect to services undertaken on the client’s behalf, including proxy voting.”

B. The Duty of Prudence

Investor fiduciaries must exercise their management responsibilities prudently, in a fact-based and forward-looking manner, with reference to the care, skill, diligence, and prudence similar investors use. This contemplates the use of processes which recognize practices at peer institutions as a reference point. An understanding of peer practices is required, but the duty of prudence does not create a “mindless lemming” standard. Instead, the duty of prudence mandates consideration of peer practices in the context of each fund’s unique structure, risk appetite, strategy, governing documents, and liabilities.

The duty of prudence also requires that fiduciaries investigate and verify facts relevant to investment decisions. Personal preferences and beliefs (whether liberal or conservative) are insufficient to support fiduciary decisions, including those relating to proxy votes.

A current application of fiduciary principles includes understanding that prudent practices evolve over time. The Third Restatement of Trusts, a leading authority on investor fiduciary law, confirms that fiduciary practices cannot remain static: “Trust investment law should reflect and accommodate current knowledge and concepts. It should also avoid repeating the mistake of freezing its rules against future learning and developments.”

---

8 Id. at 95,880.
10 See Gary, supra note 4, 789-94 (highlighting importance of fiduciary duty to act prudently).
11 See id. at 757-58 (recommending examining “effects of corporate sustainability strategies” employed by other companies).
12 See UNIF. PRUDENT MGMT. OF INSTITUTIONAL FUNDS ACT § 3(c)(2) cmt. (UNIF. LAW COMM’N 2006) (“The subsection requires persons who make investment and management decisions to investigate the accuracy of the information used in making decisions.”).
13 RESTATEMENT (THIRD) OF TRUSTS ch. 17, intro. note (AM. LAW INST. 1992). For example, during much of the twentieth century, investing in stock was seen as imprudent for
Investor fiduciaries must pay particular attention to changes in investment theories, knowledge base, and industry practices. We are currently at an industry inflection point. For instance, the January 2018 letter from BlackRock’s CEO, Larry Fink, to the world’s largest companies highlighted their fiduciary duties as requiring a new emphasis on companies’ long-term strategic planning, sustainability, and understanding of social purpose. BlackRock also announced it is doubling the size of its investment stewardship team to implement this obligation. Similar letters to companies that emphasize materiality of long-term value creation and sustainability practices were also sent by industry giants State Street Global Advisors and Vanguard. Larry Fink’s January 2019 letter provided additional detail on how its proxy voting and shareholder engagement activities now reflect links between sustainability factors, corporate purpose, and profit.

Regulators have also acknowledged that long-term investors’ understanding of ESG factors’ materiality is evolving. For instance, the DOL December 2016 Interpretive Bulletin confirmed that ESG factors can be material to proxy voting decisions and sustainable value creation. In a 2018 Field Assistance Bulletin, an institutional fiduciary.

Larry Fink, Larry Fink’s 2018 Letter to CEOs: A Sense of Purpose, BLACKROCK, https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter [https://perma.cc/7YGW-9AQ2] (last visited Apr. 8, 2019) (“The statement of long-term strategy is essential to understanding a company’s actions and policies, its preparation for potential challenges, and the context of its shorter-term decisions. Your company’s strategy must articulate a path to achieve financial performance. To sustain that performance, however, you must also understand the societal impact of your business as well as the ways that broad, structural trends – from slow wage growth to rising automation to climate change – affect your potential for growth.”).

See id. (“We also intend to double the size of the investment stewardship team over the next three years. The growth of our team will help foster even more effective engagement with your company by building a framework for deeper, more frequent, and more productive conversations.”).


See Larry Fink, Larry Fink’s 2019 Letter to CEOs: Purpose & Profit, BLACKROCK, https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter [https://perma.cc/JJX8-XK5F] (last visited Apr. 8, 2019) (“BlackRock’s Investment Stewardship engagement priorities for 2019 are: governance, including your company’s approach to board diversity; corporate strategy and capital allocation; compensation that promotes long-termism; environmental risks and opportunities; and human capital management. These priorities reflect our commitment to engaging around issues that influence a company’s prospects not over the next quarter, but over the long horizons that our clients are planning for.”).

the DOL reaffirmed the ESG factors’ materiality by reiterating that ESG factors can be significant drivers of company and investor success:

[There] may be circumstances, for example involving significantly indexed portfolios and important corporate governance reform issues, or other environmental or social issues that present significant operational risks and costs to business, and that are clearly connected to long-term value creation for shareholders with respect to which reasonable expenditure of plan assets to more actively engage with company management may be a prudent approach to protecting the value of a plan’s investment.19

In fact, levels of mainstream investor support for ESG shareholder resolutions have been increasing:

- American Funds, BlackRock, Fidelity, and Vanguard, amongst the largest mutual fund investors in the world, began voting in favor of climate-related resolutions in 2017.20
- Ernst & Young found that favorable votes of 30% or more (the level at which boards begin to pay serious attention) on environmental and social shareholder resolutions increased from 29% of those resolutions in 2017 to 41% in 2018, a significant upward trend.21 The Climate 50/50 Project identified increasing support from large mutual funds for shareholder proposals on key climate change and political influence disclosure resolutions at carbon-intensive companies, but also identified a clear pattern of trend leaders and laggards.22 For example, during the last proxy season, Legal & General and PIMCO voted in favor of 100% of the political influence disclosure resolutions while BlackRock, JP Morgan, Prudential, and Vanguard, supported none.23

95,879, 95,880-84 (Dec. 29, 2016) (to be codified at 29 C.F.R. pt. 2509) (discussing in-depth importance of ESG factors to proxy voting).

19 Memorandum from John J. Canary, Dir. of Regs. & Interpretations, Dep’t of Labor, to Mabel Capolongo, Dir. of Enfhl. Reg’l Dir., Dep’t of Labor (Apr. 23, 2018) (on file with authors).


23 See id. at 5, 7.
• Broadridge and PwC report that overall institutional investor support for political spending resolutions increased from 21% in 2014 to 29% in 2018.24

• More companies reached settlements with proponents of environmental and social shareholder resolutions in 2018 than ever before, indicating that the proposals now enjoy mainstream acceptance. ISS reports that 48% of those resolutions were withdrawn in 2018 after implementation agreements were reached, up from 37% the year before.25

A prudent proxy voting process requires understanding what exactly drives such trends in peer voting practices. The duty to investigate and verify material facts also compels evaluation of current research findings, as well as company disclosures, to ensure voting decisions are based on an up-to-date factual investigation. 26 These responsibilities are shared by named asset owner fiduciaries and investment managers to whom proxy voting is delegated, and require ongoing fiduciary oversight.27

C. The Duty of Loyalty

Investor fiduciaries must also exercise their responsibilities with absolute loyalty to the interests of fund participants and beneficiaries, managing assets to provide promised benefits and cover reasonable administrative expenses.

---


26 See UNIF. MGMT. OF PUB. EMP. RET. SYS. ACT § 8(a)(3) cmt. (UNIF. LAW COMM’N 1997) (emphasizing that duty to make reasonable effort to verify facts “incorporates the traditional duty of the fiduciary investor to examine information likely to bear importantly on the value or security of an investment”). The duty contemplates use of a reasonable process rather than absolute confirmation of every material fact. See id. It must be balanced with peer practice standards and the duty to incur only reasonable expenses. See id. § 7(5) cmt.

27 Even when proxy voting duties are delegated to a third-party manager, the primary fiduciary must have policies and procedures that are reasonably designed to provide sufficient ongoing oversight of the third party. SEC Staff Legal Bulletin No. 20, supra note 9 (“[A]n investment adviser that has retained a third party (such as a proxy advisory firm) to assist with its proxy voting responsibilities should, in order to comply with the Proxy Voting Rule, adopt and implement policies and procedures that are reasonably designed to provide sufficient ongoing oversight of the third party . . .”). SEC Staff Legal Bulletin No. 20 also requires that, when investment advisors engage proxy advisors, they must “ascertain that the proxy advisory firm has the capacity and competency to adequately analyze proxy issues, which includes the ability to make voting recommendations based on materially accurate information.” Id.
Section 404 of the Employees Retirement Income Security Act ("ERISA") explicitly provides that "a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries." This is intended to guard against harm to beneficiaries from self-dealing, fraud, and the personal biases of delegated fiduciary agents.

1. Conflicts of Interest

When it established proxy voting rules in 2003, the SEC recognized the 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 widely held companies paying service fees to investment managers who in turn are casting their clients’ votes at proxy contests, business interests in attracting new public company clients, and manager compensation structures that are misaligned with the interests of fund participants. Of particular note for current regulatory debates is that investment managers and proxy advisors owe fiduciary duties to their investor clients rather than to subject companies.

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 effect 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 nonlabor 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.’"
Although our research has only uncovered that one 2009 SEC enforcement action, a number of academic studies have identified apparent widespread links between mutual fund business interests and their proxy voting patterns. This could be a significant fiduciary issue, and one that merits the attention of both regulators and the asset owners who delegate proxy voting to fund managers. While we do not contend that investment manager conflict of interest situations always involve Investment Adviser Act or fiduciary duty violations, some might conclude that there is more evidence that investment manager conflicts of interest influence some voting decisions than there is evidence supporting the other proxy voting conflict of interest allegations currently being debated.

2. Public Statements and Vote Consistency

Recent public statements from investment managers regarding material ESG factors and systemic risk exposures also present an opportunity for asset owner fiduciaries possessing delegated proxy voting authority to conduct congruity analyses of proxy votes with those public statements. The results could help fiduciaries identify situations where a delegated manager’s proxy voting processes might not be adequate to ensure that votes are always being cast in the interests of fund participants and not being influenced by the manager’s own

37 See, e.g., Rasha Ashraf, Narayanan Jayaraman & Harley E. Ryan, Jr., Do Pension-Related Business Ties Influence Mutual Fund Proxy Voting? Evidence from Shareholder Proposals on Executive Compensation, 47 J. FIN. & QUANTITATIVE ANALYSIS 567, 568 (2012) (“Our analysis of nearly 18,000 votes cast by 143 fund families, 67 with pension-related business ties and 76 without ties, documents a strong relation between the likelihood that a fund family votes against shareholder proposals on compensation and pension-related business ties . . . fund families tend to vote with management at all firms, possibly to maintain reputation and to minimize the potential for lawsuits.”); Dragana Cvijanović, Amil Dasgupta & Konstantinos E. Zachariadis, Ties that Bind: How Business Connections Affect Mutual Fund Activism, 71 J. FIN. 2933, 2933-66 (2016) (“We investigate whether business ties with portfolio firms influence mutual funds’ proxy voting using a comprehensive data set spanning 2003 to 2011. . . . [W]e find that business ties significantly influence promanagement voting at the level of individual pairs of fund families and firms after controlling for [ISS] recommendations and holdings. The association is significant only for shareholder-sponsored proposals and stronger for those that pass or fail by relatively narrow margins . . . Further, we find that large and small fund families without business ties vote similarly, whereas large fund families with business ties vote in a more management-friendly manner than small families with business ties.”); Jennifer Taub, Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders’ Rights, 34 J. CORP. L. 843, 875 (2009) (“I found that the instances of support by a mutual fund family for shareholder-sponsored resolutions declined as the value of assets the Adviser had under management through DC plans increased . . . the probability that this occurred randomly is less than one percent.”).


39 See Fink, supra note 17 (emphasizing importance of ESG factors for fiduciaries to take into account in running their companies); Fink, supra note 14 (same); McNabb, supra note 16 (advocating for consideration of social factors, such as higher gender diversity in board composition).
business interests. Additional scrutiny and inquiries regarding compliance might be merited where inconsistencies are apparent.

As an example of how such potential inconsistencies might appear, BlackRock states in its *Investment Stewardship 2018 Annual Report*:

During our direct engagements with companies, we address the issues covered by any shareholder proposals that we believe to be material to the long-term value of that company. Where management demonstrates a willingness to address the material issues raised, and we believe progress is being made, we will generally support the company and vote against the shareholder proposal.40

On the surface, this stated practice of voting against shareholder resolutions that have been determined to be in the best interests of the company suggests a preference for supporting management over client interests in improving company performance as soon as practical. The resulting disconnect between value creation and proxy voting sends mixed signals to clients, the company, and the marketplace. For example, it could have the practical effect of giving companies more room to ignore or delay value enhancing actions.

Some clients might be concerned that a manager’s interests in attracting or keeping business from companies could be the root cause of such disconnects between voting practices and company value creation. These disconnects may also result from a misconception that the fiduciary duty of loyalty in the exercise of proxy voting rights runs to the interests of company management or business goals of the fund manager rather than to fund beneficiaries (who will benefit from improving company performance as soon as practical). Or, they might be a result of the tension between beliefs about advantages of relying only on continued engagement with a company over first sending a consistent proxy vote message, and then offering to continue dialogue.

In any event, when proxy voting responsibilities are delegated, the named fiduciary still retains oversight duties.41 Robust reporting and monitoring procedures are necessary to put teeth into compliance with the duty of loyalty when voting duties are delegated.42


41 Interpretive Bulletin Relating to Written Statements of Investment Policy, Including Proxy Voting Policy or Guidelines, 29 C.F.R. § 2509.94-2 (2018) (“The fiduciary duties described at ERISA § 404(a)(1)(A) and (B) . . . also require that the named fiduciary appointing an investment manager periodically monitor the activities of the investment manager with respect to the management of plan assets, including decisions made and actions taken by the investment manager with regard to proxy voting decisions.”).

42 It is worth noting that Morningstar recently acquired Fund Votes, which provides mutual fund and exchange-traded fund proxy voting data on company resolutions and shareholder proposals, including ESG topics. See Jon Hale, Morningstar Acquires Fund Votes, and Company Responses to the Main St. Investors Coalition Letter, Medium (Oct. 5, 2018), https://medium.com/the-esg-advisor/morningstar-acquires-fund-votes-and-company-
D. Duty of Impartiality

The duty of impartiality, often considered part of the duty of loyalty, requires that fiduciaries balance conflicting interests of different beneficiary groups. This requires consideration of cross-generational equity and other potentially conflicting interests among beneficiaries. 43 Like the duty of prudence, impartiality mandates that fiduciaries diligently identify and manage conflicting beneficiary interests. 44 Attention to alignment of time horizons with fiduciary decision processes is especially important for implementation of impartiality duties.

The potential for uncompensated transfer of risks and wealth creation between generations can be exacerbated by myopic investment practices that undermine sustainable long-term corporate wealth creation, favoring older fund participants. A growing body of research has found that companies that maintain the discipline to focus on long-term strategic planning and risk management can substantially outperform other companies over the long term. 45 Proxy votes on issues relating to executive compensation plan design, climate change exposure, mergers and acquisitions, election of directors, reporting on sustainability risks, and similar matters can have long-term value creation implications which should be covered in proxy analyses. 46

Systemic issues are often invisible to fiduciaries that focus exclusively on short-term returns or are evaluated against only a market-relative performance benchmark. Nevertheless, systemic risks can spread across portfolio companies and compound over time, increasing risk exposures and degrading future returns

\[\text{responses-to-the-main-st-investors-coalition-letter-33f5aa3c7571} \] [https://perma.cc/JJQ3-G8J5]. This could provide asset owners with greater access to data for analyses of mutual fund voting practices. See id.

43 See Varity v. Howe, 516 U.S. 489, 514 (1996) (“The common law of trusts [made applicable to ERISA §§ 404, 409] recognizes the need to preserve assets to satisfy future, as well as present, claims and requires a trustee to take impartial account of the interest of all beneficiaries.”).

44 Fiduciaries cannot “ignore the interests of some beneficiaries merely as a result of oversight or neglect.” RESTATEMENT (THIRD) OF TRUSTS § 79 cmt. b (AM. LAW INST. 1992).

45 See, e.g., Dominic Barton, James Manyika & Sarah Keohane Williamson, Finally, Evidence That Managing for the Long Term Pays Off, HARV. BUS. REV. (Feb. 7, 2017), https://hbr.org/2017/02/finally-proof-that-managing-for-the-long-term-pays-off (“New research . . . found that companies that operate with a true long-term mindset have consistently outperformed their industry peers since 2001 across almost every financial measure that matters.”); Alex Edmans, Vivian W. Fang & Allen H. Huang, The Long-Term Consequences of Short-Term Incentives 2 (European Corp. Governance Inst., Working Paper No. 527, 2017) (“The concern with short-term incentives is that they lead to the CEO taking myopic actions that boost the short-term stock price at the expense of long-run value.”).

46 See, e.g., Fink, supra note 14 (“We have no intention of telling companies what their purpose should be – that is the role of your management team and your board of directors. Rather, we seek to understand how a company’s purpose informs its strategy and culture to underpin sustainable financial performance.”).
of fund participants.\textsuperscript{47} The resulting potential for inequitable intergenerational treatment in the resulting transfer of risk and value is high.

Climate risk presents perhaps the most obvious systemic risk. However, other factors, like future value destruction from environmental damage, wealth creation limits imposed by ecosystem decline, the effects of excessive income inequality on consumer demand, and political risk, also raise impartiality concerns. The duty of impartiality requires analysis and a good faith effort to balance fund participant intergenerational and other beneficiary group conflicts as part of proxy voting processes. Use of decision processes that balance short- and long-term value creation and consider the effects of systemic risks are critical to fulfilling impartiality obligations, especially for younger plan participants who are more likely to be harmed over the long term by a failure to observe the duty of impartiality.

ESG, and sustainability issues in particular, often have systemic or long-term cost, risk, and return implications. Proxy policies and analyses that do not take these considerations into account are likely to raise duty of impartiality and prudence concerns, especially in regard to identification and balancing of intergenerational risk, cost, and wealth creation transfers. Analysis of the intergenerational effects of climate change, resource restraints, excessive income inequality, health and safety risks, reports on long-term strategic planning, executive compensation plan design, board succession planning, and similar matters would help investor fiduciaries implement impartiality obligations.

E. The Duty to Manage Costs

Put simply, wasting the money of participants and beneficiaries is imprudent. A fiduciary must be alert to balancing projected benefits against the likely costs when selecting and delegating duties to an agent, such as an investment advisor or manager.\textsuperscript{48} This duty involves exercising discretion, under the circumstances, with the care, skill, diligence, and prudence that similar investors use. It does

\textsuperscript{47} See Jim Hawley & Jon Lukomnik, The Long and Short of It: Are We Asking the Right Questions? Modern Portfolio Theory and Time Horizons, 41 Seattle U. L. Rev. 449, 450 (2018) (“[Modern Portfolio Theory (‘MPT’)] accepts that some risks are systemic and non-diversifiable: Those are the risks that contribute to beta. Those risks can be financial (e.g., global financial crisis), environmental (e.g., climate change), or social (e.g., income inequality or political stability), but the focus of MPT is to create an efficient mean-variance portfolio within that systematic risk framework by diversifying idiosyncratic risk (or as alpha seekers do, by seeking some idiosyncratic risks and avoiding others). The remaining systemic risk constitutes beta, and the investor is exposed to it. There is no consideration that investment decisions themselves—whether intentionally or accidentally—can affect systemic risk. It is a central point of our argument that while some risks are systemic and non-diversifiable, that does not suggest that they are immune from mitigation.”).

\textsuperscript{48} See UNIF. MGMT. OF PUB. EMP. RET. SYS. ACT § 6 (UNIF. LAW COMM’N 1997); UNIF. TRUST CODE § 805 (UNIF. LAW COMM’N 2010) (prescribing duties to fiduciaries tasked with management of trusts); RESTATEMENT (SECOND) OF TRUSTS § 188 (AM. LAW INST. 1957) (advocating for reasonableness standard to apply to fiduciary’s actions with regards to management).
not mandate selection of the lowest cost provider, as consideration of the net cost-benefit result over an appropriate time period with an acceptable level of risk is contemplated.

There are signs that industry standards for reasonable costs of engaging with agents or advisors to assist in implementation of proxy voting responsibilities are evolving. For example, Larry Fink recently announced his intent to double BlackRock’s staff allocated to corporate engagement and proxy voting.\(^\text{49}\) Knowledge about the collective role that investors can play in creation and management of systemic risks that influence long-term investment outcomes is growing.\(^\text{50}\) The availability of proxy advisors, new data sources, and investor collaboration networks also allows for greater efficiency through cost and work sharing.\(^\text{51}\) These cost management and service improvement opportunities must be considered by investor fiduciaries in order to fulfill their cost management obligations.

One practical implication of this is that most investor fiduciaries are essentially obligated to use proxy advisors and similar service providers in order to control costs and improve their ability to exercise informed proxy voting rights. Therefore, it would be imprudent for them to ignore these cost and work sharing opportunities.

That does not mean that the quality of services that agents and other entities provide in the proxy voting service chain cannot be improved. However, improved alignment of proxy voting with fiduciary duty principles would undoubtedly involve additional costs. It would require that investor fiduciaries conduct a prudent balancing of the related costs and benefits over an appropriate time period and with an acceptable level of risk. Use of such an evaluative process is their legal obligation.

II. THE FINANCIAL MATERIALITY OF ESG

A source of particular policy concern among members of the corporate community is that proxy advisors ISS and Glass Lewis often issued recommendations to vote yes on shareholder proposals raising ESG issues. A typical statement in comment letters regarding the SEC’s Proxy Roundtable, when discussing ISS and Glass Lewis advising “yes” on many ESG shareholder proposals, reads as follows: “Unfortunately, the voting recommendations flowing from the [proxy advisory] services have been shaped by incentives very

\(^{49}\) See Fink, supra note 14.

\(^{50}\) See generally Hawley & Lukomnik, supra note 47.

\(^{51}\) For example, efficiencies can be generated by proxy advisors and other entities or collaborations, like the Council of Institutional Investors (“CII”), Focusing Capital on the Long Term (“FCLTGlobal”), Institutional Investor Group on Climate Change (“IIGCC”), International Corporate Governance Network (“ICGN”), Principles for Responsible Investment (“PRI”), and numerous other entities. See Hale, supra note 42 (discussing benefits arising from Morningstar’s acquisition of Fund Star).
different from enhancing value for the shareholders and future pensioners who participate in the funds.”

Recent investment industry analyses have confirmed the financial materiality of much ESG information. For instance, a June 2017 Bank of America Merrill Lynch study highlighted by the Sustainability Accounting Standards Board found sustainability factors to be “strong indicators of future volatility, earnings risk, price declines, and bankruptcies.” Also in June 2017, Allianz Global Investors produced a research report with similar findings, concluding that the heightened transparency of ESG disclosure lowered companies’ cost of capital by reducing the “investment risk premium” that sophisticated investors would require. Additionally, in September 2017, Nordea Equity Research published an analytic research report concluding that there is “solid evidence that ESG matters, both for operational and share price performance.”

Goldman Sachs also concluded in April 2018 that “integrating ESG factors allows for greater insight into intangible factors such as culture, operational excellence and risk that can improve investment outcomes.”

These industry studies are consistent with, and indeed rely upon, a number of influential academic studies that have analyzed over two thousand research studies that show the economic materiality of ESG information. Two such studies are of particular note. First, Deutsche Asset & Wealth Management, in conjunction with researchers from the University of Hamburg, analyzed 2,250 individual studies of the relationship between ESG data and corporate financial performance. From this analysis, the researchers concluded that improvements

52 Letter from Benjamin Zycher to Brent J. Fields, supra note 3.


54 See Allianz Global Investors, Added Value or a Mere Marketing Tool? What Does ESG Mean For Investments? 2-4 (2017) (describing pursuit of ESG factors as contributing to enhancement of company management and investment returns).


in ESG performance generally lead to improvements in financial performance.\footnote{Id.} Second, a comprehensive review published in 2015 of empirical studies found that 90% of studies show that sound sustainability standards lower firms’ cost of capital, 80% of studies show that companies’ stock price performance is positively influenced by good sustainability practices, and 88% of studies show that better ESG practices result in better operational performance.\footnote{See Gordon L. Clark, Andreas Feiner & Michael Viehs, Univ. of Oxford & Arabesque Partners, From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance 3 (2015), https://arabesque.com/research/From_the_stockholder_to_the_stakeholder_web.pdf [https://perma.cc/HS3W-ZW6F]. This report is an excellent resource because it analyzes the empirical literature on the financial effects of sustainability initiatives by type of initiative (E, S, or G) and by various financial measures of interest (cost of debt capital, cost of equity capital, operating performance, and effect on stock prices). See generally id.}

What should be emphasized here is that not one of these industry letters is from a socially responsible investment (“SRI”) fund. Rather, over the last few years, mainstream asset managers have started to recognize what SRI funds have long known: ESG issues are often material economic issues. Even if not immediately translated into financial materiality, how managers handle ESG issues is often a good indication of the general quality of management. Therefore, ISS and Glass Lewis are not imposing their own political or moral views in suggesting positive votes on ESG shareholder proposals, as is often asserted by corporate critics. Rather, ISS and Glass Lewis are taking account of the improved understanding of the materiality of ESG issues, particularly with respect to long-term trends and company performance.

III. IMPLICATIONS FOR PROXY ANALYSES AND POLICIES

Despite criticism that most proxy analyses and proxy voting policies lack a basis of rigorous inquiry and consideration, most of these analyses and policies have actually been subject to in-depth consideration and research prior to being issued.

Nevertheless, many proxy advisor reports, investor fiduciary proxy voting policies, and practices for oversight of delegated proxy voting duties miss the mark by not adopting an analytical approach that provides for a full implementation of all fiduciary duties. The legal construct underlying many of these analyses, policies, and proxy voting oversight programs is heavily weighted toward static implementation of a retrospective duty of prudence (what have similar fiduciaries done), gives cursory attention to conflicts of interest, ignores systemic risks, and applies only a short-term horizon (one-to-two years) for identification and evaluation of issues. Compliance with other aspects of investor fiduciary duties is simply not addressed. This appears to be a widespread problem that could undermine the integrity of the proxy voting system and impede sustainable corporate performance.
Given that fiduciary duties are primarily process-oriented, the remedy for these shortcomings lies in modifications to the questions addressed, expertise applied, and processes used by proxy advisors, investment managers, and oversight fiduciaries. However, it should be recognized that fiduciary duties do not supply a preconceived answer—reasonable fiduciaries with varying liability structures, investment strategies, resources, and investment beliefs may reach different conclusions even when using similar up-to-date decision making processes. The focus should be on use of a forward-looking and prudent process that covers all relevant fiduciary principles.

For example, diligent and good faith attention to the following questions, where relevant, would improve alignment of proxy voting practices with investor fiduciary responsibilities:

- Are voting practices of similar fiduciaries changing on the issue, and if so, why? What credible research and data is there that supports or challenges these changing views? How do these voting trends relate to fact-based investment beliefs of the fiduciary whose shares are being voted?
- Does the vote have ramifications regarding material challenges, risks or opportunities that face the company and its industry over the long term? Have those issues been adequately addressed by the company? Does the matter involve tradeoffs between short-term and long-term concerns or between the effects of voting options on different generations of fund beneficiaries? If so, how can those divergent effects be fairly balanced?
- Does the vote involve a matter with material systemic risk or future harm implications that could spread across companies over time? If so, is the issue adequately addressed?
- Are there potential conflicts between the financial interests, business model, personal beliefs of the manager, advisor, or another intermediary involved in analyzing the issue or making a recommendation? If so, how have those conflicts been managed?

Adoption of a process that complies with the full range of investor fiduciary duties is likely to require allocation of additional resources to proxy voting

60 A “demonstrable partiality” standard, which offers guidance on how to provide assurance to beneficiaries that a fiduciary agent’s conflict of interest has not improperly influenced a decision, has been developed in the common law. See Paul B. Miller, Multiple Loyalties and the Conflicted Fiduciary, 40 Queen’s L.J. 301, 320 (2014) (“In order to demonstrate uncompromised loyalty, the conflicted fiduciary must show that her decisions were reasonably calculated to advance or protect the interests of the beneficiary. The demonstrable partiality standard calls upon the fiduciary to identify the reasons for which the decision was made (i.e., her basis for thinking that a decision would promote or secure the interests of the beneficiary) and to explain how those reasons influenced her course of conduct (i.e., to demonstrate the nexus between consideration of decision options and their projected impact on the beneficiary and subsequent decisions with respect to the exercise of fiduciary powers.”).
analyses, policy development, and oversight. For example, new personnel with different training and expertise might be needed to evaluate academic research and assess the systemic risk and long-term sustainability implications of voting decisions. The content and structure of vote recommendation reports, as well as proxy voting and manager voting oversight policies, might have to be revised. However, collaborative use of shared advisory services should provide a cost-effective means of securing the reduced risk, improving long-term returns and enhancing company sustainability benefits discussed above.

CONCLUSION

Shareholder voting is an essential corporate governance right under state law. It is an important channel of communication between shareholders and companies that supports governance balance between the board, shareholders, and management. Accordingly, integrity and alignment of the proxy voting process are critical investor fiduciary concerns.

Decisions on management of the proxy processes, service standards, and related costs for administration of proxy voting constitute investor fiduciary acts that should be linked with implementation of fiduciary obligations. Legal obligations of prudence, loyalty, and cost management are rooted in the common law of trusts and transcend the debates currently occurring at the federal level. Application of a twenty-first century understanding of these fiduciary duties serve as a guide for proxy voting policies, analyses, and reports.

The keys to improving alignment of proxy voting policies and practices with fiduciary duties include a greater focus by investor fiduciaries and their service providers on the analysis of:

- Evolution in knowledge, research findings and developments, which could lead trends in proxy voting;
- Oversight of how conflicts of interest in the proxy voting service provider and investment management chain are managed;
- Balance between the short- and long-term effects on different groups of fund beneficiaries over their investment time horizons;
- Aggregated influence of voting practices on systemic risks that can spread across portfolio companies and compound over time; and
- Cost-benefit considerations in management of proxy voting services.

We believe that greater attention to these fiduciary duty fundamentals could help drive an increase in company and investor performance over the long term, enhance sustainability, and encourage more effective management of systemic risks. This greater attention has implications for the content of proxy analyses,

---

61 Reduction of proxy rights at the federal level would restrict information flow to the board and could result in shareholders using election of directors as the remaining option for communicating on governance issues.

staffing of proxy voting functions, and structure of proxy policies, and may increase costs for proxy advisers and asset managers in the short term. However, both companies and investment fund beneficiaries are likely to benefit from improved alignment between proxy advising and voting with an up-to-date application of fiduciary duty principles.