

Gathering Strength: The Reinforcement of Fiduciary Responsibility for Proxy Voting

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Overview

For years the issue of fiduciary responsibility for proxy voting was mostly a distant blip on the radar of plan sponsor concerns. But in recent months we have noticed both a strengthening of interest in this issue, and a gathering of common regulatory momentum across such agencies as the DOL and SEC. It is difficult to predict the long run implications of these developments, but in the short run we believe that plan sponsors should carefully track this issue. We also recommend that plan sponsors take some basic steps to ensure that their plans are prepared for the new wave of proxy attention and controversy.

Not a New ERISA Issue

The issue of whether fiduciaries are responsible for voting proxies is not a new one. The Department of Labor has directly addressed the issue in advisory opinion letters dating back at least to the Avon Letter of 1988, and culminating in a 1994 Interpretative Bulletin that now appears far ahead of its time.

Avon Advisory Letter, 1988

In its "Avon Letter," the DOL explicitly connected the dots of plan assets, proxies, and fiduciary responsibility.

It may be useful at this point to highlight the two levels of proxy voting that impact plan sponsors. First, corporate proxies are voted by institutional and individual shareholders. At this level, the principal concern of plan sponsors is that fund managers are voting corporate proxies in a manner consistent with the interests of plan-participant-investors. Second, investment company proxies are voted by plan sponsors and other major fund investors. At the investment company level, plan sponsors vote directly. It is important that plan sponsors cast their votes in ways that benefit and/or defend the interests of plan participants.

The logic of the DOL's Avon letter rests on certain ERISA sections directly related to identity and responsibility of parties responsible for managing and operating a pension plan (sections 402, 403, 404 and 405); the Department summarized its position:

*"In general, the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock. For example, it is the Department's position that the decision as to how proxies should be voted with regard to the issues presented by the fact pattern are fiduciary acts of plan asset management ..."*¹

It is noteworthy that in this 1988 letter, the DOL also stated that named fiduciaries should monitor and document proxy voting:

"In this regard, this duty would encompass the monitoring of decisions made and actions taken by investment managers with regard to proxy voting. In this regard, it is the opinion of the Department that section 404(a)(1)(B) requires proper documentation of the activities of the investment manager and of the named fiduciary of the plan in monitoring the activities of the investment manager. Specifically, with respect to proxy voting, this would require the



investment manager or other responsible fiduciary to keep accurate records as to the voting of proxies.”¹

Monks Advisory Letter, 1990

Robert Monks wrote to the DOL in 1990, raising a number of questions about proxy policies, particularly those used by some investment companies “opt out” of voting proxies. In effect, these “opt out” policies resulted in a volleyball match between investment companies and plan administrators, with neither clearly responsible for proxy voting.

DOL responded directly to the concerns raised by Monks:

“If either the plan or the investment management contract (in the absence of a specific plan provision) expressly precludes the investment manager from voting proxies, the responsibility for such proxy voting would be part of the trustees’ exclusive responsibility to manage and control the assets of the plan.”²

Again, the Monks letter reinforced the requirements of fiduciaries to monitor and document proxy voting. In particular, the letter stated that fiduciaries must make reasonable steps to ensure that they receive all proxies for which it is their responsibility to vote, and that the fiduciary must be able to regularly review both the voting records and procedures of any investment company voting on their behalf.

Interpretive Bulletin (29 CFR 2509.94-2), 1994

In 1994 the DOL reinforced the positions it had described in its “Avon” and “Monks” letters, and clarified the documentation requirements that would satisfy the fiduciary responsibility for voting proxies. Although the matter received little attention at the time, this bulletin highlighted rather comprehensive documentation requirements. Fiduciaries were required to “maintain accurate records as to proxy voting,” including both voting records and procedures as well as “actions taken in individual proxy situations.”³

This bulletin also included a proxy policy provision that is mirrored in recent SEC rules on proxy disclosure. In this 1994 document, the DOL stated that “...a statement of proxy voting policy would be an important part of any comprehensive statement of investment policy.”³

New Urgency

As we noted in a recent white paper,⁴ the SEC recently announced new rules requiring mutual funds to disclose their proxy voting policies, and voting records. Fund companies are required to file the new “N-PX” form with the SEC by August 31, 2004. In addition to this new requirement specific to investment companies, the SEC also adopted a new rule requiring corporations to provide additional disclosure in proxy materials associated with the election of directors.

Because we have previously reviewed these developments, we will not retrace our steps here. But we would like to link our previous review to the topic at hand—**interest in proxy voting is growing, and the fiduciary responsibility to oversee proxy policy, voting, and documentation is likely to gain strength over the next few proxy seasons.**

Weathering the Changes

Proxy voting is clearly on the radar of DOL and SEC. Together with renewed proxy interest from shareholders, we expect much greater attention and scrutiny of fiduciary proxy procedures, voting and documentation. Finally, the next few proxy seasons are likely to be quite active, in both *corporate* and *investment company* arenas. In particular, all mutual funds will be required to meet the new SEC requirements for board independence (75% independent directors, and an independent chairman). These votes alone will crowd the investment company proxy card.



If there is a silver lining here, it may be that the new regulations provide plan sponsors with more information about how funds vote their proxies. Also, the SEC based its recent rule changes, at least in part, on the argument that the reform of mutual fund proxy voting may be one of the most powerful tools for reforming corporate governance. By extension, plan sponsors are well positioned to use their proxy votes to help support stronger governance and greater transparency.

We recommend that plan sponsors take the long-term perspective on the proxy voting issue, and position their plans to meeting ongoing requirements for thoughtful voting and documentation. Specifically, we recommend the following steps:

1. Review Basic ERISA Compliance: Using the 1994 DOL Interpretive Bulletin, check your plan to ensure that you are meeting the following basic criteria:
 - Clear documentation of proxy voting policy, including who is responsible for voting (investment company, plan sponsor or trustee)
 - Ensure that all proxies are being received for all investments that require proxy voting
 - Ensure that documentation is kept for all votes, and for the procedures used to make specific votes

2. Study Alignment of Fund Proxy Policies with Best Interests of Plan Participants: Beginning August 31, 2004, investment companies will submit their proxy policy and voting records to the SEC. Plan sponsors may check these “N-PX” form disclosures for the degree to which they line up with plan participant interests. Some examples of issues along which interests may not line up include:
 - Supermajority voting requirements
 - Executive compensation and accounting for options
 - Governance provisions (e.g., changing the size of the board)

3. Test Current Fund Proxy Policies against Actual Voting Records: It is noteworthy that mutual fund companies did not resist the disclosure of their proxy policies, but *vigorously* opposed the disclosure of their voting records. Since the SEC rule requires disclosure of both documents, plan sponsors can compare “words” to “actions.” Funds that consistently state one voting policy, but vote another, should be monitored carefully.

4. Beware the Shrinking Proxy Card: Although it may be difficult enough to keep up with what *does appear* on the proxy card, pension professionals should also watch for what may *not appear* on some proxy cards over time. This is not a concern in the immediate proxy season, as voting materials are already in the works. But we expect the pressures of public disclosure to lead some corporations to make greater use of “exclusion criteria” to prevent issues from making it to a proxy vote. A tug-of-war is likely at this first “gate” between more activist shareholders and more skittish boards.

The next few proxy seasons are going to be open to more sunlight. New disclosure requirements offer voters more information, and perhaps more opportunity to exert positive influence on corporate governance. But the next few proxy seasons also promise to be turbulent. This is a good time to ensure that pension plans and their named fiduciaries are ready for the rowdy weather ahead.



Endnotes

- ¹ Avon Advisory Letter, Department of Labor, 1988
- ² Monks Advisory Letter, Department of Labor, 1990
- ³ Department of Labor Interpretive Bulletin, 29 CFR 2509.94-2—“Interpretive bulletin relating to writing statements of investment policy, including proxy voting guidelines, July 29, 1994
- ⁴ Pension Consultants, Inc. White Paper Series, Paper 2, “N-PX and the new proxy landscape,” August 2004

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