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Fiduciary Governance Group Celebrates First Year

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April 10, 2019

Update on CITs & Thoughts on Proxy Voting

Patrick Green and John Baker discuss the SEC's recent decision to allow Puerto Rico-only plans to invest in collective trust funds; Sara Crovitz walks us through some of the issues and considerations of fund manager proxy voting

A More Consistent PROPosal – SEC Permits Puerto Rico-Only Plans to Invest in Collective Trust Funds, Aligning the SEC Relief Granted With Past IRS Guidance

by J. Patrick Green & John M. Baker

The Securities and Exchange Commission's ("SEC") staff has granted no-action relief stating that it will not recommend enforcement action if Puerto Rico-only plans ("PROPs") participate in collective trust funds.[1] The SEC staff has issued relatively few no-action letters with respect to collective trust funds in recent years, even as collective trust funds have become an increasingly popular vehicle.

A collective trust fund is a pooled investment vehicle for employee benefit plans. Unlike mutual funds and exchange-traded funds, a collective trust fund is regulated by bank regulators, not the SEC. These vehicles provide product design flexibility while typically offering substantially lower expenses than mutual funds, in no small part because of the regulatory and related expenses that they avoid. As a result, the popularity of collective trust funds has increased substantially in recent years. Collective trust funds are excluded from the definition of an investment company under the Investment Company Act of 1940 (the "1940 Act") so long as they are maintained by a bank and their participants

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are limited to employee benefit plans that meet the requirements for qualification under Section 401 of the Internal Revenue Code ("Code"), as well as governmental plans and church plans.

A PROP does not meet the requirements for qualification under Section 401 of the Code. The relief granted by the SEC staff in this letter effectively allows PROPs to participate in collective trust funds without the trust having to register under the 1940 Act, in reliance upon the exception for collective trust funds in Section 3(c)(11) of the 1940 Act.[2] The relief also makes it unnecessary to register the beneficial interests of the collective trust funds under the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act") in reliance upon exemptions under Sections 3(a)(2)[3] and 12(g)(2)(H)[4] of those Acts, respectively.

The no-action relief was requested by the John Hancock Stable Value Fund Collective Investment Trust (the "Trust"), a collective trust fund that seeks to invest in, among other things, other collective trust funds (the "Underlying Trusts"). Neither the Trust nor the Underlying Trusts intend to register with the SEC. To maintain its "unregulated" status, the Trust requires that any plan investing in it must be qualified pursuant to Section 401 of the Code.

Section 1022(i)(1) of ERISA provides that, for purposes of Section 501(a) of the Code, any trust forming part of a pension, profit-sharing or stock bonus plan all of the participants of which are residents of Puerto Rico is treated as an organization described under Section 401(a) of the Code and is therefore generally exempt from income taxation, provided that the trust 1) forms part of a pension, profit-sharing or stock bonus plan and 2) is exempt from income tax under the laws of Puerto Rico. Therefore, under ERISA, a PROP would be treated as an organization described in Section 401(a) of the Code, but the caveat is that it would still not legally be qualified under Section 401(a).

The Trust, like most collective trust funds, is taxed as a group trust under Revenue Ruling 81-100. Under Revenue Ruling 81-100, as amended, retirement plans, including retirement plans qualified under Section 401(a) of the Code, can pool their assets for investment purposes in tax-exempt group trusts so long as certain requirements are satisfied. The Trust at issue in this scenario received a determination letter from the IRS that the Trust is an 81-100 group trust. Under Revenue Ruling 2014-24, the IRS later ruled that PROPs may invest in 81-100 group trusts such as a collective trust fund without jeopardizing the fund's tax-exempt status.[5] This ruling acknowledged that PROPs are not legally qualified retirement plans under Section 401(a) of the Code.

However, even though PROPs were allowed by the IRS to invest in 81-100 group trusts such as the Trust at issue as a result of this ruling, this did not allow them to invest in collective trust funds that are not required to register with the SEC. Because PROPs are not legally qualified under Section 401 of the Code, the acceptance of such investments by the Trust implicated registration by the Trust and its beneficial interests under the federal securities laws absent no-action relief.

In the request for no-action relief for the Trust, it was argued that PROPs were "substantial[ly] equivalen[t]" to those qualified plans under Section 401(a) of the Code, and that to allow PROPs to invest in collective trust funds without jeopardizing their "unregulated" status from the federal securities laws would "foster consistency among the [federal] securities laws, ERISA and the Code, with the benefit of furthering the objectives behind the IRS's Revenue Ruling . . . and those underlying [Section] 1022(i)(1) of ERISA, as expressed in its legislative history." The Trust represented

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in its request letter that, if the SEC provided no-action assurance, it would maintain the following conditions: any PROPs that invest in the Trust would meet the tax exemption requirements under the Puerto Rico Code; the Trust, any PROP and any Underlying Trusts would be subject to the provisions of Title I of ERISA; the Trust and any Underlying Trusts, but for the acceptance of PROP assets, would qualify for the exception and exemptions from the federal securities laws; and the Trust and any Underlying Trusts would, at all times, remain in compliance with the terms of Revenue Ruling 81-100.

In response, the SEC staff stated that it would not recommend enforcement action to the Commission if PROPs participate in the Trust (and, by extension, the Underlying Trusts) without registration of the Trust or the Underlying Trusts under the 1940 Act, the 1933 Act or the 1934 Act. The staff was careful to state in a footnote that this no-action assurance applies solely to the eligibility of PROPs, and does not apply to any other category of tax-favored retirement plans or other asset class permitted to invest in 81-100 group trusts. However, the openness of the staff to the no-action request may bode well for collective trust fund sponsors that are interested in accepting other participants that do not meet the letter of the requirements of the securities laws, when a good case can be made that no-action relief is appropriate.

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[1] John Hancock Stable Value Fund, SEC No-Action Letter (March 25, 2019), https://www.sec.gov/divisions/investment/noaction/2019/john-hancock-stable-value-fund-032519-3c5a.

[2] Section 3(c) of the 1940 Act excepts various entities from the definition of "investment company" provided by Section 3(a) of the 1940 Act. Specifically, Section 3(c)(11) excepts from the definition "any employee's stock bonus, pension, or profit-sharing trust which meets the requirements for qualification under section 401 of the Internal Revenue Code of 1986. . . or any collective trust fund maintained by a bank consisting solely of assets of one or more of such trusts, government plans, or church plans . . . ."

[3] Section 3(a) of the 1933 Act provides various exemptions from registering an offering of a security with the SEC, including an exemption in Section 3(a)(2) for interests or participations in a collective trust fund maintained by a bank. Among other requirements for this exemption, for interests or participations issued in connection with a stock bonus, pension or profit-sharing plan, the plan must meet the requirements for qualification under Section 401 of the Code.

[4] Section 12(g)(2) of the 1934 Act exempts certain classes of securities from registration with the SEC. Section 12(g)(2)(H) specifically exempts "any interest or participation in any collective trust funds maintained by a bank . . . which interest or participation is issued in connection with (i) a stock-bonus, pension, or profit-sharing plan which meets the requirements for qualification under section 401 of the [Code] . . . ."

[5] Rev. Rul. 2014-24, 2014-2 C.B. 5.

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FUND PROXY VOTING: Looking Back to Look Forward

by Sara P. Crovitz

In recent years, the frequency of proxy contests at public companies has increased, focusing more attention on the way institutional investors decide how to vote their proxies. Issuer dissatisfaction with the role of proxy advisory firms in this decision-making process has been a steady drumbeat for decades. In part, public company issuers are understandably unhappy that there is not more competition; Institutional Shareholder Services Inc. ("ISS") and Glass Lewis dominate the market for providing proxy advisory services. The Securities and Exchange Commission ("SEC"), however, cannot regulate its way to requiring that additional players enter the market. Absent legislation, the question becomes what, if anything, the SEC can achieve under its current rulemaking authority or through SEC staff guidance. What action could help address public company issuer concerns without raising barriers to entry or otherwise negatively impacting competition for proxy advisory firms by increasing regulatory costs, which would undoubtedly be passed on to institutional investor clients? It is a complicated path strewn with the potential for unintended consequences.

This article describes the history of the issues around fund and asset manager use of proxy advisory firms in connection with fund proxy voting, highlighting how we got to where we are today. It then discusses some of the difficulties the SEC faces in moving forward with any additional regulation. Finally, it provides some practical considerations to fund directors and asset managers with regard to fund proxy voting in this uncertain time.

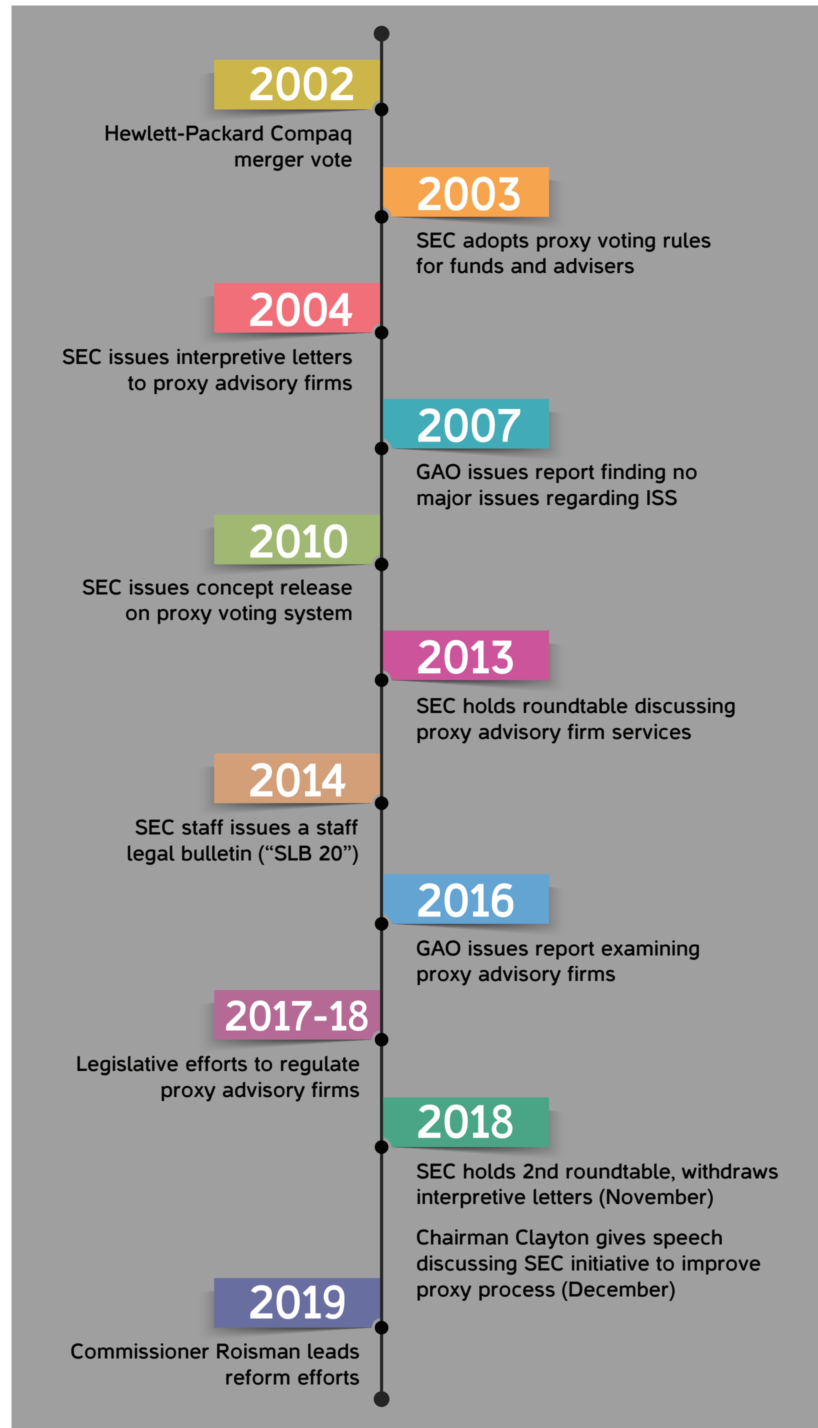
LOOKING BACK

SEC Proxy Voting Regulation and Staff Guidance

On March 19, 2002, shareholders narrowly approved a hotly contested shareholder vote on the merger between Hewlett-Packard and Compaq. Merger opponents alleged that a fund asset manager had switched its vote at the last minute to favor the merger after Hewlett-Packard executives threatened to lock its parent company out of future Hewlett-Packard investment banking business if it voted against the merger. A dissident director of Hewlett-Packard filed suit to block the merger, alleging Hewlett-Packard executives used corporate assets "to entice and coerce" the fund asset manager.[1] The SEC eventually settled an enforcement action against the asset manager, alleging that it had failed to disclose to its clients the existence of a material conflict in connection with its proxy vote.[2]

On the heels of this controversy, the SEC, under the leadership of then-Chairman Harvey Pitt, finalized proxy voting rules for both funds and advisers.[3] On the one hand, the rules were typical to the regulatory regime under the Investment Company Act of 1940 ("Investment Company Act") and the Investment Advisers Act of 1940 ("Advisers Act") in that the rules were disclosure-based and operated mainly through policies and procedures that could be adapted to a fund's or asset

manager's particular circumstances. Funds were required to disclose the policies and procedures they used to vote proxies and to disclose to shareholders the specific proxy votes the funds cast.[4] Advisers were required to maintain policies and procedures reasonably designed to ensure that the adviser voted proxies in the best interest of clients, including how the adviser addressed material conflicts.[5]



On the other hand, the Adviser Rule Release indicated that voting proxies was an explicit fiduciary duty of care: "The duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies."[6] While the SEC stated in the Adviser Rule Release that "we do not suggest that an adviser that fails to vote every proxy would necessarily violate its fiduciary obligations," it provided only one very limited exception to an adviser's duty to vote every proxy, namely voting on a foreign security as that could involve costs such as hiring a translator or traveling to a foreign country to vote in person.[7] The SEC also noted in the Adviser Rule Release that if an investment adviser had a conflict with regard to voting, one way to address that conflict would be to have a third party assist in determining how to vote: "[A]n adviser could demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, based upon the recommendation of an independent third party."[8]

A year or so later, certain proxy advisory firms asked the SEC staff to clarify how investment advisers could determine that a third party, like a proxy advisory firm, was, in fact, independent for purposes of Advisers Act rule 206(4)-6. The SEC staff issued two interpretive letters outlining that an

investment adviser could use a proxy advisory firm that itself had a conflict if the adviser determined that the proxy advisory firm "has the capacity and competency to adequately analyze proxy issues and can make such recommendations in an impartial manner and in the best interests of the adviser's clients."[9] In particular, the letters indicated that advisers should obtain information from the proxy advisory firm to make this determination and suggested that an adviser require the proxy advisory firm to disclose relevant facts relating to the conflict, whether that be on a case-by-case basis or on the basis of the proxy advisory firm's conflict procedures.

Within a couple of years, public company issuers began questioning proxy advisory firm's potential conflicts, particularly with regard to ISS, which had two services: providing reports about issuers and consulting services to corporations seeking to improve their corporate governance. Critics contended that issuers could feel obligated to retain ISS's consulting services in order to obtain favorable vote recommendations when ISS issued reports about that particular issuer.[10] Responding to requests from the House Committee on Financial Services, the Government Accountability Office ("GAO") issued a report in 2007 generally finding that, while ISS may have conflicts of interest, it discloses such conflicts, and, as a registered investment adviser, it has been subject to examination by the SEC staff, which had not identified any major issues.[11]

SEC Concept Release

In 2010, the SEC issued a concept release on the proxy voting system, noting that it had been almost 30 years since the SEC last conducted a comprehensive review of proxy voting issues and pointing to corporate and investor interest in promoting greater efficiency and transparency in the system.[12] The concept release sought comments as to whether the proxy system as a whole operated with the accuracy, reliability, transparency, accountability and integrity that investors and issuers should expect, and focused on issues such as over- and under-voting, vote confirmation, proxy voting in the context of securities lending, proxy distribution fees and issuers' ability to communicate with beneficial owners. As part of that release, the SEC suggested that proxy advisory firms may be investment advisers because part of their service is issuing reports about securities.[13] The SEC noted that, as fiduciaries, proxy advisory firms that were registered as advisers would have to disclose conflicts of interest to the institutional investors they advised.

Over the next few years, public companies and certain academics increasingly criticized proxy advisory firms, focusing on a perceived lack of sufficient resources, which led to errors in issuer reports, as well as reiterating prior criticism that certain proxy advisory firms suffered from misaligned incentives and conflicts. Critics also began to attack asset manager use of proxy advisory firms, including claims that, because of perverse incentives created by Advisers Act rule 206(4)-6 and the related interpretive letters, asset managers and funds outsourced decision making and blindly relied on proxy advisory firms.[14] For example, these critics pointed to data indicating that shortly after ISS would release a report on a public company issuer, a significant number of shares would

be voted in a lock-step manner.[15] The real concern, however, seemed to be the influence that proxy advisory firms have on shaping corporate policy.[16]

First SEC Roundtable and Staff Guidance

The SEC held a roundtable in 2013 that focused, in part, on the factors that had contributed to the use of proxy advisory firm services and the purposes such firms serve; conflicts of interest that may exist for proxy advisory firms and users of their services; the transparency and accuracy of the recommendations made by proxy advisory firms; and what the nature and extent of reliance by investors on proxy advisor recommendations was and should be. Not surprisingly, vastly different views were expressed by public companies, institutional investors and proxy advisory firms themselves.[17]

Following the roundtable, the SEC's Chairman and Commissioners continued to speak to issues around corporate governance.[18] In mid-2014, SEC staff from both the Division of Investment Management ("IM") and the Division of Corporation Finance ("CF") issued a staff legal bulletin that provided guidance about investment adviser responsibilities in voting client proxies and retaining proxy advisory firms ("SLB 20").[19] SLB 20 also provided guidance on the availability and requirements of two exemptions to the federal proxy rules that are often relied upon by proxy advisory firms. In particular, IM staff reiterated positions from the interpretive letters that investment advisers, in determining whether to retain or continue using a proxy advisory firm, should conduct due diligence to ensure that the adviser, acting through the proxy advisory firm, continued to vote in the best interests of its clients. In addition, IM staff clarified that an investment adviser and its clients may agree to arrangements whereby the adviser would not vote every proxy. In addition, CF staff made clear that, if a proxy advisory firm relied on certain exemptions from the federal proxy rules and therefore was required to disclose a significant relationship or material interest, that disclosure must be sufficient for the recipient to understand the nature and scope of the relationship or interest, including the steps taken to mitigate the conflict of interest, such that the recipient could make an assessment about the objectivity of the recommendation. In other words, the proxy advisory firm must make more than a boilerplate disclosure regarding the conflict of interest.

In 2016, in response to issues raised by some members of Congress, industry associations and academics, the GAO issued another report that examined proxy advisory firms' influence on voting and corporate governance, the level of transparency in their methods and the level of regulatory oversight with regard to such methods.[20] The GAO interviewed various stakeholders, including public company issuers, institutional investors and proxy advisory firms. The GAO report reflected varying views, but it contained no recommendations.

In the last couple of years, there have been legislative efforts to address issues raised about proxy advisory firms. In 2017, the House of Representatives passed H.R. 4015, but it was not taken up by the Senate.[21] H.R. 4015, which was in many ways similar to the Credit Rating Agency Reform Act of 2006, would have, among other things, required proxy advisory firms to register under the Securities Exchange Act of 1934, disclose potential conflicts of interest and codes of ethics and make public their methodologies for formulating recommendations. Most importantly, H.R. 4015 would have required proxy advisory firms to provide access, in a reasonable amount of time, to a draft report on a public company issuer, including data, analysis and the proposed recommendation, to the public company issuer before sending the report to their institutional investor clients; if the public

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company issuer objected to the analysis and the objection could not be resolved, H.R. 4015 would have required that the public company issuer's objection and rebuttal be included in the report.[22] More recently, a bipartisan bill was introduced by six Senators in November 2018, which would have required that all proxy advisory firms register as investment advisers, that the SEC conduct periodic inspections of proxy advisory firms, that the SEC submit periodic reports to Congress evaluating the policies and procedures at proxy advisory firms and that the SEC continue to examine whether additional investor protection regulation is necessary.[23]

Second SEC Roundtable

In November 2018, the SEC held a second roundtable. In advance of that roundtable and "to facilitate the discussion," IM staff withdrew the two interpretive letters.[24] The staff did not withdraw SLB 20, which, as discussed earlier, reiterated positions in the interpretive letters. While there was little discussion of the interpretive letters at the roundtable, it is noteworthy that no one at the roundtable strongly supported additional regulation for proxy advisory firms.[25]

Although not directly related to fund use of proxy advisory firms, another important conversation taking place around fund voting relates to the "common ownership" theory expounded by certain academics. This theory posits that index funds and index ETFs have perverse incentives because they seek only to match the performance of an index (rather than over-perform) and will use their vote to induce portfolio company management to reduce intra-industry competition, thereby harming the portfolio company's other shareholders. Some academics that subscribe to this theory have argued that passive funds should not be permitted to vote or should have to pass voting to fund shareholders.[26] While the asset management industry and certain other academics have criticized the common ownership theory,[27] it has caught the attention of regulators globally,[28] and its potential impact on fund voting cannot be ignored in the debate around fund voting and the use of proxy advisory firms.

LOOKING FORWARD

On December 6, 2018, SEC Chairman Clayton gave a speech during which he discussed significant initiatives for 2019, including SEC action to improve the proxy process.[29] The Chairman recognized the consensus view that proxy "plumbing" (i.e., issues raised by the 2010 Concept Release around proxy voting mechanics such as over- and under-voting, accuracy and transparency in voting and issuer communication with beneficial owners) needs a major overhaul, and he appeared to endorse consideration of changes to the ownership and resubmission thresholds for shareholder proposals. Specifically with respect to proxy advisory firms, he also indicated that the SEC should consider: (1) "the division of labor, responsibility and authority between proxy advisors and the investment advisers they serve"; (2) "clarity regarding the analytical and decision-making processes advisers employ, including the extent to which those analytics are company- or industry-specific"; (3) "the framework for addressing conflicts of interest at proxy advisory firms"; and (4) "ensuring that investors have effective access to issuer responses to information in proxy advisory firm reports." Subsequently, the Chairman asked SEC Commissioner Roisman to lead efforts to improve the proxy voting process and infrastructure.[30]

While there is general agreement that improvements are needed with regard to the proxy voting process, there is no consensus around issues related to fund adviser and other institutional investor

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use of proxy advisory firms. While these issues have been discussed and debated for years, and while the SEC staff has made efforts to address at least some aspects of these issues, the SEC's efforts have not stopped the criticism. Public company issuers believe ISS and Glass Lewis have too much power over public company governance. Asset managers believe that their use of proxy advisory firms, whether for administrative processing of votes, research reports, assistance with custom guidelines, or otherwise, is appropriate.

The SEC faces significant hurdles to moving forward with any rules or regulations. First is the issue of bandwidth. Issues specifically related to proxy voting are on the long-term actions (as opposed to active list) on the recent Regulatory Flexibility Agenda, and the Chairman has spoken publicly, including in his December 6, 2018 speech, about his intent to focus the agenda on rulemakings that the Commission can reasonably complete. Moreover, in addition to issues around proxy advisory firms, there are a number of other proxy-related issues (e.g., proxy voting mechanics and issues around shareholder proposals). All of these issues have the potential to be complicated and controversial, and stakeholders with strongly held views will likely challenge any rules or regulation from different perspectives. In addition, the SEC is subject to significant regulatory requirements to justify regulation on cost-benefit grounds.[31] For all of these reasons, the SEC faces a difficult road ahead in taking action to significantly improve the situation for all interested parties in 2019.

PRACTICAL CONSIDERATIONS

Funds and their advisers cast a large number of votes on public company proxies in a short proxy season.[32] This section highlights some background on proxy voting, including common proxy voting structures and processes and practical considerations for fund boards and advisers.

KEY TAKEAWAYS

- **A fund's board has certain responsibilities concerning proxy voting.**
- **Proxy voting policies should be reviewed and refreshed periodically.**
- **Consideration should be given to how conflict situations will be identified and addressed.**

Fund Boards

As the SEC stated in the adopting release to the Fund Rule Release in 2003, a fund's board of directors or trustees (the "board") has the right to vote proxies for the fund.[33] The SEC recognized, however, that most boards delegate responsibility to the fund's investment adviser subject to board oversight.[34] The board retains responsibility for overseeing the processes put in place by the adviser.[35]

The board also must approve and annually review the adequacy of a fund's policies and procedures as part of the fund's compliance program. Some boards adopt a separate fund policy while others determine to rely on the fund adviser's policy.[36] If relying on the fund adviser's policy, the board should understand the process the adviser uses to determine when it has a conflict, how the adviser's process addresses conflicts (e.g., use of committees, firewalls or third-party service providers) and how the adviser will disclose conflicts to the board or otherwise provide appropriate reporting to the board.

Fund Advisers

Advisers that have been delegated authority for the administrative process of voting or delegated voting authority may engage in different practices with regard to the use of proxy advisory services. Larger asset managers may have sufficient in-house resources and staff to conduct research on proxy votes and address conflicts (i.e., by having separate governance staff), such that they do not rely on proxy advisory firms' recommendations at all. Most advisers, however, use proxy advisory firms for at least some of the following services:

- **Administrative services**. An adviser could be responsible for thousands of votes per year for registered investment companies. Advisers may engage proxy advisory firms to assist in the mechanical processing of proxy votes, similar to how advisers engage other service providers for operational functions. This might include data tracking and administration as well as workflow management processes. For example, an adviser could use a proxy advisory firm to provide notifications and reminders of upcoming proxy votes; provide coverage and translation services with respect to foreign issuers; communicate voting recommendations and rationales; execute voting instructions; record and report proxy voting records; and prepare and/or file Form N-PX for funds.

- **Research and analytics.** An adviser may receive research from proxy advisory firms to use as an input to the adviser's own decision making. Advisers may choose to receive information based on standard benchmark policies or more specific policies.

- **Using proxy advisory firm recommendations**. Proxy advisory firms may offer vote recommendations based on their own guidelines that the adviser takes into account in its own decision-making process. Smaller asset managers may vote proxies in line with a proxy advisory firm's recommendations subject to the asset manager's override.

- **Using a proxy advisory firm to help draft guidelines**. Some advisers use a proxy advisory firm to help draft or update their own voting guidelines, especially in areas where the adviser lacks expertise.

As a fiduciary to the funds it advises, an adviser must address conflicts consistent with Advisers Act rule 206(4)-6. A fund adviser with voting authority must adopt and implement policies and procedures reasonably designed to ensure that it votes proxies in the best interest of the funds it advises, and those policies and procedures must address material conflicts that may arise between the interests of the adviser and the funds it advises.

To address these fiduciary responsibilities, there are a number of methods that advisers use, some of which involve proxy advisory firms:

- **Creating a predetermined voting policy**. This effectively limits the adviser's own voting discretion on individual votes. A predetermined policy may not always be sufficient as the adviser may have valid (i.e., non-conflict related) reasons to deviate from the policy, or the policy may not cover every possible situation. An adviser therefore may wish to consider appointing a committee or designating particular personnel who otherwise are not involved in the proxy voting process to help determine how such matters should be voted.

- Use of a proxy advisory firm. Just as it would for any service provider, an adviser should conduct due diligence before retaining a proxy advisory firm and continue to monitor the proxy advisory firm's services.[37]

Given the current focus on adviser use of proxy advisory firms, advisers should review their policies and procedures relating to proxy voting, including how they evaluate and use proxy advisory firms' services, and particularly in circumstances where a proxy vote relates to more controversial proposals.[38]

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[1] Chris Gaither, Hewlett Heir Files Lawsuit to Overturn Merger Vote (https://www.nytimes.com/2002/03/29/business/hewlett-heir-files-lawsuit-to-overturn-merger-vote.html), NY Times (March 29, 2002).

[2] Deutsche Asset Management, Inc., Advisers Act Release No. 2160 (https://www.sec.gov/litigation/admin/ia-2160.htm) (Aug. 19, 2003) (SEC alleged that the asset manager failed to disclose a material conflict, namely that its parent was working for Hewlett-Packard on the merger and had intervened in the asset manager's proxy voting process on behalf of Hewlett Packard). See also U.S. Gov't Accountability Office, GAO-04-749, Additional Transparency and Other Actions Needed in Connection with Proxy Voting (https://www.gao.gov/new.items/d04749.pdf) (2004) (recommending changes to ERISA and DOL action).

[3] See Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies (https://www.sec.gov/rules/final/33-8188.htm), Investment Company Act Release No. 25922 (Jan. 31, 2003) (the "Fund Rule Release"), and Proxy Voting by Investment Advisers, Advisers Act Release No. 2106 (https://www.sec.gov/rules/final/ia-2106.htm) (Jan. 31, 2003) (the "Adviser Rule Release").

[4] See Investment Company Act rule 30b1-4 and form N-PX.

[5] See Advisers Act rule 206(4)-6. In addition, Advisers Act rule 206(4)-6 requires an adviser to disclose to its clients information about the policies and procedures and to disclose to clients how they may obtain information on how the adviser has voted proxies.

[6] See Adviser Rule Release, supra note 3.

[7] Id.

[8] Id.

[9] Egan-Jones Proxy Services (pub. avail. May 27, 2004); Institutional Shareholder Services, Inc. (pub. avail. Sept. 15, 2004).

[10] Some also have contended that Glass Lewis's ownership by the Ontario Teachers' Pension Plan Board raises conflicts. See, e.g., Chamber of Commerce Comment Letter to the SEC (http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/2012-5.30-Glass-Lewis-letter-release.pdf) (May 30, 2012) (alleging that its activist owner influenced Glass Lewis's recommendation to oppose the board of directors for a Canadian railway in a proxy battle with an activist hedge fund). Both ISS (https://www.issgovernance.com/compliance/due-diligence-materials/?_sm_au_=iVVJkpn0nJ5tN7WP) and Glass Lewis (http://www.glasslewis.com/conflict-of-interest/?_sm_au_=iVVJkpn0nJ5tN7WP) publicly disclose information about their respective conflicts of interest.

[11] U.S. Gov't Accountability Office, GAO-07-765, Issues Relating to Firms that Advise Institutional Investors on Proxy Voting (https://www.gao.gov/new.items/d07765.pdf) (2007). The GAO report contained no recommendations.

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[12] Concept Release on the U.S. Proxy System, Investment Company Act Release No. 29340 at 109 (https://www.sec.gov/rules/concept/2010/34-62495.pdf) (Jul. 14, 2010) ("Concept Release"). See also, Mary L. Schapiro, Chairman, Remarks at the National Conference of the Society of Corporate Secretaries and Governance Professionals (https://www.sec.gov/news/speech/2010/spch070910mls.htm) (Jul. 9, 2010).

[13] As indicated, ISS already had been registered as an investment adviser, but certain other proxy advisory firms, such as Glass Lewis, had not registered.

[14] See, e.g., James K. Glassman & J. W. Verret, How to Fix our Broken Proxy Advisory System (https://www.mercatus.org/publication/how-fix-our-broken-proxy-advisory-system), Mercatus Ctr. at George Mason Univ. (April 16, 2013) ("How to Fix our Broken Proxy Advisory System"), ("Unfortunately, the rule became a classic case of unintended consequences. Many institutional investors largely outsourced their shareholder voting policies to a proxy advisory industry that relies on precisely the type of 'one-size-fits-all' policies that were intentionally excluded from the original regulation because of objections by commissioners. The SEC staff interpretation of the rules on proxy voting have led to the opposite result of what many of its supporters intended."). See also, Daniel M. Gallagher, Commissioner, Remarks at Society of Corporate Secretaries & Governance Professionals (https://www.sec.gov/news/speech/spch071113dmghtm#.UpEMPHcgqSo)," (July 11, 2013), ("Given the sheer volume of votes, institutional shareholders, particularly investment advisers, may view their responsibility to vote on proxy matters with more of a compliance mindset than a fiduciary mindset. Sadly, the Commission may have been a significant enabler of this [through rule 206(4)-6 and the interpretive letters]"). But see Stephen Choi, Jill Fisch & Marcel Kahan, Who Calls the Shots? How Mutual Funds Vote on Director Elections, 3 Harv Bus L. Rev. 35 (2013) (finding a substantial degree of divergence in fund voting from ISS recommendations).

[15] See IBM Comment Letter on the Concept Release (https://www.sec.gov/comments/s7-14-10/s71410-84.pdf) (Oct. 15, 2010), (institutional investors vote in a lock-step manner (i.e., 100% in accordance) with the ISS recommendation). See also Morris Mitler, Sean Collins & Dorothy Donohue, Funds and Proxy Voting: Funds Vote Thoughtfully and Independently (https://www.ici.org/viewpoints?tag=Proxy%20Voting) (Nov. 7, 2018), (in 2017, while funds voted in lock-step with ISS recommendations on proposals submitted by management, which tend to be routine business matters, that correlation breaks down when funds vote on shareholder proposals, which tend to be much more debated).

[16] "To a large degree, corporate directors and executives are now subject to decision making on critical issues by organizations that have no direct stake in corporate performance and make poor decisions as a result. Conscientious shareholders, who do have such a stake, also suffer because their votes are usurped or overwhelmed by these same organizations. The SEC's proxy policy rules have led to results unimagined by their original advocates." How to Fix our Broken Proxy Advisory System, supra note 14.

[17] The Commissioners themselves disagreed on the extent of any problems. For example, Commissioner Gallagher strongly sided with corporate interests, arguing for the need for "Commission guidance clarifying to institutional investors that they need to take responsibility for their voting decisions rather than engaging in rote reliance on proxy advisory firm recommendations would go a long way toward mitigating the concerns arising from the outsized and potentially conflicted role of proxy advisory firms" supra note 14. Chair White indicated that proxy advisory firms play an important role in assisting institutional investors and stated that she was "particularly interested in the discussion of conflicts of interest that may or may not arise in connection with the participation of proxy advisors in our system." Mary J. White, Chairman, Welcoming Remarks at Proxy Advisory Services Roundtable (https://www.sec.gov/spotlight/proxy-advisory-services/proxy-advisory-services-transcript.txt) (Dec. 5, 2013).

[18] See, e.g., Mary Jo White, Chairman, Completing the Journey: Women as Directors of Public Companies (https://www.sec.gov/news/speech/2014-spch091614-mjw) (Sept. 16, 2014), (encouraging greater diversity in public company boards); Kara M. Stein, Commissioner, Remarks to the Council of Institutional Investors (https://www.sec.gov/news/speech/2014-spch050814kms) (May 8, 2014), (SEC should consider permitting, if not mandating, universal proxy ballots and clarifying process for evaluating issuer no-action requests to

exclude shareholder proposals); Luis A. Aguilar, Commissioner, Looking at Corporate Governance from the Investor's Perspective (https://www.sec.gov/news/speech/2014-spch042114laa.html) (Apr. 21, 2014), (examining three fundamental principles of an effective corporate governance regime – accountability, transparency and engagement – in the context of the executive compensation process); Michael S. Piwowar, Commissioner, Advancing and Defending the SEC's Core Mission (https://www.sec.gov/news/speech/2014-spch012714msp) (Jan. 27, 2014), (the SEC should "move forward with initiatives to curb the unhealthy over-reliance on proxy advisory firm recommendations"); and Daniel M. Gallagher, Commissioner, Remarks to the Forum for Corporate Directors (https://www.sec.gov/news/speech/2014-spch012413dmg) (Jan. 24, 2014), ("Proxy advisory firms have gained an outsized role in corporate governance, both in the United States and abroad.").

[19] SEC Staff Legal Bulletin No. 20 (https://www.sec.gov/interps/legal/cfslb20.htm) (June 30, 2014).

[20] U.S. Gov't Accountability Office, GAO-17-47, Proxy Advisory Firms' Role in Voting and Corporate Governance Practices (https://www.gao.gov/assets/690/681050.pdf) (2016).

[21] See H.R. 4015, 115th Cong. (https://www.congress.gov/bill/115th-congress/house-bill/4015/text) (2017)

[22] Id. While the legislation defined a "reasonable time" to be one that did not interfere with the proxy advisory firm's ability to provide the report to its institutional investor client, it is not clear how this process would be possible given the tight timelines during the proxy season.

[23] S. 3614, 115th Cong. (https://www.congress.gov/bill/115th-congress/senate-bill/3614/text) (2018) The legislation appears to have been intended to deny Glass Lewis the ability to rely on the publisher's exclusion from registration as an investment adviser as it specifically states that a proxy advisory firm may not rely on section 202(a)(11)(D) of the Advisers Act.

[24] See Statement Regarding Proxy Advisory Letters (https://www.sec.gov/news/public-statement/statement-regarding-staff-proxy-advisory-letters) (Sept. 13, 2018).

[25] See, e.g., Adam Kokas, Exec. Vice President, General Counsel and Sec'y, Atlas Air Worldwide, Remarks at U.S. SEC Roundtable on the Proxy Process (https://www.sec.gov/files/proxy-round-table-transcript-111518.pdf) (Nov. 15, 2018).

[26] See, e.g., Dorothy Shapiro Lund, The Case Against Passive Shareholder Voting, Coase-Sandor Working Paper Series in Law and Economics 846 (https://chicagounbound.uchicago.edu/law_and_economics/846/) (2017); and José Azar, Martin C. Schmalz & Isabel Tecu, Anticompetitive Effects of Common Ownership (http://www.utahwfc.org/uploads/2015_10b.pdf) (Jan. 30, 2015).

[27] See, e.g., BlackRock Index Investing and Common Ownership Theories (https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-index-investing-and-common-ownership-theories-eng-march.pdf) (Mar. 2017); Daniel P. O'Brien & Keith Waehrer, The Competitive Effects of Common Ownership: We Know Less Than We Think, 81 Antitrust L. J.l No. 3 (Feb. 2017); Pauline Kennedy, Daniel P. O'Brien, Minjae Song & Keith Waehrer, The Competitive Effects of Common Ownership: Economic Foundations and Empirical Evidence (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3008331) (July 2017).

[28] The Federal Trade Commission held a hearing (https://www.ftc.gov/news-events/events-calendar/ftc-hearing-8-competition-consumer-protection-21st-century) addressing common ownership in December 2018. A European Parliament member recently told the Financial Times that "[t]he effects of [large passive funds] have to be taken into account and regulated," and the European Competition Commissioner has been looking into issues since December 2018. See Siobhan Riding, Brussels targets large index fund managers on "common ownership" (https://www.ft.com/content/0308f2e2-9e4a-34bf-b40b-745e62a536bb) (Jan. 21, 2019). The OECD held a hearing (http://www.oecd.org/daf/competition/common-ownership-and-its-impact-on-competition.htm) on common ownership in December 2017.

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[29] Jay Clayton, Chairman, SEC Rulemaking Over the Past Year, the Road Ahead and Challenges Posed by Brexit, LIBOR Transition and Cybersecurity Risks (https://www.sec.gov/news/speech/speech-clayton-120618) (Dec. 6, 2018).

[30] Elad L. Roisman, Commissioner, Brief Statement on Proxy Voting Process: Call with the SEC Investor Advisory Committee (https://www.sec.gov/news/public-statement/statement-roisman-020619) (Feb. 6, 2019).

[31] See, e.g., Division of Risk, Strategy and Financial Innovation and the Office of the General Counsel, Current Guidance on Economic Analysis in SEC Rulemakings (https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf) (March 16, 2012).

[32] Recent data published by the Investment Company Institute indicates that during the 2017 proxy season, funds cast more than 7.6 million votes for proxy proposals. See Mitler, Collins & Donohue, supra note 15.

[33] "Because a mutual fund is the beneficial owner of its portfolio securities, the fund's board of directors, acting on the fund's behalf, has the right and the obligation to vote proxies relating to the fund's portfolio securities." See Fund Rule Release, supra note 3.

[34] "As a practical matter, however, the board typically delegates this function to the fund's investment adviser as part of the adviser's general management of fund assets, subject to the board's continuing oversight." Id.

[35] A board's oversight is subject to its general fiduciary duty, and the "business judgment" rule should apply so long as the board has exercised reasonable judgment and not put its interests above those of the fund and its shareholders.

[36] Fund boards that rely on the adviser's policy and procedures should conduct a periodical review to determine the continued appropriateness of such policy and procedures.

[37] The SEC staff in SLB 20 suggested good practices for an adviser to consider with regard to retaining the services of a proxy advisory firm and in determining whether to maintain such services. With regard to initial retention, the SEC staff suggested an adviser diligence the adequacy and quality of the proxy advisory firm's staffing and resources and examine the robustness of its policies and procedures with regard to, for example, conflicts. With regard to maintaining such services, the SEC staff suggested, for example, periodically sampling proxy votes to determine if they are consistent with the adviser's policy and procedures and having a process to investigate any material factual errors identified that formed the basis of a recommendation.

[38] For example, many advisers include in their proxy voting guidelines that the adviser will make a case-by-case determination for more controversial proposals rather than having a proxy advisory firm vote according to a pre-determined guideline.

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Media

ESG from a Fiduciary Perspective

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Investing According to Environmental, Social, and Governance Mandates

By George Michael Gerstein, Esq.[*]

ESG INVESTING OVERVIEW

Investment decisions that take into account environmental, social, and/or governance (ESG) risks will likely grow in prominence and prevalence over the coming years. This means that, with the increased attention given to ESG in today's markets, fiduciaries of private and public retirement plans are appreciating both the investment opportunities, and fiduciary duty risks, that lie ahead. ESG investing can broadly be described as a strategy to incorporate ESG factors into the investment process. These factors may be viewed as a source of material investment risk or return on investment. ESG may also be pursued in order to further non-investment performance reasons, which has been the historical approach to ESG investments. It can be said that, "gone are the days when ESG investing consisted primarily of either screening out, or divesting, of certain issuers/sectors because they did not meet some moral or other non-economic test," because "today's ESG is much more driven by data linking one or more ESG factors and investment performance."[1]

ESG as a hard-nosed, data-driven investment strategy is of somewhat recent vintage. Historically, institutional investors targeted "sin stocks," such as tobacco and alcohol, primarily out of moral outrage. This practice can be referred to "socially responsible investing" and has spurred values-based funds. Divestment, a form of exclusionary investing, has also long been a practice associated with ESG. Perhaps the most famous example of divestment was during the 1980s when many investors sold positions in South African companies during apartheid.

Interest in ESG strategies and products has grown considerably because there is greater understanding of how various E, S, and G issues can affect investment performance.

Terminology

Admittedly, there is fairly widespread confusion over what ESG means and which factors technically fall under the ESG umbrella. Under some definitions, upwards of 40 different environmental, social, and governance issues can be considered "ESG factors." Part of any fiduciary's consideration and implementation of ESG strategies is a clear understanding of the terminology. Unfortunately, that clarity does not yet (completely) exist, though the following definitions may be helpful:

- **Environmental (E) factors.** Issues or facts related to the natural environment, such as climate change, carbon emissions, waste management, recycling, energy, biodiversity, pollution, and conservation.
- **Social (S) factors.** Issues or facts related to human relations of an issuer (e.g., a corporation or country), such as employee relations, community relations, board diversity, human rights, demography, food security, poverty/inequality, child labor, and health and safety.
- **Governance (G) factors.** Issues or facts related to the governance of an issuer, such as executive compensation, board structure, shareholder rights, bribery, corruption, and cybersecurity.

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[1] George Michael Gerstein, *A Fiduciary's Retrospective (and Predictions for 2019)*, Fiduciary Governance Blog (Jan. 7, 2019).

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Many also wonder how "ESG investing" differs from "impact investing," "socially responsible investing," and "sustainable investing." Ultimately, these terms and approaches differ by the degree to which they emphasize E, S, and/or G factors **and** the rationale for why those factors are included.

Impact investing. The selection of investments in respect of an ESG factor where the **primary** purpose is for non-investment performance reasons, such as the promotion of an ESG public policy, and a **secondary** purpose is to enhance portfolio return or reduce portfolio risk.

Responsible investing. The selection of investments where (1) the **primary** purpose is for non-investment performance reasons, namely the promotion of a governance-related (G) factor (see above), and a **secondary** purpose is to enhance portfolio return or reduce portfolio risk **or** (2) the **exclusive** purpose is for one or more non-investment performance reasons, namely the promotion of a G factor.

Socially responsible investing. The selection of investments where (1) the **primary** purpose is for non-investment performance reasons, namely the promotion of a social-related (S) factor (see above), and a **secondary** purpose is to enhance portfolio return or reduce portfolio risk **or** (2) the **exclusive** purpose is for one or more non-investment performance reasons, namely the promotion of an S factor.

Sustainable investing. The selection of investments where (1) the **primary** purpose is for non-investment performance reasons, namely the promotion of an environmental-related (E) factor (see above), and a **secondary** purpose is to enhance portfolio return or reduce portfolio risk **or** (2) the exclusive purpose is for one or more non-investment performance reasons, namely the promotion of an E factor.

Thematic investing. The utilization of negative screening, positive screening, integration, and/or engagement (as defined below) to invest in issuers that share a common ESG purpose, industry, or product.

ESG investing. Can broadly be defined to include each of these strategies and approaches, as further refined below.

ESG APPROACHES

Major ESG Approaches

With an understanding of key ESG terminology, the fiduciary can proceed to consider the additional ways that ESG factors can become part of an investment process. The major ESG approaches include:

- **Exclusionary (negative) screening.** Avoiding the purchase of prospective investments, or divesting from existing investments, on the basis of such investments not meeting a designated ESG standard, rating, or requirement where (1) the **exclusive** purpose is to enhance portfolio return or reduce portfolio risk, (2) the **primary** purpose is for non-investment performance reasons, such as the promotion of an ESG public policy, and a **secondary** purpose is to enhance portfolio return or reduce portfolio risk **or** (3) the **exclusive** purpose is for one or more non-investment performance reasons, such as the promotion of an ESG public policy.
- **Positive Screening.** Selecting investments on the basis of meeting a designated ESG standard, rating, or requirement where (1) the **exclusive** purpose is to enhance portfolio return or reduce portfolio risk, (2) the **primary** purpose is for non-investment performance reasons, such as the promotion of an ESG public policy, and a **secondary** purpose is to enhance portfolio return or reduce portfolio risk **or** (3) the **exclusive** purpose is for one or more non-investment performance reasons, such as the promotion of an ESG public policy.
- **Integration.** Incorporating ESG-related data and/or information in respect of an ESG factor into the usual process when making an investment decision where such data or information is material to investment performance **and** where the **exclusive** purpose is to enhance portfolio return or reduce portfolio risk.
- **Engagement.** Exercising one or more rights of a holder of interests in an issuer, such as proxy voting, introducing resolutions, or participating in formal or informal meetings with the issuer board, in respect of an ESG factor where (1) the **exclusive** purpose is to enhance portfolio return or reduce portfolio risk, (2) the **primary** purpose is for non-investment performance reasons, such as the promotion of an ESG policy, and a **secondary** purpose is to enhance portfolio return or reduce portfolio risk **or** (3) the **exclusive** purpose is for one or more non-investment performance reasons, such as the promotion of an ESG policy.[2]

Growth in ESG Investing

Interest in and development of investment products, services, and data related to ESG has grown over the

[2] George Michael Gerstein, An ESG Proposal For You, Fiduciary Governance Blog (Oct. 17, 2018).

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past decade or so on a seemingly exponential basis. This holds true across investor type, asset class, and country (to various degrees). By some accounts, approximately $30 trillion in global assets take into account ESG factors.[3]

Role of Fiduciaries in ESG Investing

Fiduciaries of plans subject to the Employee Retirement Income Security Act of 1974 (ERISA) should consider their fiduciary duties set forth in ERISA §404, and applicable Department of Labor (DOL) guidance on the interplay of fiduciary duties and ESG investing. Similarly, fiduciaries of governmental plans should evaluate their fiduciary duties and any specific ESG-related restrictions and requirements set forth in the state constitution and applicable statutes and/or regulations. While the discussion that follows is focused on ERISA, governmental plan fiduciaries will also benefit from these insights.

> **Practice Tip:** Fiduciaries should be mindful of how they can satisfy their duties of loyalty, prudence, and diversification when taking ESG factors into account in investment decisions. It is also important for fiduciaries to confirm that ESG investing does not violate plan documents, such as an Investment Policy Statement (IPS) or the plan's proxy voting policy, if any.

FIDUCIARY RESPONSIBILITIES IN ESG INVESTING

Fiduciary Investment Responsibilities

The crux of fiduciary responsibility under ERISA, in pertinent part, is the duty to:

- act solely in the interest of participants and beneficiaries in their pursuit of retirement income/promised benefits;[4]
- engage in prudent decisionmaking, including a thoughtful and informed process when selecting and monitoring investments and investment managers;[5]
- select investments that are appropriate for the plan, taking into account the benefits of portfolio diversification based on factors that materially affect risk and reward of the investment consistent with the plan's funding and investment objectives;[6] and
- comply with the governing documents of the plan.[7]

As discussed above, a fiduciary incorporating ESG factors may do so by a combination of investment approach (e.g., positive and negative screens, engagement, etc.). Each of these activities must be performed in accordance with the fiduciary duties outlined above.

> **Practice Tip:** Whether and to what extent to incorporate one or more ESG factors into the investment process is an important decision. A fiduciary may wish to consider:
>
> 1. Whether and how the plan will address ESG broadly or instead focus on discrete E, S, and/or G factors.
>
> 2. Whether the plan will screen for best-in-class ESG investments/issuers, divest from "bad actors," select an investment for other than investment performance reasons, and/or engage the companies in which they are already invested.
>
> 3. Whether and how to address ESG in the plan's IPS or have ESG-specific policies.
>
> 4. Whether and how to select (and monitor) third-party investment managers based on their ability to incorporate ESG factors into their investment process.

Addressing ESG in Investment Policy Statements

An IPS may be considered part of the governing documents of a plan, particularly under ERISA. Investment managers, and other fiduciaries, therefore, should comply with the IPS unless doing so would violate their fiduciary obligations. Moreover, merely determining the terms of an IPS is considered a fiduciary decision under ERISA.[8] Items to consider include:

- **Scope.** How does the plan define "ESG"? Is it focused on **all** E, S, and G factors or a subset of them?

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[3] *See, e.g.*, US SIF Foundation, Sustainable and Impact Sustainable and Impact Investing— Overview; Axel Peirron, ESG Data: Mainstream Consumption, Bigger Spending, Opimas (Jan. 9, 2019); and 2018 ESG Survey, Callan Institute (2018).

[4] ERISA §404(a)(1)(A).

[5] ERISA §404(a)(1)(B).

[6] ERISA §404(a)(1)(B), 29 C.F.R. §2550.404a-1. Please note that this prong reinforces the importance of a prudent process while recognizing the importance of diversification, a distinct fiduciary duty set forth in ERISA §404(a)(1)(C).

[7] ERISA §404(a)(1)(D).

[8] DOL IB 2016-01, 81 Fed. Reg. 95,879 (Dec. 29, 2016).

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- **Test and Analysis.** Is the plan only focused on ESG factors that are material to portfolio performance by reason of their risk and return characteristics or is ESG sought for non-investment performance reasons? Will scenario analysis be used?
- **Asset class.** Should all asset classes account for ESG factors? Institutional investors are not only incorporating ESG into equities, but also in fixed income (e.g., sustainable and green bonds), alternatives (both private equity and hedge funds, for example, offer ESG strategies, though to different degrees), and foreign exchange.
- **Passive vs. active.** Does the plan want to employ passive (e.g., a themed index) and/or active strategies to incorporate ESG factors?
- **ESG approach.** Will positive or negative screening be used? Engagement, etc.?
- **Benchmark.** How will investments and investment managers be evaluated? Will the benchmark be ESG-specific or will a more traditional benchmark be optimized?
- **Investment managers.** Will the plan condition appointment of the investment manager on the investment manager being a United Nations Principles for Responsible Investment (PRI) signatory? Will the plan require ESG-specific reporting?[9]

Selecting and Monitoring Investment Managers

Some plan fiduciaries, such as an investment committee, may not feel that they have the requisite experience and expertise to incorporate ESG factors into the investment process. The outsourcing of ESG responsibility has grown, as investment managers must now respond to ESG-related questions in the request for proposal process.[10] PRI and the Financial Stability Board's Task Force on Climate-related Financial Disclosures each offer useful frameworks for both asset owners and managers to address myriad ESG-related issues. These frameworks, for example, can assist with engaging company boards to address ESG risks, selecting service providers/products, devising and implementing investment policy statements, and incorporating E, S, and/or G factors on an asset class basis.

ERISA requires oversight of investment managers. The plan investment committee, for example, "must reasonably conclude that the investment manager's practices in selecting investments are consistent with" the DOL guidance on ESG investments.[11] The committee may seek reporting from its investment managers on which ESG tools the manager uses, how ESG factors influence buy/sell decisions, and to what extent engagement influences a decision to hold or sell a position. In addition to written reports, a committee may wish to discuss ESG incorporation when it meets with the plan's investment managers.[12]

The PRI and FSB Task Force frameworks can be useful in this regard. For example, when selecting hedge funds, institutional investors may wish to consider using the PRI due diligence questionnaire as a guide.

Prudent Process and Analysis

Under ERISA, the duty of prudence entails, as part of a methodical and documented process, a fiduciary giving "appropriate consideration" to facts and circumstances that are relevant to a proposed investment, "including the role the investment. . .plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties. . . ."[13] "Appropriate consideration" in this context means a determination that the proposed investment is reasonably designed, as part of the portfolio, to further the purposes of the plan, taking into account the risk/return characteristics of the investment based on the consideration of the following factors:

- the composition of the portfolio with regard to diversification;
- the liquidity and current return of the portfolio relative to the plan's anticipated cash flow requirements; and
- the projected return of the portfolio relative to the plan's funding objectives.[14]

Practice Tip: Fiduciaries evaluating ESG investment funds should examine and address, as part of a prudent process, whether these funds (1) are more expensive than comparable non-ESG funds, (2) lack track records, and/or (3) lack significant

[9] *See*, George Michael Gerstein, Considerations for Fiduciaries When Investing Based on Environmental, Social, and Governance (ESG) Factors (Checklist), Bloomberg Law.

[10] The sheer number of ESG-related questions is reported to have increased quite significantly in RFPs, including the level of detail sought by plans. This has led to challenges in time and resources to respond to these questions in a thoughtful and thorough manner.

[11] DOL IB 2015-01, 80 Fed. Reg. 65,135 (Oct. 26, 2015).

[12] PRI, A Practical Guide to ESG Integration for Equity Investing (Sept. 5, 2016).

[13] 29 C.F.R. §2550.404a-1.

[14] *Id.*

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assets under management. Moreover, fiduciaries making portfolio changes to account for ESG risks should be mindful of diversification issues, which are an important, but often overlooked, consideration.

There are a number of services available to fiduciaries that score and rank public companies, investment funds, and investment manager strategies based on ESG metrics. Each of the available services uses different inputs and weightings, creating issues of comparability. Some of the data used to create the ratings derive from data voluntarily disclosed by a public company.

Practice Tip: Fiduciaries should consider the utility and limitations of data providers.

Over the past 30 years, the DOL has wrestled with whether ERISA fiduciaries may, when making investment decisions, consider economic, social, or other benefits **unrelated to** the plan's investment return (i.e., collateral benefits), in a manner consistent with ERISA §403 and §404. For example, the collateral benefits of investment include spurring local jobs and supporting union labor.

DOL Guidance on ESG Investing

The DOL has long construed ERISA as mandating that fiduciaries act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries. This means that a fiduciary cannot subordinate the interests of participants and beneficiaries to objectives unrelated to retirement income.

In 1994, the DOL formalized its guidance on investments that create ''collateral benefits.''[15] In general, ''an investment will not be prudent if it would provide a plan with a lower expected rate of return than available alternative investments with commensurate degrees of risk or is riskier than alternative available investments with commensurate rates of return.'' In other words, a fiduciary cannot rely on some basis other than investment performance as a decisive factor in whether to make an investment if the plan would be disadvantaged economically. Conversely, **all else being equal**, a fiduciary can select an investment that furthers an environmental, social, or governance issue. This is sometimes called the ''tie-breaker'' test. The idea is that, if the plan is not harmed from an investment that spins off collateral benefits, then ERISA's lack of a legal list permits fiduciaries to meaningfully consider these types of investments.

[15] DOL IB 1994-1, 59 Fed. Reg. 32,606 (June 23, 1994).

Practice Tip: This analysis may not apply to numerous governmental plans because many states still have laws that list approved/disapproved securities, products, and countries.

In the fall of 2008, the DOL released IB 2008-1, where the DOL stressed that ''that fiduciary consideration of non-economic factors should be rare and, when considered, should be documented in a manner that demonstrates compliance with ERISA's rigorous fiduciary standards.'' At the heart of IB 2008-1 is a requirement for robust documentation of the quantitative and qualitative comparison of the ESG and non-ESG investment.

In 2015, the DOL withdrew IB 2008-01 and replaced it with IB 2015-01. In reinstating the language from IB 94-01, the DOL clarified and elaborated upon a number of different items that reflected the evolution of ESG strategies.

First, the DOL broadened the discussion of the DOL's often used ''economically-targeted investment'' term—which the DOL had over the years referred to in its ESG guidance as investments that created **economic** benefits (in addition to investment return)—to encompass **non-economic** benefits (e.g., social) that may flow from an investment. This means that IB 2015-01 informs a fiduciary's analysis of investments that provide economic, social, governance, and environmental benefits in addition to investment return. The DOL did this because it (correctly) recognized that ''the terminology is evolving.'' In any event, popular strategies, such as ''socially responsible investing,'' ''sustainable and responsible investing,'' ''environmental, social and governance (ESG) investing,'' and ''impact investing,'' appear to be viewed in a similar light by the DOL.

Second, the DOL reaffirmed that a fiduciary may make an investment to promote a social, environmental, or governance-related goal when such ESG investment's risk and return characteristics are the same as alternative investments. In this respect, ERISA fiduciaries are still forbidden from **subordinating** the participants' and beneficiaries' interest in retirement income and other promised benefits in pursuit of environmental, social, or governance benefits.[16]

Third, and most importantly, the DOL explicitly acknowledged that ''[e]nvironmental, social, and governance issues **may have a direct relationship** to the economic value of the plan's investment.''[17] This is an important precedent and means that:

1. The ESG factor is treated the same as any other material factor in the usual investment analysis.

[16] DOL IB 2015-1.

[17] *Id. (emphasis added).*

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2. Consideration of the ESG factor is **not** subject to the tie-breaker test or any other form of greater scrutiny.

The DOL clearly recognized the growing body of work linking ESG factors to investment performance.

Change in Treatment of Risk

There has been a proliferation of studies explaining how climate change risk presents material risks and opportunities for institutional investors. Under IB 2015-01, the fiduciary treats the ESG factor as if it is **any other** material risk/return factor associated with an investment—no more stringent or lenient. This acknowledgment by the DOL is a tipping point for approaching ESG issues on behalf of plan investors: ESG is no longer shackled to its historical association with lower returns or greater risks in pursuit of goals **unrelated** to performance.

In 2018, the DOL updated its ESG guidance. Some claimed it was a rollback of a fiduciary's ability to incorporate ESG considerations into investment decisions. For the most part, it did not. At most, it warned fiduciaries against overstating a nexus between an ESG factor and investment performance. The DOL, in FAB 2018-01, stated "[i]t does not ineluctably follow from the fact that an investment promotes ESG factors, or that it arguably promotes positive general market trends or industry growth, that the investment is a prudent choice for retirement or other investors." Nevertheless, the DOL continues to acknowledge that ESG issues may "present material business risk or opportunities to companies that company officers and directors need to manage as part of the company's business plan and that qualified investment professionals would treat as economic considerations under generally accepted investment theories."[18]

Selecting investment options for a participant-directed plan lineup is subject to the same analysis outlined above. The DOL did, however, express reservations over the selection of an **ESG-themed** fund as a "qualified default investment alternative."[19]

Practice Tip: Fiduciaries contemplating an investment that relates to an ESG issue need to determine if the ESG factor has a material effect on the investment's risk and reward characteristics. Ideally, the fiduciary should make this decision based on an examination of the data linking the factor to the economic value of the plan's investment. This analysis should be documented. If, on the other hand, the ESG investment is intended to promote a policy, industry, or other non-investment reason, then the fiduciary needs to confirm, through a careful analysis, that it is not accepting added risk relative to competing investments with a similar return or accepting lower returns relative to competing investments with a similar risk profile.

Unique Issues of Shareholder Engagement

Shareholder engagement is an additional (and increasingly popular) strategy institutional investors and fiduciaries deploy to incorporate ESG factors. This generally takes the form of proxy voting, proposing shareholder resolutions, and meeting with company boards. ERISA's duties of prudence and loyalty require the "responsible fiduciary" to "vote proxies on issues that may affect the economic value of the plan's investment." The exercise of shareholder rights is itself a fiduciary function.[20] Plan fiduciaries should avoid increasing expenses, sacrificing investment returns, **or** reducing the security of plan benefits in order to promote goals unrelated to the protection and growth of plan assets.[21]

A first step is to determine **who** is responsible for shareholder engagement. Under ERISA, the duty to vote proxies rests exclusively with the trustee unless "the power to manage, acquire or dispose of the relevant assets has been delegated by a named fiduciary to one or more investment managers" pursuant to section 403(a)(2) of ERISA."[22] Where there has been a delegation to an investment manager, then only the investment manager has a right to vote proxies of the assets over which it has responsibility, unless the named fiduciary has reserved to itself the right to direct the trustee as to how the proxies should be voted. The investment management agreement should expressly address whether or not the investment manager has the responsibility for proxy voting and other forms of shareholder engagement. Fiduciaries should receive and review the plan's proxy voting policies.

Most proxy voting, and indeed other forms of shareholder engagement, rarely entail a significant expenditure of plan assets. At times, though, the exercise of shareholder rights involves unusual costs or requirements, as may happen with voting proxies of foreign corporations. Where the plan fiduciary is contemplating a routine or substantial expenditure of plan assets on engagement (direct or indirect), then the fiduciary should analyze the cost of the shareholder

[18] FAB 2018-1.

[19] *Id.*

[20] See, e.g., DOL IB 2016-01 ("The 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.").

[21] DOL IB 2016-01.

[22] *Id.*

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activity against the expected gain over an appropriate time horizon.

The DOL, in FAB 2018-01, cautioned against ''an individual plan investor. . .routinely incur[ing] significant expenses to engage in direct negotiations with the board or management of publicly held companies with respect to which the plan is just one of many investors.'' Nor, the DOL added, would it be appropriate for ''plan fiduciaries, including appointed investment managers, [to] routinely incur significant plan expenses to, for example, fund advocacy, press, or mailing campaigns on shareholder resolutions, call special shareholder meetings, or initiate or actively sponsor proxy fights on environmental or social issues related to such companies.''

Practice Tip: As a general matter, absent situations when significant sums are spent on engagement, a fiduciary is typically on strong(er) footing for proxy voting and other engagement on ESG issues.

The DOL recognizes the growing recognition of the long-term benefits, even if not easily quantifiable, that arise from shareholder engagement. The DOL has expressly acknowledged that there may be shareholder engagement on a host of issues:

- the independence and expertise of candidates for the corporation's board of directors and assuring that the board has sufficient information to carry out its responsibility to monitor management;
- board composition;
- transparency and accountability in corporate decision-making;
- responsiveness to shareholders;
- executive compensation;
- the corporation's policy regarding mergers and acquisitions;
- the extent of debt financing and capitalization;
- the nature of long-term business plans;
- plans on climate change preparedness and sustainability;
- governance and compliance policies and practices for avoiding criminal liability;
- ensuring employees comply with applicable laws and regulations;
- employee training;
- workplace practices;
- investment in training to develop its work force, diversity, and equal employment opportunity;
- policies and practices to address environmental or social factors that have an impact on shareholder value;
- financial and non-financial measures of corporate performance.

Practice Tip: The investment manager needs to maintain accurate records of its proxy voting. These records likely require some granularity, reflecting not only the procedures the investment manager follows when voting proxies, but also sufficiently detailed records showing how the investment manager voted in particular instances.

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COMPLIANCE January 16, 2019

Advisers Play Important Role in Bringing ESG to ERISA Plan Clients

The Department of Labor issued a Field Assistance Bulletin in 2018 that caused some confusion about its true stance with respect to ESG investing inside ERISA plans; investment experts and attorneys say interest remains strong among plan sponsors and participants, nonetheless.

By John Manganaro

Art by Dalbert B. Vilarino

On April 23, 2018, the U.S. Department of Labor (DOL) published a Field Assistance Bulletin providing guidance to fiduciaries of private-sector employee benefit plans as they consider implementing environmental, social and governance (ESG) investing for assets covered by the Employee Retirement Income Security Act (ERISA).

According to the DOL, the "sub-regulatory action" was not meant to substantially change the status quo with respect to ESG investing under ERISA, but instead merely to clarify how the new administration views existing regulations in this area. In particular, the Field Assistance Bulletin addressed Obama-era DOL 2015 guidance on economically targeted investments and related 2016 DOL guidance on shareholder engagement.

Even though the DOL was careful to note that it had not changed the underlying regulations with its bulletin, retirement industry stakeholders were left to reassess their own stances on the risks and rewards of utilizing ESG investments for plan assets. According to attorneys with Stradley Ronon, this period of introspection has largely concluded, and ESG "continues to

An ESG proposal for you

George Michael Gerstein • October 17, 2018 • *Risk & Reward* • Tags: ESG

I routinely speak on Environmental, Social & Governance (ESG) issues. Time and again, I hear that there is widespread confusion over ESG terminology. This lack of clarity vexes many institutional investors, including fiduciaries. A number of great glossaries are out there (those of SSgA and Mercer immediately come to mind). But the US Department of Labor has its own understanding of ESG, as most recently reflected in Field Assistance Bulletin 2018-01. *To better align the fiduciary duty nuance with industry practice, I am proposing definitions to certain key terms*. As you will see, most of the definitions allow for a *plug-and-play approach* to ensure that a plan sponsor and investment manager, for instance, are on the same page when it comes to utilizing a particular ESG strategy. I certainly welcome any feedback.

ENGAGEMENT: Exercising one or more rights of a holder of interests in an ISSUER, such as proxy voting, introducing resolutions or participating in formal or informal meetings with the ISSUER board, in respect of an ESG FACTOR where (A) the *exclusive* purpose is to enhance portfolio return or reduce portfolio risk, (B) the *primary* purpose is for non-investment performance reasons, such as the promotion of an ESG policy, and a *secondary* purpose is to enhance portfolio return or reduce portfolio risk or (C) the *exclusive* purpose is for one or more non-investment performance reasons, such as the promotion of an ESG policy.

ENVIRONMENTAL: Issues or facts related to the natural environment, such as climate change, carbon emissions, waste management, recycling, energy, biodiversity, pollution, and conservation.

ESG (FACTOR): ENVIRONMENTAL, SOCIAL and/or GOVERNANCE-related issues or facts.

ESG INVESTING: Employing NEGATIVE SCREENING, POSITIVE SCREENING, THEMATIC INVESTING, INTEGRATION, ENGAGEMENT, IMPACT INVESTING, SOCIALLY RESPONSIBLE INVESTING, RESPONSIBLE INVESTING AND/OR SUSTAINABLE INVESTING.

EXCLUSIONARY SCREENING: See NEGATIVE SCREENING.

GOVERNANCE: Issues or facts related to the governance of an ISSUER, such as executive compensation, board structure, shareholder rights, bribery and corruption, and cybersecurity.

IMPACT INVESTING: Selecting investments in respect of an ESG FACTOR where the *primary* purpose is for non-investment performance reasons, such as the promotion of an ESG public policy, and a *secondary* purpose is to enhance portfolio return or reduce portfolio risk.

INTEGRATION: Incorporating ESG-related data and/or information in respect of an ESG FACTOR into the usual process when making an investment decision where such data or information is material to investment performance and where the *exclusive* purpose is to enhance portfolio return or reduce portfolio risk.

ISSUER: Any issuer, such as a corporation or country, whether in the public or private markets, that issue investible holdings, whether a security or not, in which an investment can be made.

NEGATIVE SCREENING: Avoiding the purchase of prospective investments, or DIVESTING from existing investments, on the basis of such investments not meeting a designated ESG standard, rating or requirement where (A) the *exclusive* purpose is to enhance portfolio return or reduce portfolio risk, (B) the *primary* purpose is for non-investment performance reasons, such as the promotion of an ESG public policy, and a *secondary* purpose is to enhance portfolio return or reduce portfolio risk or (C) the *exclusive* purpose is for one or more non-investment performance reasons, such as the promotion of an ESG public policy. Also called EXCLUSIONARY SCREENING.

POSITIVE SCREENING: Selecting investments on the basis of meeting a designated ESG standard, rating or requirement where (A) the *exclusive* purpose is to enhance portfolio return or reduce portfolio risk, (B) the *primary* purpose is for non-investment performance reasons, such as the promotion of an ESG public policy, and a *secondary* purpose is to enhance portfolio return or reduce portfolio risk or (C) the *exclusive* purpose is for one or more non-investment performance reasons, such as the promotion of an ESG public policy.

RESPONSIBLE INVESTING: Selecting investments where (A) the *primary* purpose is for non-investment performance reasons, namely the promotion of a GOVERNANCE ESG FACTOR, and a *secondary* purpose is to enhance portfolio return or reduce portfolio risk or (B) the *exclusive* purpose is for one or more non-investment performance reasons, namely the promotion of a GOVERNANCE ESG FACTOR.

SOCIAL: Issues or facts related to human relations of an ISSUER, such as employee relations, community relations, board diversity, human rights, demography, food security, poverty/inequality, child labor and health and safety.

SOCIALLY RESPONSIBLE INVESTING: Selecting investments where (A) the *primary* purpose is for non-investment performance reasons, namely the promotion of a SOCIAL ESG FACTOR, and a *secondary* purpose is to enhance portfolio return or reduce portfolio risk or (B) the *exclusive* purpose is for one or more non-investment performance reasons, namely the promotion of a SOCIAL ESG FACTOR.

SUSTAINABLE INVESTING: Selecting investments where (A) the *primary* purpose is for non-investment performance reasons, namely the promotion of an ENVIRONMENTAL ESG FACTOR, and a *secondary* purpose is to enhance portfolio return or reduce portfolio risk or (B) the *exclusive* purpose is for one or more non-investment performance reasons, namely the promotion of an ENVIRONMENTAL ESG FACTOR.

THEMATIC INVESTING: Utilizing NEGATIVE SCREENING, POSITIVE SCREENING, INTEGRATION and/or ENGAGEMENT to invest in ISSUERS that share a common ESG purpose, industry or product.

George Michael Gerstein

George Michael Gerstein advises financial institutions on the fiduciary and prohibited transaction provisions of ERISA. As co-chair of the fiduciary governance group, he assists clients with tracking, and understanding, the numerous fiduciary developments at the federal and state levels, including the rules and regulations of governmental plans. He also advises clients with respect to the fiduciary duty implications of ESG investing.

UN PRI warns signatories (particularly, investment managers) that they are prepared to thin the herd

George Michael Gerstein · October 23, 2018 · *News* · Tags: ESG

While we have been alerting clients to this risk for the past several months, there is now some media pickup on a new initiative of PRI: to target (mostly) asset manager-signatories who have not undertaken steps to implement the PRI principles with the (ultimate) threat of delistment. Though the number of signatories that are US managers and institutional investors has swelled (though stills noticeably trails that of Europe), there has been a concern of a "set it and forget it" mentality. Investment managers are encouraged to review PRI guidance on compliance (especially the guidance intended for asset owners) and reach out to them to facilitate achievement.

Fund Proxy Voting: Looking Back to Look Forward

Sara Crovitz · March 29, 2019 · *Risk & Reward* · Tags: Proxy voting

Sara Crovitz

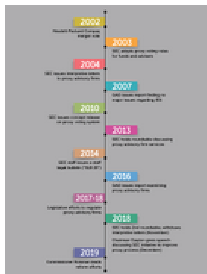
In recent years, the frequency of proxy contests at public companies has increased, focusing more attention on the way institutional investors decide how to vote their proxies. Issuer dissatisfaction with the role of proxy advisory firms in this decision-making process has been a steady drumbeat for decades. In part, public company issuers are understandably unhappy that there is not more competition; Institutional Shareholder Services Inc. ("ISS") and Glass Lewis dominate the market for providing proxy advisory services. The Securities and Exchange Commission ("SEC"), however, cannot regulate its way to requiring that additional players enter the market. Absent legislation, the question becomes what, if anything, the SEC can achieve under its current rulemaking authority or through SEC staff guidance. What action could help address public company issuer concerns without raising barriers to entry or otherwise negatively impacting competition for proxy advisory firms by increasing regulatory costs, which would undoubtedly be passed on to institutional investor clients? It is a complicated path strewn with the potential for unintended consequences.

This article describes the history of the issues around fund and asset manager use of proxy advisory firms in connection with fund proxy voting, highlighting how we got to where we are today. It then discusses some of the difficulties the SEC faces in moving forward with any additional regulation. Finally, it provides some practical considerations to fund directors and asset managers with regard to fund proxy voting in this uncertain time.

Looking Back

SEC Proxy Voting Regulation and Staff Guidance

On March 19, 2002, shareholders narrowly approved a hotly contested shareholder vote on the merger between Hewlett-Packard and Compaq. Merger opponents alleged that a fund asset manager had switched its vote at the last minute to favor the merger after Hewlett-Packard executives threatened to lock its parent company out of future Hewlett-Packard investment banking business if it voted against the merger. A dissident director of Hewlett-Packard filed suit to block the merger, alleging Hewlett-Packard executives used corporate assets "to entice and coerce" the fund asset manager.[1] The SEC eventually settled an enforcement action against the asset manager, alleging that it had failed to disclose to its clients the existence of a material conflict in connection with its proxy vote.[2]



Click image to view full size

On the heels of this controversy, the SEC, under the leadership of then-Chairman Harvey Pitt, finalized proxy voting rules for both funds and advisers.[3] On the one hand, the rules were typical to the regulatory regime under the Investment Company Act of 1940 ("Investment Company Act") and the Investment Advisers Act of 1940 ("Advisers Act") in that the rules were disclosure-based and operated mainly through policies and procedures that could be adapted to a fund's or asset manager's particular circumstances. Funds were required to disclose the policies and procedures they used to vote proxies and to disclose to shareholders the specific proxy votes the funds cast.[4] Advisers were required to maintain policies and procedures reasonably designed to ensure that the adviser voted proxies in the best interest of clients, including how the adviser addressed material conflicts.[5]

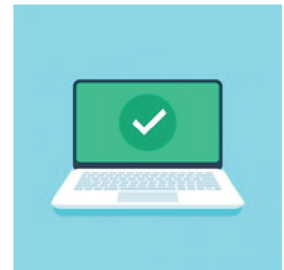
On the other hand, the Adviser Rule Release indicated that voting proxies was an explicit fiduciary duty of care: "The duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies."[6] While the SEC stated in the Adviser Rule Release that "we do not suggest that an adviser that fails to vote every proxy would necessarily violate its fiduciary obligations," it provided only one very limited exception to an adviser's duty to vote every proxy, namely voting on a foreign security as that could involve costs such as hiring a translator or traveling to a foreign country to vote in person.[7] The SEC also noted in the Adviser Rule Release that if an investment adviser had a conflict with regard to voting, one way to address that conflict would be to have a third party assist in determining how to vote: "[A]n adviser could demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, based upon the recommendation of an independent third party."[8]

A year or so later, certain proxy advisory firms asked the SEC staff to clarify how investment advisers could determine that a third party, like a proxy advisory firm, was, in fact, independent for purposes of Advisers Act rule 206(4)-6. The SEC staff issued two interpretive letters outlining that an investment adviser could use a proxy advisory firm that itself had a conflict if the adviser determined that the proxy advisory firm "has the capacity and competency to adequately analyze proxy issues and can make such recommendations in an impartial manner and in the best interests of the adviser's clients."[9] In particular, the letters indicated that advisers should obtain information from the proxy advisory firm to make this determination and suggested that an adviser require the proxy advisory firm to disclose relevant facts relating to the conflict, whether that be on a case-by-case basis or on the basis of the proxy advisory firm's conflict procedures.

Within a couple of years, public company issuers began questioning proxy advisory firm's potential conflicts, particularly with regard to ISS, which had two services: providing reports about issuers and consulting services to corporations seeking to improve their corporate governance. Critics contended that issuers could feel obligated to retain ISS's consulting services in order to obtain favorable vote recommendations when ISS issued reports about that particular issuer.[10] Responding to requests from the House Committee on Financial Services, the Government Accountability Office ("GAO") issued a report in 2007 generally finding that, while ISS may have conflicts of interest, it discloses such conflicts, and, as a registered investment adviser, it has been subject to examination by the SEC staff, which had not identified any major issues.[11]

SEC Concept Release

In 2010, the SEC issued a concept release on the proxy voting system, noting that it had been almost 30 years since the SEC last conducted a comprehensive review of proxy voting issues and pointing to corporate and investor interest in promoting greater efficiency and transparency in the system.[12] The concept release sought comments as to whether the proxy system as a whole operated with the accuracy, reliability, transparency, accountability and integrity that investors and issuers should expect, and focused on issues such as over- and under-voting, vote confirmation, proxy voting in the context of securities lending, proxy distribution fees and issuers' ability to communicate with beneficial owners. As part of that release, the SEC suggested that proxy advisory firms may be investment advisers because part of their service is issuing reports about securities.[13] The SEC noted that, as fiduciaries, proxy advisory firms that were registered as advisers would have to disclose conflicts of interest to the institutional investors they advised.



Over the next few years, public companies and certain academics increasingly criticized proxy advisory firms, focusing on a perceived lack of sufficient resources, which led to errors in issuer reports, as well as reiterating prior criticism that certain proxy advisory firms suffered from misaligned incentives and conflicts. Critics also began to attack asset manager use of proxy advisory firms, including claims that, because of perverse incentives created by Advisers Act rule 206(4)-6 and the related interpretive letters, asset managers and funds outsourced decision making and blindly relied on proxy advisory firms.[14] For example, these critics pointed to data indicating that shortly after ISS would release a report on a public company issuer, a significant number of shares would be voted in a lock-step manner.[15] The real concern, however, seemed to be the influence that proxy advisory firms have on shaping corporate policy.[16]

First SEC Roundtable and Staff Guidance

The SEC held a roundtable in 2013 that focused, in part, on the factors that had contributed to the use of proxy advisory firm services and the purposes such firms serve; conflicts of interest that may exist for proxy advisory firms and users of their services; the transparency and accuracy of the recommendations made by proxy advisory firms; and what the nature and extent of reliance by investors on proxy advisor recommendations was and should be. Not surprisingly, vastly different views were expressed by public companies, institutional investors and proxy advisory firms themselves.[17]

Following the roundtable, the SEC's Chairman and Commissioners continued to speak to issues around corporate governance.[18] In mid-2014, SEC staff from both the Division of Investment Management ("IM") and the Division of Corporation Finance ("CF") issued a staff legal bulletin that provided guidance about investment adviser responsibilities in voting client proxies and retaining proxy advisory firms ("SLB 20").[19] SLB 20 also provided guidance on the availability and requirements of two exemptions to the federal proxy rules that are often relied upon by proxy advisory firms. In particular, IM staff reiterated positions from the interpretive letters that investment advisers, in determining whether to retain or continue using a proxy advisory firm, should conduct due diligence to ensure that the adviser, acting through the proxy advisory firm, continued to vote in the best interests of its clients. In addition, IM staff clarified that an investment adviser and its clients may agree to arrangements whereby the adviser would not vote every proxy. In addition, CF staff made clear that, if a proxy advisory firm relied on certain exemptions from the federal proxy rules and therefore was required to disclose a significant relationship or material interest, that disclosure must be sufficient for the recipient to understand the nature and scope of the relationship or interest, including the steps taken to mitigate the conflict of interest, such that the recipient could make an assessment about the objectivity of the recommendation. In other words, the proxy advisory firm must make more than a boilerplate disclosure regarding the conflict of interest.

In 2016, in response to issues raised by some members of Congress, industry associations and academics, the GAO issued another report that examined proxy advisory firms' influence on voting and corporate governance, the level of transparency in their methods and the level of regulatory oversight with regard to such methods.[20] The GAO interviewed various stakeholders, including public company issuers, institutional investors and proxy advisory firms. The GAO report reflected varying views, but it contained no recommendations.

In the last couple of years, there have been legislative efforts to address issues raised about proxy advisory firms. In 2017, the House of Representatives passed H.R. 4015, but it was not taken up by the Senate.[21] H.R. 4015, which was in many ways similar to the Credit Rating Agency Reform Act of 2006, would have, among other things, required proxy advisory firms to register under the Securities Exchange Act of 1934, disclose potential conflicts of interest and codes of ethics and make public their methodologies for formulating recommendations. Most importantly, H.R. 4015 would have required proxy advisory firms to provide access, in a reasonable amount of time, to a draft report on a public company issuer, including data, analysis and the proposed recommendation, to the public company issuer before sending the report to their institutional investor clients; if the public company issuer objected to the analysis and the objection could not be resolved, H.R. 4015 would have required that the public company issuer's objection and rebuttal be included in the report.[22] More recently, a bipartisan bill was introduced by six Senators in November 2018, which would have required that all proxy advisory firms register as investment advisers, that the SEC conduct periodic inspections of proxy advisory firms, that the SEC submit periodic reports to Congress evaluating the policies and procedures at proxy advisory firms and that the SEC continue to examine whether additional investor protection regulation is necessary.[23]

Second SEC Roundtable

In November 2018, the SEC held a second roundtable. In advance of that roundtable and "to facilitate the discussion," IM staff withdrew the two interpretive letters.[24] The staff did not withdraw SLB 20, which, as discussed earlier, reiterated positions in the interpretive letters. While there was little discussion of the interpretive letters at the roundtable, it is noteworthy that no one at the roundtable strongly supported additional regulation for proxy advisory firms.[25]

Although not directly related to fund use of proxy advisory firms, another important conversation taking place around fund voting relates to the "common ownership" theory expounded by certain academics. This theory posits that index funds and index ETFs have perverse incentives because they seek only to match the performance of an index (rather than over-perform) and will use their vote to induce portfolio company management to reduce intra-industry competition, thereby harming the portfolio company's other shareholders. Some academics that subscribe to this theory have argued that passive funds should not be permitted to vote or should have to pass voting to fund shareholders.[26] While the asset management industry and certain other academics have criticized the common ownership theory,[27] it has caught the attention of regulators globally,[28] and its potential impact on fund voting cannot be ignored in the debate around fund voting and the use of proxy advisory firms.

Looking Forward

On December 6, 2018, SEC Chairman Clayton gave a speech during which he discussed significant initiatives for 2019, including SEC action to improve the proxy process.[29] The Chairman recognized the consensus view that proxy "plumbing" (i.e., issues raised by the 2010 Concept Release around proxy voting mechanics such as over- and under-voting, accuracy and transparency in voting and issuer communication with beneficial owners) needs a major overhaul, and he appeared to endorse consideration of changes to the ownership and resubmission thresholds for shareholder proposals. Specifically with respect to proxy advisory firms, he also indicated that the SEC should consider: (1) "the division of labor, responsibility and authority between proxy advisors and the investment advisers they serve"; (2) "clarity regarding the analytical and decision-making processes advisers employ, including the extent to which those analytics are company- or industry-specific"; (3) "the framework for addressing conflicts of interest at proxy advisory firms"; and (4) "ensuring that investors have effective access to issuer responses to information in proxy advisory firm reports." Subsequently, the Chairman asked SEC Commissioner Roisman to lead efforts to improve the proxy voting process and infrastructure.[30]

While there is general agreement that improvements are needed with regard to the proxy voting process, there is no consensus around issues related to fund adviser and other institutional investor use of proxy advisory firms. While these issues have been discussed and debated for years, and while the SEC staff has made efforts to address at least some aspects of these issues, the SEC's efforts have not stopped the criticism. Public company issuers believe ISS and Glass Lewis have too much power over public company governance. Asset managers believe that their use of proxy advisory firms, whether for administrative processing of votes, research reports, assistance with custom guidelines, or otherwise, is appropriate.

The SEC faces significant hurdles to moving forward with any rules or regulations. First is the issue of bandwidth. Issues specifically related to proxy voting are on the long-term actions (as opposed to active list) on the recent Regulatory Flexibility Agenda, and the Chairman has spoken publicly, including in his December 6, 2018 speech, about his intent to focus the agenda on rulemakings that the Commission can reasonably complete. Moreover, in addition to issues around proxy advisory firms, there are a number of other proxy-related issues (e.g., proxy voting mechanics and issues around shareholder proposals). All of these issues have the potential to be complicated and controversial, and stakeholders with strongly held views will likely challenge any rules or regulation from different perspectives. In addition, the SEC is subject to significant regulatory requirements to justify regulation on cost-benefit grounds.[31] For all of these reasons, the SEC faces a difficult road ahead in taking action to significantly improve the situation for all interested parties in 2019.

Practical Considerations

Funds and their advisers cast a large number of votes on public company proxies in a short proxy season.[32] This section highlights some background on proxy voting, including common proxy voting structures and processes and practical considerations for fund boards and advisers.

Fund Boards

As the SEC stated in the adopting release to the Fund Rule Release in 2003, a fund's board of directors or trustees (the "board") has the right to vote proxies for the fund.[33] The SEC recognized, however, that most boards delegate responsibility to the fund's investment adviser subject to board oversight.[34] The board retains responsibility for overseeing the processes put in place by the adviser.[35]

KEY TAKEAWAYS

- A fund's board has certain responsibilities concerning proxy voting.
- Proxy voting policies should be reviewed and refreshed periodically.
- Consideration should be given to how conflict situations will be identified and addressed.

The board also must approve and annually review the adequacy of a fund's policies and procedures as part of the fund's compliance program. Some boards adopt a separate fund policy while others determine to rely on the fund adviser's policy.[36] If relying on the fund adviser's policy, the board should understand the process the adviser uses to determine when it has a conflict, how the adviser's process addresses conflicts (e.g., use of committees, firewalls or third-party service providers) and how the adviser will disclose conflicts to the board or otherwise provide appropriate reporting to the board.

Fund Advisers

Advisers that have been delegated authority for the administrative process of voting or delegated voting authority may engage in different practices with regard to the use of proxy advisory services. Larger asset managers may have sufficient in-house resources and staff to conduct research on proxy votes and address conflicts (i.e., by having separate governance staff), such that they do not rely on proxy advisory firms' recommendations at all. Most advisers, however, use proxy advisory firms for at least some of the following services:

- **Administrative services.** An adviser could be responsible for thousands of votes per year for registered investment companies. Advisers may engage proxy advisory firms to assist in the mechanical processing of proxy votes, similar to how advisers engage other service providers for operational functions. This might include data tracking and administration as well as workflow management processes. For example, an adviser could use a proxy advisory firm to provide notifications and reminders of upcoming proxy votes; provide coverage and translation services with respect to foreign issuers; communicate voting recommendations and rationales; execute voting instructions; record and report proxy voting records; and prepare and/or file Form N-PX for funds.

- **Research and analytics.** An adviser may receive research from proxy advisory firms to use as an input to the adviser's own decision making. Advisers may choose to receive information based on standard benchmark policies or more specific policies.

- **Using proxy advisory firm recommendations.** Proxy advisory firms may offer vote recommendations based on their own guidelines that the adviser takes into account in its own decision-making process. Smaller asset managers may vote proxies in line with a proxy advisory firm's recommendations subject to the asset manager's override.

- **Using a proxy advisory firm to help draft guidelines.** Some advisers use a proxy advisory firm to help draft or update their own voting guidelines, especially in areas where the adviser lacks expertise.

As a fiduciary to the funds it advises, an adviser must address conflicts consistent with Advisers Act rule 206(4)-6. A fund adviser with voting authority must adopt and implement policies and procedures reasonably designed to ensure that it votes proxies in the best interest of the funds it advises, and those policies and procedures must address material conflicts that may arise between the interests of the adviser and the funds it advises.

To address these fiduciary responsibilities, there are a number of methods that advisers use, some of which involve proxy advisory firms:

- **Creating a predetermined voting policy.** This effectively limits the adviser's own voting discretion on individual votes. A predetermined policy may not always be sufficient as the adviser may have valid (i.e., non-conflict related) reasons to deviate from the policy, or the policy may not cover every possible situation. An adviser therefore may wish to consider appointing a committee or designating particular personnel who otherwise are not involved in the proxy voting process to help determine how such matters should be voted.

- **Use of a proxy advisory firm.** Just as it would for any service provider, an adviser should conduct due diligence before retaining a proxy advisory firm and continue to monitor the proxy advisory firm's services.[37]

Given the current focus on adviser use of proxy advisory firms, advisers should review their policies and procedures relating to proxy voting, including how they evaluate and use proxy advisory firms' services, and particularly in circumstances where a proxy vote relates to more controversial proposals.[38]

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[1] Chris Gaither, Hewlett Heir Files Lawsuit to Overturn Merger Vote, NY Times (March 29, 2002).

[2] Deutsche Asset Management, Inc., Advisers Act Release No. 2160 (Aug. 19, 2003) (SEC alleged that the asset manager failed to disclose a material conflict, namely that its parent was working for Hewlett-Packard on the merger and had intervened in the asset manager's proxy voting process on behalf of Hewlett Packard). See also U.S. Gov't Accountability Office, GAO-04-749, Additional Transparency and Other Actions Needed in Connection with Proxy Voting (2004) (recommending changes to ERISA and DOL action).

[3] See Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Investment Company Act Release No. 25922 (Jan. 31, 2003) (the "Fund Rule Release"), and Proxy Voting by Investment Advisers, Advisers Act Release No. 2106 (Jan. 31, 2003) (the "Adviser Rule Release").

[4] See Investment Company Act rule 30b1-4 and form N-PX.

[5] See Advisers Act rule 206(4)-6. In addition, Advisers Act rule 206(4)-6 requires an adviser to disclose to its clients information about the policies and procedures and to disclose to clients how they may obtain information on how the adviser has voted proxies.

[6] See Adviser Rule Release, supra note 3.

[7] Id.

[8] Id.

[9] Egan-Jones Proxy Services (pub. avail. May 27, 2004); Institutional Shareholder Services, Inc. (pub. avail. Sept. 15, 2004).

[10] Some also have contended that Glass Lewis's ownership by the Ontario Teachers' Pension Plan Board raises conflicts. See, e.g., Chamber of Commerce Comment Letter to the SEC (May 30, 2012) (alleging that its activist owner influenced Glass Lewis's recommendation to oppose the board of directors for a Canadian railway in a proxy battle with an activist hedge fund). Both ISS and Glass Lewis publicly disclose information about their respective conflicts of interest.

[11] U.S. Gov't Accountability Office, GAO-07-765, Issues Relating to Firms that Advise Institutional Investors on Proxy Voting (2007). The GAO report contained no recommendations.

[12] Concept Release on the U.S. Proxy System, Investment Company Act Release No. 29340 at 109 (Jul. 14, 2010) ("Concept Release"). See also, Mary L. Schapiro, Chairman, Remarks at the National Conference of the Society of Corporate Secretaries and Governance Professionals (Jul. 9, 2010).

[13] As indicated, ISS already had been registered as an investment adviser, but certain other proxy advisory firms, such as Glass Lewis, had not registered.

[14] See, e.g., James K. Glassman & J. W. Verret, How to Fix our Broken Proxy Advisory System, Mercatus Ctr. at George Mason Univ. (April 16, 2013) ("How to Fix our Broken Proxy Advisory System"), ("Unfortunately, the rule became a classic case of unintended consequences. Many institutional investors largely outsourced their shareholder voting policies to a proxy advisory industry that relies on precisely the type of 'one-size-fits-all' policies that were intentionally excluded from the original regulation because of objections by commissioners. The SEC staff interpretation of the rules on proxy voting have led to the opposite result of what many of its supporters intended."). See also, Daniel M. Gallagher, Commissioner, Remarks at Society of Corporate Secretaries & Governance Professionals," (July 11, 2013), ("Given the sheer volume of votes, institutional shareholders, particularly investment advisers, may view their responsibility to vote on proxy matters with more of a compliance mindset than a fiduciary mindset. Sadly, the Commission may have been a significant enabler of this [through rule 206(4)-6 and the interpretive letters]"). But see Stephen Choi, Jill Fisch & Marcel Kahan, Who Calls the Shots? How Mutual Funds Vote on Director Elections, 3 Harv Bus L. Rev. 35 (2013) (finding a substantial degree of divergence in fund voting from ISS recommendations).

[15] See IBM Comment Letter on the Concept Release (Oct. 15, 2010), (institutional investors vote in a lock-step manner (i.e., 100% in accordance) with the ISS recommendation). See also Morris Mitler, Sean Collins & Dorothy Donohue, Funds and Proxy Voting: Funds Vote Thoughtfully and Independently (Nov. 7, 2018), (in 2017, while funds voted in lock-step with ISS recommendations on proposals submitted by management, which tend to be routine business matters, that correlation breaks down when funds vote on shareholder proposals, which tend to be much more debated).

[16] "To a large degree, corporate directors and executives are now subject to decision making on critical issues by organizations that have no direct stake in corporate performance and make poor decisions as a result. Conscientious shareholders, who do have such a stake, also suffer because their votes are usurped or overwhelmed by these same organizations. The SEC's proxy policy rules have led to results unimagined by their original advocates." How to Fix our Broken Proxy Advisory System, supra note 14.

[17] The Commissioners themselves disagreed on the extent of any problems. For example, Commissioner Gallagher strongly sided with corporate interests, arguing for the need for "Commission guidance clarifying to institutional investors that they need to take responsibility for their voting decisions rather than engaging in rote reliance on proxy advisory firm recommendations would go a long way toward mitigating the concerns arising from the outsized and potentially conflicted role of proxy advisory firms" supra note 14. Chair White indicated that proxy advisory firms play an important role in assisting institutional investors and stated that she was "particularly interested in the discussion of conflicts of interest that may or may not arise in connection with the participation of proxy advisors in our system." Mary J. White, Chairman, Welcoming Remarks at Proxy Advisory Services Roundtable (Dec. 5, 2013).

[18] See, e.g., Mary Jo White, Chairman, Completing the Journey: Women as Directors of Public Companies (Sept. 16, 2014), (encouraging greater diversity in public company boards); Kara M. Stein, Commissioner, Remarks to the Council of Institutional Investors (May 8, 2014), (SEC should consider permitting, if not mandating, universal proxy ballots and clarifying process for evaluating issuer no-action requests to exclude shareholder proposals); Luis A. Aguilar, Commissioner, Looking at Corporate Governance from the Investor's Perspective (Apr. 21, 2014), (examining three fundamental principles of an effective corporate governance regime – accountability, transparency and engagement – in the context of the executive compensation process); Michael S. Piwowar, Commissioner, Advancing and Defending the SEC's Core Mission (Jan. 27, 2014), (the SEC should "move forward with initiatives to curb the unhealthy over-reliance on proxy advisory firm recommendations"); and Daniel M. Gallagher, Commissioner, Remarks to the Forum for Corporate Directors (Jan. 24, 2014), ("Proxy advisory firms have gained an outsized role in corporate governance, both in the United States and abroad.").

[19] SEC Staff Legal Bulletin No. 20 (June 30, 2014).

[20] U.S. Gov't Accountability Office, GAO-17-47, Proxy Advisory Firms' Role in Voting and Corporate Governance Practices (2016).

[21] See H.R. 4015, 115th Cong. (2017)

[22] Id. While the legislation defined a "reasonable time" to be one that did not interfere with the proxy advisory firm's ability to provide the report to its institutional investor client, it is not clear how this process would be possible given the tight timelines during the proxy season.

[23] S. 3614, 115th Cong. (2018) The legislation appears to have been intended to deny Glass Lewis the ability to rely on the publisher's exclusion from registration as an investment adviser as it specifically states that a proxy advisory firm may not rely on section 202(a)(11)(D) of the Advisers Act.

[24] See Statement Regarding Proxy Advisory Letters (Sept. 13, 2018).

[25] See, e.g., Adam Kokas, Exec. Vice President, General Counsel and Sec'y, Atlas Air Worldwide, Remarks at U.S. SEC Roundtable on the Proxy Process (Nov. 15, 2018).

[26] See, e.g., Dorothy Shapiro Lund, The Case Against Passive Shareholder Voting, Coase-Sandor Working Paper Series in Law and Economics 846 (2017); and José Azar, Martin C. Schmalz & Isabel Tecu, Anticompetitive Effects of Common Ownership (Jan. 30, 2015).

[27] See, e.g., BlackRock Index Investing and Common Ownership Theories (Mar. 2017); Daniel P. O'Brien & Keith Waehrer, The Competitive Effects of Common Ownership: We Know Less Than We Think, 81 Antitrust L. J.l No. 3 (Feb. 2017); Pauline Kennedy, Daniel P. O'Brien, Minjae Song & Keith Waehrer, The Competitive Effects of Common Ownership: Economic Foundations and Empirical Evidence (July 2017).

[28] The Federal Trade Commission held a hearing addressing common ownership in December 2018. A European Parliament member recently told the Financial Times that "[t]he effects of [large passive funds] have to be taken into account and regulated," and the European Competition Commissioner has been looking into issues since December 2018. See Siobhan Riding, Brussels targets large index fund managers on "common ownership" (Jan. 21, 2019). The OECD held a hearing on common ownership in December 2017.

[29] Jay Clayton, Chairman, SEC Rulemaking Over the Past Year, the Road Ahead and Challenges Posed by Brexit, LIBOR Transition and Cybersecurity Risks (Dec. 6, 2018).

[30] Elad L. Roisman, Commissioner, Brief Statement on Proxy Voting Process: Call with the SEC Investor Advisory Committee (Feb. 6, 2019).

[31] See, e.g., Division of Risk, Strategy and Financial Innovation and the Office of the General Counsel, Current Guidance on Economic Analysis in SEC Rulemakings (March 16, 2012).

[32] Recent data published by the Investment Company Institute indicates that during the 2017 proxy season, funds cast more than 7.6 million votes for proxy proposals. See Mitler, Collins & Donohue, supra note 15.

[33] "Because a mutual fund is the beneficial owner of its portfolio securities, the fund's board of directors, acting on the fund's behalf, has the right and the obligation to vote proxies relating to the fund's portfolio securities." See Fund Rule Release, supra note 3.

[34] "As a practical matter, however, the board typically delegates this function to the fund's investment adviser as part of the adviser's general management of fund assets, subject to the board's continuing oversight." Id.

[35] A board's oversight is subject to its general fiduciary duty, and the "business judgment" rule should apply so long as the board has exercised reasonable judgment and not put its interests above those of the fund and its shareholders.

[36] Fund boards that rely on the adviser's policy and procedures should conduct a periodical review to determine the continued appropriateness of such policy and procedures.

[37] The SEC staff in SLB 20 suggested good practices for an adviser to consider with regard to retaining the services of a proxy advisory firm and in determining whether to maintain such services. With regard to initial retention, the SEC staff suggested an adviser diligence the adequacy and quality of the proxy advisory firm's staffing and resources and examine the robustness of its policies and procedures with regard to, for example, conflicts. With regard to maintaining such services, the SEC staff suggested, for example, periodically sampling proxy votes to determine if they are consistent with the adviser's policy and procedures and having a process to investigate any material factual errors identified that formed the basis of a recommendation.

[38] For example, many advisers include in their proxy voting guidelines that the adviser will make a case-by-case determination for more controversial proposals rather than having a proxy advisory firm vote according to a pre-determined guideline.

Live Blogging: Boston – ESG through a fiduciary lens

George Michael Gerstein · October 11, 2018 · *News* · Tags: ESG

In just a few hours, I will be joined by Mary Gregory of Brown Advisory and Hillary Flynn of Wellington to discuss how a fiduciary can consider ESG factors in a manner consistent with fiduciary duties. We'll be discussing what the data says, issues of product availability, ratings services and regulatory guidance. Boston BASIC is sponsoring this event and it's sold out, reflecting the growing interest in this topic.

George Michael Gerstein to discuss ESG compliance considerations at upcoming ACA Compliance Group conference

George Michael Gerstein · September 24, 2018 · *News* · Tags: ESG

I am happy to be speaking once again at the ACA Compliance Group Fall Conference in Scottsdale, Arizona on Oct. 5 to address ESG issues. Here is a description of the panel:

> **Navigating the Demand for Environmental, Social, and Governance (ESG) Policies**
> Client and investor focus on environmental, social, and governance issues has grown. As this demand continues, investment advisers seek to apply ESG standards to the investment process. Panelists will discuss how compliance intersects with ESG, and the roles compliance officers can expect to play when developing and maintaining an ESG program.

George Michael Gerstein to discuss ESG with a panel from Wellington and Brown Advisory

George Michael Gerstein · September 18, 2018 · *News* · Tags: ESG

Join Boston BASIC (Building A Sustainable Investment Community), a consortium of Boston area SRI professionals, on **Thursday, October 11th** for a practical discussion of the considerations fiduciaries should take into account when incorporating environmental, social and governance factors into their investment process. The event will take place in Boston.

The discussion is hosted by George Michael Gerstein, Co-Chair Fiduciary Governance at Stradley Ronon, and joined by:

Hillary Flynn, ESG Analyst at Wellington Management

Mary Gregory, Sustainable Investing Specialist at Brown Advisory

The event is closed to the press.

ESG Update for Asset Managers

George Michael Gerstein · August 8, 2018 · *Risk & Reward* · Tags: ESG

I was particularly excited when I learned that Callan had published its 2018 ESG survey. I encourage all ESG managers to review the survey in its entirety, not only to see the trajectory of adoption rates among retirement plans (governmental and ERISA), but trends of other important institutional investors, such as endowments and foundations. In terms of take-aways, incorporation of ESG factors increased by 95% since 2013 (22% then vs. 43% today) by respondents. This is great news, but ERISA plans (both DB and DC) lag other institutional investors in terms of growth rates and overall adoption. Interestingly, Callan found that DB plans were more than 3x more likely to incorporate ESG factors into investment decisions than DC plans. 13% of DC plans have an ESG fund in its lineup (we'll have to wait until next year to see how the recent DOL guidance will affect this). Inflows into ESG options in DC plans continue to be less than desired.

The survey also found that one of the top ways institutional investors are implementing ESG is by conveying its importance to investment managers (though many fewer asset owners reported using actual metrics to score managers on using ESG). These showings are consistent with what I have been hearing, both from the asset owner and manager standpoint. A struggle to standardize a cross-manager analysis based on ESG metrics has proved challenging. I know that investment managers are fielding more and more questions on their ESG credentials.

There seems to be different reactions by institutional investors to the data that is coming out on the link between ESG and investment performance. The top reason cited by those who incorporated ESG was an expectation that it would improve their risk profile, followed by fiduciary responsibility. Yet, the principal reason why some institutional investors are holding back on ESG incorporation is the perceived paucity of data linking one or more ESG factors to investment performance. This also showed up in a recent NEPC survey.

I would urge fiduciaries to review the governing documents of the institutional investor regarding ESG and make sure that the implementation process squares with the stated objectives of the investor. This could be a higher risk when investors pursue E, S and G factors discretely.

PRI is probably happy to see more and more interest from managers and asset owners on becoming signatories. Managers should be mindful that PRI will want to see some concrete steps taken and not a "set-it-and-forget-it" approach.

The asset management community may wish to consider whether the DOL should be pressed to issue additional guidance in this area. The GAO has already indicated that the DOL is open to that possibility.

George Michael Gerstein sits down with Bloomberg Law to discuss fiduciary implications of ESG

George Michael Gerstein · July 18, 2018 · *News* · Tags: ESG, Fiduciary Duties

Bloomberg Law Q&A With George Michael Gerstein: Key Issues for Fiduciaries When Investing for a Cause

Many retirement plan participants and plan sponsors are no longer content with investments that simply bring them good returns. They also want their investments to do some good in the world.

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George Michael Gerstein Interviewed About GSAM's New ESG ETF

George Michael Gerstein · June 14, 2018 · *News* · Tags: ESG

Goldman Sachs Asset Management's new JUST U.S. Large Cap Equity ETF (JUST) hauled in $250 million in its first day of trading. I speak to Fund Intelligence about ESG product development.

George Michael Gerstein

George Michael Gerstein advises financial institutions on the fiduciary and prohibited transaction provisions of ERISA. As co-chair of the fiduciary governance group, he assists clients with tracking, and understanding, the numerous fiduciary developments at the federal and state levels, including the rules and regulations of governmental plans. He also advises clients with respect to the fiduciary duty implications of ESG investing.

George Michael Gerstein Sits Down With 401(k) Specialist Magazine to Discuss Fiduciary Implications of ESG Investing

George Michael Gerstein · May 29, 2018 · *News* · Tags: ESG, Fiduciary Duties

Extract from 401(k) Specialist Magazine: "Does anyone have a concise definition of ESG? Anyone? Neither do we. It's one of the main sticking points for many 401k advisors and their plan sponsor clients when constructing investment menus with environmental, social and governance (ESG) factors in mind. The DOL and similar regulatory bodies have made attempts at guidance to help clear it all up (most notable in 2008, 2015 and just last month), but true to form with government "help," it's too often anything but. Which is why we called George Michael Gerstein, Fiduciary Governance Group Co-Chair with legal powerhouse Stradley Ronon Stevens & Young. Gerstein has followed the issue closely and cleared much of the confusion during a presentation and panel at Fi360's annual conference in San Diego in April. He took some time to answer the most common questions he's getting on the topic, and the red flags 401k advisors, sponsors and participants should watch for when entering the space." A link to the Q&A can be found here.

Key Takeaways from the GAO Report on ESG Investing by ERISA Fiduciaries

George Michael Gerstein • May 23, 2018 • *Risk & Reward* • Tags: DOL, ESG, Fiduciary Duties

The Government Accountability Office (GAO) yesterday released a new report on ERISA fiduciaries' incorporation of environmental, social and governance (ESG) factors into its investment process. At 63 pages, here are the key takeaways:

1. The report is focused only on instances where fiduciaries consider ESG factors *as material risk factors that are part of an ordinary prudence analysis*. In other words, the GAO did *not* focus on other strategies (e.g., impact investing), such as those that select an ESG factor for moral reasons, etc., which is the historical association of ESG investing. In this sense, the GAO deserves a lot of credit for focusing on this sophisticated approach to ESG. You may recall that my paper on climate change risk focused on this very issue.
2. Rather unfortunately, the report was largely completed *prior to* the DOL's issuance of Field Assistance Bulletin (FAB) 2018-01, which we discussed here. The principal recommendation by the GAO is for the DOL to issue guidance on whether a fiduciary can incorporate ESG factors into the management of a default investment option in a defined contribution plan. As you may know, FAB 2018-01 seemed to do just that, though not in an entirely clear manner. Nevertheless, the GAO addressed FAB 2018-01 at the end of the report and narrowed its initial recommendation, namely, that the DOL better explain how fiduciaries can utilize the integration strategy in a QDIA. In the DOL's defense, FAB 2018-01 seems to address (to some extent) whether a QDIA can utilize the integration strategy; the DOL instead hit the brakes on offering a *themed* ESG product as a QDIA.
3. According to the GAO, the DOL is amenable to issuing additional guidance on ESG investing, provided there is enough interest by fiduciaries. The DOL is mum on its Form 5500 project, and whether any ESG disclosures on a revised 5500 are in the works.
4. Those close to ESG will unlikely find anything surprising in the GAO report on the various reasons why ESG is not yet widely adopted by US retirement plans: questions over the reliability/comparability of disclosures, ratings and rankings–designed to help fiduciaries incorporate ESG factors–all continue to be cited as impediments. Regulatory uncertainty, and definitional ambiguities, also remain hindrances. I recently spoke on a number of these constraints to greater adoption by fiduciaries.

ESG Considerations for ERISA Fiduciaries

George Michael Gerstein · May 18, 2018 · *News* · Tags: ESG, Fiduciary Duties

I recently moderated a panel for Fi360 called, "ESG Considerations for ERISA Fiduciaries." Here is a link to the recording.

I was joined by Ali Caffery of Envestnet and Jason Blackwell of Mercer. Too many ESG panels either sidestep the fiduciary issues altogether or discuss them in such abstract terms so as to not be terribly useful. We took a practical approach and walked the audience through some of the key issues a fiduciary should take into account when considering an ESG strategy. We received really strong feedback. I want to thank again Blaine Aikin and his entire team for allowing us to speak on this important topic!

ESG Considerations for ERISA Fiduciaries: Fi360 Annual Conference

Posted by John Sullivan, Editor-In-Chief — April 26, 2018 in Regulation, Your 401k News 0

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ESG investing is a lot like derivatives. It can be immensely additive and helpful from a return and competitive standpoint, but also incredibly harmful if not understood.

So began George Michael Gerstein, counsel with legal powerhouse Stradley Ronon, in a session entitled "ESG Considerations for ERISA Fiduciaries" at the Fi360 Annual Conference Thursday afternoon in San Diego.

Referencing the DOL's Field Assistance Bulletin released on Monday, he pointed to the varying phrases it contained, including ESG, SRI, impact investing and economically targeted investments (ETI).

"They all mean different things with different legal ramifications and responsibilities, and it's not just semantics," Gerstein noted.

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He asked co-panelist Alexandra Caffrey, portfolio manager with Envestnet, for a definition of ESG, an acronym for environmental, social and governance investing, noting it's something difficult to do.

"On one end of the spectrum is values-based investing, better known as socially responsible investing," Caffrey gamely explained. "On the other end is impact, or thematic investing. Somewhere in the middle is ESG, which states, 'first do no harm' and screens out harmful companies. It's also more proactive than SRI in that there is a dual goal of achieving good returns while doing good overall."

Echoing Gerstein, she added that the industry and investors must be careful about how they use different terms and categories.

"Part of what causes the confusion is how different people view different sectors and investments," co-panelist Jason Blackwell, principal with Mercer, said. "I'm in California, so I was told it's okay to mention pot from the stage. When pot is mentioned, some ESG investors say, 'Absolutely not. It's the same as alcohol.' But many millennials say pot is no big deal. So we have to know how they feel about certain items to be able to match the appropriate investment."

Trump's DOL Expresses Its Own Views on ESG Investing

George Michael Gerstein • April 26, 2018 • *Risk & Reward* • Tags: DOL, ERISA, ESG

This week's U.S. Department of Labor (DOL) Field Assistance Bulletin (FAB) 2018–01 on environmental, social and governance (ESG) investing seems to have both caught everyone by surprise and caused confusion amongst a good many. This is unfortunate because ESG, with its various connotations, already eludes some. But despite its shortcomings, FAB 2018-01 reflects an unease by the DOL over certain ESG practices and largely clarifies existing fiduciary obligations in this space. Here are our key observations:

- ESG guidance issued by the DOL during the Obama administration in 2015 and 2016 was largely viewed as supportive of including ESG factors in the investment process. For example, Interpretive Bulletin (IB) 2015–01 recognized that an ESG factor can in fact have a close nexus with investment performance, and, therefore, should be considered by a fiduciary like any other material investment factor (e.g., inflation risk) in the usual prudence analysis. This acknowledgement recognized the growing body of research linking ESG factors, such as climate change, with investment performance. In respect of climate change, for example, an issuer may now be facing numerous risks, including stranded asset risk, the prospect of heightened government regulation that disproportionally affects certain industries or sectors (and the resulting litigation) and even the risk that some companies or industries may be rendered obsolete as global markets search for solutions to what is called, the transition to a low-carbon economy. IB 2015-01 also restated the historical test for ESG investing: only when competing investment options serve the plan's interests equally well may a fiduciary use an ESG factor as the tie-breaker. This historical approach, sometimes called the tie-breaker test, was designed to address the early iterations of ESG investing, where the fiduciary would want to pursue an objective *unrelated* to investment performance, such as to spur jobs in the local economy. In 2016, the DOL issued IB 2016–01 in which it permitted plan-funded shareholder engagement if "the responsible fiduciary concludes that there is a reasonable expectation that [such engagement] with management, by the plan alone or together with other shareholders, is likely to enhance the value of the plan's investment in the corporation, after taking into account the costs involved." Issues on which engagement may be appropriate included "the nature of long-term business plans including plans on climate change preparedness and sustainability" and "policies and practices to address environmental or social factors that have an impact on shareholder value."
- FAB 2018–01 preserves the notion that an ESG factor can have a direct link to investment performance and may be added to the investment decision mix with all other material factors, such as volatility and its correlation with other securities in the portfolio. But the DOL cautioned that there must in fact be a real nexus between the ESG factor and shareholder value in order to avoid having to satisfy the tie-breaker test. Fiduciaries will want to build a record in support of the view that a particular factor bears a relationship with investment performance, and carefully consider how much weight to put on that specific factor.
- Though hardly clear, the DOL is seemingly still comfortable with fiduciaries populating plan investment lineups with an ESG-themed investment option, provided the fiduciary can justify its inclusion on prudence grounds. The DOL is definitely wary of a fiduciary's selection of an ESG-themed QDIA, though FAB 2018–01 does not completely close the door on such an investment product. Moreover, the DOL, in expressing skepticism of ESG-related QDIA products, distinguished between "ESG-themed funds (e.g., Socially Responsible Index Fund, Religious Belief Investment Fund, or Environmental and Sustainable Index Fund)," from funds "in which ESG factors may be incorporated…as one of many factors in ordinary portfolio management and shareholder engagement decisions." The former seems to be more concerning to the DOL than the latter. This potentially has the effect of favoring some ESG products and strategies over others.
- The DOL also zeroed-in on shareholder engagement in respect of ESG issues that have a connection to the value of the plan's investment in the company, where the plan may be paying significant expenses for the engagement or development of proxy resolutions. FAB 2018-01 states that if "a plan fiduciary is considering a routine or substantial expenditure of plan assets to actively engage with management on environmental or social factors, either directly or through the plan's investment manager," then that may warrant "a documented analysis of the cost of the shareholder activity compared to the expected economic benefit (gain) over an appropriate investment horizon." It is not evident why the DOL raised a concern over shareholder engagement that results in an ERISA plan incurring significant expenses due to direct engagement with company boards because we are not aware of that being much of a practice (at least as of yet). The DOL may have simply taken notice of other types of institutional investors, such as very large governmental plans, which are pushing for more engagement with corporate boards as an alternative to divestment, for example.

Even with FAB 2018-01, ESG remains an entirely viable investment approach under ERISA, provided it is structured in a way that satisfies the duties of prudence and loyalty. Fiduciaries face a proliferation of data and analytic tools to help identify managers and investment opportunities that are sufficiently attuned to ESG risks and best practices. Nomenclature and disclosure remain sources of concern and confusion among ESG specialists and newcomers alike. ESG's historical association with the pursuit of objectives unrelated to financial performance give the DOL and some fiduciaries pause, but a more nuanced understanding of how ESG factors can shape a portfolio's performance is emerging apace.

COMPLIANCE December 21, 2017

CalPERS' Ongoing Push Into ESG Drives a Healthy Debate

The debate started when the American Council for Capital Formation published a sharply written report alleging that, as the group puts it, "CalPERS has prioritized relatively poor performing environmental, social and governance [ESG] investments at the expense of other investments more likely to optimize returns."

By John Manganaro

While many in the wider retirement planning industry have rightly been focused on the final stages of the GOP tax cut legislation, George Michael Gerstein, ERISA council with Stradley Ronon, has been following another important story.

As he tells PLANSPONSOR, there is a hot debate going on between the lobbying and advocacy organization known as the American Council for Capital Formation (ACCF) and the California public employee's pension fund known as CalPERS. Readers will likely know of CalPERS as one of the largest public pension funds in the world, but for its part, the ACCF has had an active history in Washington dating back to its first advocacy effort in support of the Revenue Act of 1978, which cut capital gains taxes.

The debate involves the proper use of environmental, social and governance (ESG) investments within the context of institutional tax-qualified retirement investing. While ERISA attorneys and asset managers broadly agree that ESG is rapidly becoming a cornerstone issue for defined contribution (DC) and defined benefit (DB) plan sponsors—and most other categories of institutional investors for that matter—the ACCF says there is evidence that the leaders of CalPERS are not adhering to the federal government's strict rules putting limits on the use of non-financial factors when investing employees' tax-qualified retirement assets.

The whole saga started when the American Council for Capital Formation (ACCF) published a sharply written report alleging that, as the group puts it, "CalPERS has prioritized relatively poor performing Environmental, Social and Governance [ESG] investments at the expense of other investments more likely to optimize returns," and for the sake of politics no less. ACCF summarizes its charges as follows: "The board uses its size and its beneficiaries' money to wage war on companies not aligned with its political views, and influences other large institutions and influential proxy advisory firms to fall in line alongside it—or run the risk of losing out in billions of dollars in annual fees and business transactions."

Stradley's Analysis of New DOL Guidance on ESG Investing Described as "Comprehensive" and "Measured"

George Michael Gerstein · May 2, 2018 · *News* · Tags: DOL, ESG, Fiduciary Duties

This week's U.S. Department of Labor (DOL) Field Assistance Bulletin (FAB) 2018–01 on environmental, social and governance (ESG) investing seems to have both caught everyone by surprise and caused confusion amongst a good many. This is unfortunate because ESG, with its various connotations, already eludes some. But despite its shortcomings, FAB 2018-01 reflects an unease by the DOL over certain ESG practices and largely clarifies existing fiduciary obligations in this space. Here are our key observations:

- ESG guidance issued by the DOL during the Obama administration in 2015 and 2016 was largely viewed as supportive of including ESG factors in the investment process. For example, Interpretive Bulletin (IB) 2015–01 recognized that an ESG factor can in fact have a close nexus with investment performance, and, therefore, should be considered by a fiduciary like any other material investment factor (e.g., inflation risk) in the usual prudence analysis. This acknowledgement recognized the growing body of research linking ESG factors, such as climate change, with investment performance. In respect of climate change, for example, an issuer may now be facing numerous risks, including stranded asset risk, the prospect of heightened government regulation that disproportionally affects certain industries or sectors (and the resulting litigation) and even the risk that some companies or industries may be rendered obsolete as global markets search for solutions to what is called, the transition to a low-carbon economy. IB 2015-01 also restated the historical test for ESG investing: only when competing investment options serve the plan's interests equally well may a fiduciary use an ESG factor as the tie-breaker. This historical approach, sometimes called the tie-breaker test, was designed to address the early iterations of ESG investing, where the fiduciary would want to pursue an objective *unrelated* to investment performance, such as to spur jobs in the local economy. In 2016, the DOL issued IB 2016–01 in which it permitted plan-funded shareholder engagement if "the responsible fiduciary concludes that there is a reasonable expectation that [such engagement] with management, by the plan alone or together with other shareholders, is likely to enhance the value of the plan's investment in the corporation, after taking into account the costs involved." Issues on which engagement may be appropriate included "the nature of long-term business plans including plans on climate change preparedness and sustainability" and "policies and practices to address environmental or social factors that have an impact on shareholder value."

Fiduciary Governance Group Overview

For more information, contact:

Lawrence Stadulis co-chairs the fiduciary governance group and advises clients in matters pertaining to the registration and regulation of investment advisers and investment companies under federal and state securities laws. He also manages related issues pertaining to investment advisers and investment companies, including matters involving ERISA, broker-dealer regulation and banking laws.

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George Michael Gerstein co-chairs the fiduciary governance group and advises clients on the fiduciary and prohibited transaction provisions of ERISA. He counsels banks, trust companies, broker-dealers, investment managers, private fund (including hedge funds and private equity funds) sponsors, and advisers on their responsibilities under federal law when managing plan assets. George routinely advises clients on the DOL Fiduciary Rule and other fiduciary developments at the federal and state levels, and additionally, he counsels clients on fiduciary-like duties and restrictions under other laws, including federal and state banking requirements, and the rules and regulations of governmental plans.

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Other members of the Fiduciary Governance Group:

Alan Goldberg represents registered investment companies and their independent board members, registered investment advisers, sponsors to unregistered investment pools and family offices. He handles all aspects of creating registered investment companies and registering new investment advisers, including the establishment of compliance policies and procedures. Alan regularly prepares regulatory filings and applications on behalf of investment companies, including mutual funds, exchange-traded funds, closed-end funds and investment advisers, and he has performed numerous comprehensive compliance reviews of investment advisers and investment companies.

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David Grim, most recently Director of the U.S. Securities and Exchange Commission's Division of Investment Management, provides counsel on all aspects of investment management law. He assists clients with a unique perspective developed during his over 20 years of public service at the SEC, including his time as one of only a small number of people who has served as the top regulator of the asset management industry. Dave joined the Division of Investment Management in 1995 directly from law school and rose to become its leader. He developed regulatory policy and legal guidance for investment advisers and investment companies, including mutual funds, exchange-traded funds, closed-end funds, variable insurance products, unit investment trusts and business development companies.

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Sara Crovitz, most recently Deputy Chief Counsel and Associate Director of the U.S. Securities and Exchange Commission's Division of Investment Management, provides counsel on all aspects of investment company and investment adviser regulation. She worked at the SEC for 21 years, including 17 years in the Division of Investment Management focusing on issues under the Investment Company and Investment Advisers Acts of 1940. While in the Division, Sara supervised the provision of significant legal guidance to the investment management industry through no-action and interpretive letters, exemptive applications, IM guidance updates and other written and oral means.

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Paula Shaffner chairs the securities litigation & enforcement practice group and is widely recognized as a fierce advocate for clients in the financial services industry. For almost 30 years, she has represented individuals and companies in securities litigation, and defended clients in regulatory matters before the U.S. Securities and Exchange Commission, the Financial Industry Regulatory Agency and various exchanges and state regulators, and also represents clients in litigation filed in court or arbitration. In addition, Paula conducts internal investigations and provides compliance counseling.

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Christopher Connell co-chairs the banking practice group. He focuses his practice on the representation of financial institutions and other corporate clients in a variety of transactional matters, including mergers and acquisitions, offerings of debt and equity securities (both public and private), initial public offerings, and securities matters for public company financial institutions. Chris also regularly advises financial institutions with respect to various federal and state regulatory and compliance matters and other general corporate law and governance issues.

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John Baker focuses his practice on complex securities law and banking issues for mutual funds and their boards of directors/trustees, investment advisers, broker-dealers, banks, hedge funds and other participants in the financial markets. Prior to joining Stradley Ronon, he was senior counsel for a leading Boston financial institution, where he served as the primary legal advisor to the bank in its role as investment adviser to mutual funds with more than $9 billion in assets.

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James Podheiser chairs the employee benefits practice group. He advises individuals, and for-profit and nonprofit organizations of all sizes and within all industries on employee benefits law, deferred compensation arrangements, stock plans, employee vs. independent contractor issues and all aspects of ERISA. Jim's practice encompasses plan design and administration, evaluation of plan compliance and liability issues in connection with merger, acquisition and lending transactions, and representing clients before government agencies in connection with employee plan matters.

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Alison Fuller regularly counsels investment companies, investment advisers and independent trustees on federal and state securities law matters. She worked at the U.S. Securities and Exchange Commission for 10 years, including eight years as Assistant Chief Counsel in the Division of Investment Management. While at the SEC, Alison worked on more than 80 substantive no-action letters and helped develop key positions on matters involving the investment management industry.

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Thomas Hanley chairs the public companies practice group. He advises public and private companies on corporate and securities law issues, including capital-raising transactions, mergers and acquisitions, corporate governance, SEC compliance and corporate litigation. Tom also counsels management, in-house counsel, boards of directors, board committees and investors on fiduciary duty issues, takeover defense, proxy contests/contested elections and related issues. Prior to entering private practice, he served as an attorney in the SEC's Division of Corporation Finance, and now serves as a primary liaison between clients and SEC, NYSE and Nasdaq staffs on disclosure, governance, listing and interpretive issues.

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William Mandia represents financial institutions and insurers in complex commercial and class action litigation. He regularly defends and advises life insurers, intermediaries, banks, broker-dealers, investment advisers, and other financial services providers in connection with sales practices claims arising from a wide range of financial and life insurance products, including, but not limited to, claims for alleged breach of fiduciary duty, fraud, and violations of state consumer protection laws.

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Nicole Kalajian represents securities and commodities professionals in a variety of regulatory, compliance and corporate matters. She provides legal and compliance guidance to registered and exempt investment advisers, commodity pool operators, commodity trading advisers, introducing brokers, FX firms, proprietary trading firms and broker-dealers; serves as counsel to boards, mutual funds and exchange-traded funds; and drafts and develops offering documents, compliance manuals, policies and procedures, corporate materials, contracts/investment agreements and advertising materials. Nicole also provides legal and structuring guidance concerning master-feeder structures, domestic and foreign funds, international offerings and separately managed accounts.

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J. Patrick Green focuses his practice on counseling investment companies and investment advisers on regulatory, compliance and transactional issues. He advises investment management clients in all aspects of legal representation, including drafting and reviewing registration statements, proxy solicitation materials, and other regulatory filings; researching various securities and corporate law issues; and preparing board materials.

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Michael Schapiro focuses his practice on counseling investment companies (including mutual funds, closed-end funds and exchange-traded funds) private funds, and investment advisers in connection with various regulatory, compliance and transactional matters. Prior to joining Stradley Ronon, he was an associate at another Washington, DC law firm where he concentrated his practice on counseling broker-dealers and investment advisers regarding regulatory and compliance issues before the SEC and FINRA.

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Michael Wallace focuses his practice on counseling investment companies (including mutual funds, private funds, closed-end funds and exchange-traded funds) and investment advisers on regulatory, compliance, and transactional issues. He advises investment management clients in all aspects of legal representation, including drafting and reviewing registration statements, proxy solicitation materials, and other regulatory filings; researching various securities and corporate law issues; and preparing board materials.

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Lauren Zychowicz focuses her practice on counseling investment companies and investment advisers on regulatory, compliance and transactional issues. She provides analysis for investment management clients in all aspects of legal representation, including drafting and reviewing registration statements, proxy solicitation materials, and other regulatory filings; and researching various securities and corporate law issues.

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Fiduciary Governance

Fiduciary Governance

OVERVIEW

Investment committees, intermediaries and other service providers to retail and institutional investors continue to face a proliferation of policy, legislative, regulatory and litigation-driven changes to scopes of fiduciary status and ever-increasing fiduciary duties and requirements. These constantly evolving changes are occurring at the federal and state levels, resulting in overlapping and disparate compliance approaches. Financial institutions may be subject to multiple and conflicting sets of fiduciary or best interest obligations arising under federal and state law as a result of the nature of the different yet interrelated services they provide to their customers. These standards may also be vague and difficult to implement. This poses particular challenges to legal risk-mitigation efforts.

Stradley's fiduciary governance group counsels investment committees and intermediaries, such as investment advisers, banks, broker-dealers, retirement plan/IRA service providers, insurance providers and mutual fund directors, by identifying and making sense of this regulatory patchwork and helping clients understand the interplay of federal and state rules on 1) whether they owe a fiduciary or best interest duty to their customers, and 2) if so, the specific requirements that flow from such status. Moreover, the group keeps clients ahead of the curve by identifying emerging trends in the fiduciary landscape, such as environmental, social & governance (ESG) investing, through fiduciarygovernanceblog.com, webinars and written alerts. The fiduciary governance group also actively tracks the burgeoning state legislative efforts to impose fiduciary or comparable investment advice standards of care.

The fiduciary governance group leverages its technical understanding of both federal and state fiduciary rules to advise clients across regulatory schemes. The group seeks to help clients scale compliance programs under a particular regulatory regime to comply with other applicable fiduciary rules and requirements. The fiduciary governance group also helps identify the daylight between the fiduciary requirements of federal and state statutes and regulations.

Members of the group have extensive technical experience with numerous federal and state laws, including in the following areas:

- counseling SEC registered investment advisers on identifying and addressing their fiduciary and related duties under the Investment Advisers Act of 1940 and applicable state laws, including those arising in connection with their portfolio management and trading functions

- advising corporate and governmental retirement plan sponsors, trustees, investment managers and other service providers on their fiduciary and related obligations under the Employee Retirement Income Security Act of 1974 (ERISA), the Internal Revenue Code and applicable state laws

- identifying the ways in which ESG investing implicates existing fiduciary duties and the ways one can incorporate these strategies as part of a prudent process

- assisting fund sponsors and investment managers with structuring private investment funds to avoid "plan assets" status or to comply with ERISA's stringent fiduciary requirements

- helping investment company boards and their investment advisers identify and address their fiduciary duties under the Investment

Company Act of 1940 and applicable state laws

- assisting national and state-chartered banks and non-depository trust companies in fulfilling their fiduciary obligations under applicable federal and state banking laws, including in connection with maintenance of common and collective trust funds

- counseling SEC registered broker-dealers on their comparable customer suitability, best execution and other legal obligations under the Securities Exchange Act of 1934, the rules of the Financial Industry Regulatory Authority and applicable state laws

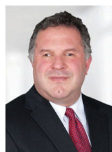
- advising financial intermediaries, such as dual-investment adviser/broker-dealer registrants, which are subject to multiple sets of fiduciary or comparable obligations, on properly identifying and meeting such obligations on a holistic, enterprise-wide basis

- representing investment intermediaries in connection with federal or state agency investigations enforcement actions or judicial proceedings involving alleged breaches of fiduciary or comparable duties

With a deep technical understanding in these areas, the fiduciary governance group collaborates to provide a streamlined service for clients operating in this complex web of fiduciary requirements by advising across regulatory schemes at both the federal and state levels.

OUR FIDUCIARY GOVERNANCE TEAM

Many members of the fiduciary governance group have previously worked for regulators or financial institutions, enabling the group to offer practical advice on fiduciary status and requirements.



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ABOUT *Stradley Ronon*

For more than 90 years, Stradley Ronon has helped private and public companies – from small businesses to Fortune 500 corporations – achieve their goals. With eight offices and more than 200 attorneys, Stradley Ronon is proud to help companies manage their legal challenges and grow their businesses.

www.stradley.com

LOCATIONS

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