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Exercising Authority, Restoring Accountability: AFL-CIO Proxy Voting Guidelines

AFL-CIO

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Abstract
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AFL-CIO, union benefits, trustees, retirement, healthcare

EXERCISING AUTHORITY, RESTORING ACCOUNTABILITY

AFL-CIO Proxy Voting Guidelines

Foreword

We are pleased to provide trustees of union benefit funds with revised *AFL-CIO Proxy Voting Guidelines*. These Guidelines have been updated to reflect major regulatory reforms enacted in 2002 and 2003, and to further raise the bar on corporate governance and accountability in the wake of recent corporate scandals.

Beginning with the collapse of Enron in late 2001, a wave of scandals at companies like WorldCom, Tyco and Global Crossing exposed how self-dealing executives can destroy companies and walk off with millions, leaving shareholders, workers and their communities to suffer the consequences. Worker benefit funds lost a staggering $35 billion in Tyco and Enron alone, and thousands of workers lost their retirement savings and in some cases their jobs and their health care.

These scandals were not merely the result of a few bad people but instead reflect a pervasive corporate culture that rewards executives for boosting the short-term stock price rather than creating long-term corporate value. As *Business Week* observed, "The tyranny of the daily stock price has led to borderline accounting and in some cases, outright fraud. And why not, when every upward tick of the stock means massive gains for option-rich executives."[1]

The *AFL-CIO Proxy Voting Guidelines* have always emphasized a long-term view of value that has served as the foundation for worker benefit funds' increasingly active participation in corporate governance. This participation goes beyond responsible proxy voting--which is a prerequisite to effective corporate governance--to include shareholder proposals and campaigns on such issues as reining in excessive executive compensation and enhancing board of director independence.

The scandals of 2001-2002 provided a painful reminder of the consequences for plan participants and beneficiaries when executives sacrifice long-term value creation for short-term gain. They also revealed an urgent need to raise the bar on corporate governance and accountability to address widespread conflicts of interest. It turns out that the very people who are supposed to be protecting investors—boards of directors, outside auditors, sell-side analysts and mutual fund managers—can be compromised by the unregulated conflicts of interest that permeate their relationships with corporate executives. For example,

- conflicted corporate boards are eager to grant outrageous pay packages to company executives, even as the company's stock price plummets, but are unwilling to ask the difficult questions of the CEO that their duties require;
- conflicted auditors compromise their "independent" audits in order to win more lucrative consulting contracts;
- conflicted investment analysts issue buy ratings on stocks that they think are junk in order to win investment banking business; and
- conflicted mutual fund companies use their enormous proxy voting power as rubberstamps for corporate management rather than to promote their investors' best interests.

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[1] Byrne, John A. et al, "How to Fix Corporate Governance", *Business Week*, May 6, 2002. See also January 2003 study by the Huron Consulting Group that found the number of restated audited financial statements more than doubled between 1998 and 2002, with fraudulent behavior cited as one of the top three reasons.

To address these conflicts and restore confidence to shaken investors, the AFL-CIO petitioned the Securities and Exchange Commission in December 2001 to adopt rules enhancing the independence of both corporate boards and outside auditors. Congress subsequently enacted a broad range of investor reforms addressing these and other conflicts of interest as part of the Sarbanes-Oxley Act of 2002. The SEC implemented these reforms in 2003, and the New York Stock Exchange and NASD are expected to institute additional reforms as part of enhanced listing standards.

In addition, even before the collapse of Enron, the AFL-CIO provided congressional testimony and sponsored shareholder proposals to adopt meaningful reforms on analyst independence, reforms now codified by New York State Attorney General Elliot Spitzer's global settlement with Wall Street. Finally, in response to another petition from the AFL-CIO, the SEC also adopted new rules requiring mutual funds to disclose their proxy voting policies and records after June 30, 2003.

We have therefore updated the Guidelines to not only reflect these regulatory reforms, but in some cases to raise the bar beyond the minimum standards established as part of the new requirements. In particular, the updated Guidelines focus on the need for truly independent boards of directors, including key committees comprised solely of independent directors, who hire independent auditors and who compensate executives based on their success in building long-term corporate value.

We hope that the substance of these Guidelines will not only be adopted by worker benefit funds and their voting fiduciaries, but will also serve as a model for other institutional investors, including the mutual funds that will soon be required to disclose their proxy voting policies and records. Armed with strong proxy voting guidelines, worker funds and other long-term investors can continue to exercise their proxy voting rights to focus corporations on building long-term value, thereby providing healthy financial returns, employment growth and retirement security.

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Introduction

The *AFL-CIO Proxy Voting Guidelines* (the Guidelines) have been developed to serve as a guide for Taft- Hartley and union benefit fund trustees in meeting their fiduciary duties as outlined in the Employee Retirement Income Security Act of 1974 (ERISA) and subsequent Department of Labor (DOL) policy statements. Most Taft-Hartley and union benefit fund trustees do not retain proxy voting authority but instead delegate it to another voting fiduciary (whether to an investment manager, custodial bank or other registered investment adviser). Although the Guidelines have been drafted specifically for this circumstance, and thus provide guidance to “the voting fiduciary”, plan trustees who decide to vote proxies in-house can also adopt the substance of the Guidelines as their fund’s proxy voting policy. In addition, the Guidelines have been created to aid public employee trustees in the review and development of guidelines for their funds.

I. Trustee Policy Statement

This statement sets forth the policy adopted by the plan's fiduciary (hereinafter "the trustees") for the voting of stock proxies. Any investment manager or adviser (hereinafter "the voting fiduciary") who is under contract to acquire, manage or dispose of plan assets, and who is responsible for the voting of common stock, is expected to take these proxy voting guidelines into consideration in making voting decisions. Additionally, the trustees request that the investment manager or adviser provide a copy of the manager's or adviser's own proxy voting guidelines to compare with these Guidelines.

Proxy voting rights have been declared by the Department of Labor to be valuable plan assets and therefore must be exercised in accordance with the fiduciary duties of loyalty and prudence. The Guidelines are intended to reinforce the voting fiduciary's duty to vote proxies loyally and prudently. The Guidelines, therefore, have been carefully crafted to meet the requirements of loyalty and prudence and will be employed by the trustees to monitor the voting fiduciary's proxy voting procedures and decisions.

The duty of loyalty requires that the voting fiduciary exercise proxy voting authority solely in the interests of participants and beneficiaries and for the exclusive purpose of providing plan benefits to participants and beneficiaries. The voting fiduciary is prohibited from subordinating the interest of participants and beneficiaries to unrelated objectives.

The duty of prudence requires that proxy-voting authority be exercised with the care, skill, prudence and diligence that a similarly situated prudent person knowledgeable in such matters would exercise. Thus, in making proxy-voting decisions, issues shall be reviewed case-by-case with final decisions based on the merits of each. The voting fiduciary should seek out information from a variety of sources to determine what is in the long-term economic best interests of plan participants and beneficiaries. A fiduciary who fails to vote without taking reasonable steps under the particular circumstances to ensure that the proxies for which the fiduciary is responsible are received, or casts a vote without considering its impact, or votes arbitrarily with management, would violate this duty.

The duties of loyalty and prudence require the voting fiduciary to make voting decisions consistent with the "economic best interests" of plan participants and beneficiaries; this does not mean that the voting fiduciary is required to maximize short-term gains if such a decision is not consistent with the long-term economic best interest of the participants and beneficiaries.[2] Some issues that may have an impact on the long-term economic best interests of participants and beneficiaries are:

- Share value and dividend yield.
- Corporate policies that affect employment security and wage levels of plan participants.
- Corporate policies that affect local economic development and stability.
- Corporate policies that affect growth and stability of the overall economy.
- Corporate responsibility to employees and local communities in which the firm operates.
- Workplace and environmental safety and health.

[2] Joint Dept. of Labor/Dept. of the Treasury Statement of Pension Investments (January 31. 1989), reprinted in 16 Pens. Rep. (BNA) 215.

The voting fiduciary is expected to weigh certain factors in determining how to vote, consistent with fiduciary obligations and the factors indicated by these Guidelines. When any issue arises in the context of an impending or ongoing change in control of a company, a more rigorous review through a thorough cost/benefit analysis is called for to fulfill the applicable fiduciary standards. In this context, the analysis must consider the long-term impact of the business plans of the competing parties.[3]

II. Reporting Requirements

To demonstrate compliance with fiduciary obligations and so that the trustees may fulfill their fiduciary duty to monitor the voting decisions they have delegated, the voting fiduciary will document and report to the trustees on an annual basis:

A. The proxy voting guidelines considered when casting votes.

B. The action taken on every proxy cast on behalf of the trustees.

C. Written justification for the following votes: (1) Any proxy vote on significant or controversial proposals including, but not limited to, such issues as mergers, restructurings, board of directors issues that may have significant impact on the company; or any proxy vote on controversial or major shareholder proposals; (2) any proxy vote that is not covered by the Guidelines; or (3) any particular proxy vote that is arguably counter to the Guidelines. In addition, the voting fiduciary should provide, when available, the overall outcome of such votes.

The voting fiduciary shall also fulfill the fiduciary duty to take reasonable steps to ensure that the proxies for all stocks owned as of the record date are actually received and acted upon. The voting fiduciary shall make the procedures used in this regard known to the trustees.

III. Revocation of Voting Authority

At any time whatsoever and without restriction, the trustee or board of trustees may, upon written notice, revoke the voting fiduciary's voting authorization unless the provisions of the plan document prohibit such revocation. Upon the revocation of the voting authorization, unless other arrangements are made, the voting fiduciary will immediately forward proxy material received to the trustee(s) or their designee.

[3] Ibid.

IV. Trustee Positions On Proxy Voting

In reviewing proxy voting issues and deciding how to vote proxies, the voting fiduciary shall take into consideration the general position of the trustees, as elaborated below, on the issues covered by these Guidelines. Although the positions discussed below have been articulated under the framework of domestic law and corporate governance, to the extent feasible and consistent with applicable foreign law these trustee positions shall also be considered when exercising shareholder rights in connection with international investments.

As discussed further in Section V, these Guidelines recognize that the ultimate exercise of judgment on a given vote is the responsibility of the voting fiduciary. Accordingly, whenever the following position summaries speak in terms of "should" or use similar language, the intention is not to usurp the voting fiduciary's responsibility, but, rather, to state the trustees' reasoned view that the circumstances described generally warrant the position and/or action recommended.

A. Board of Directors

Corporate directors have a fiduciary duty to shareholders and the corporation they serve. Shareholders elect corporate directors to hire, monitor, compensate and, if necessary, terminate senior management. For directors to effectively discharge these responsibilities, they must be highly qualified, diligent in the performance of their duties, committed to high ethical standards, and independent of the company management they oversee. The trustees expect corporate boards to be composed of qualified individuals, at least two-thirds of whom are independent, who are open to shareholder input on issues facing the company, who challenge management with tough questions and goals, and who take action when needed to maximize the long-term value of the corporation. Additionally, the trustees believe that having an independent director serve as chairperson enhances the board's independence and effectiveness.

1. Election of Directors.

When voting on directors, the voting fiduciary should consider board independence as well as the long-term performance of both the directors and the company, since these factors tend to reflect on the directors' ability, both individually and as a group, to contribute to a company's long-term value. These factors should also be considered in situations where the election is contested.

The voting fiduciary must consider taking appropriate actions if an analysis of the factors identified below indicates that the board or candidate has not served in the long-term economic best interests of plan participants and beneficiaries. The range of actions available to shareholders include, but are not limited to, withholding plan votes from some or all of the uncontested management slate, meeting with management or director candidates and supporting shareholder resolutions designed to address these issues. Withholding votes for a company nominee is one of the strongest means for shareholders to express dissatisfaction with a company's policies or with a particular director's accountability.

In voting on the entire board of directors, the voting fiduciary should consider the following factors:

- *Board Independence.* Effective boards must exercise independent judgment, and this fundamental duty can be compromised by director conflicts of interest. To mitigate these concerns, the trustees believe that at least two-thirds of a corporation's directors should be independent based on the independence definition below. This requirement, which exceeds the simple majority listing requirements established by the New York Stock Exchange ("NYSE") and NASD (formerly the National Association of Securities Dealers) in 2002, is consistent with the policy of the Council of Institutional Investors ("CII") and the recommendation of The Conference Board Commission on Public Trust and Private Enterprise. The voting fiduciary may wish to withhold votes from all non-independent nominees standing for election if 33 percent or more of the directors are non-independent based on the following definition:

  A director is defined as independent if he or she either has only one nontrivial connection to the corporation--that of his or her directorship--or is a rank-and-file employee. A director generally will not be considered independent if currently or previously employed by the company or an affiliate in an executive capacity; if employed by a present or former auditor of the company in the past five years; if employed by a firm that is one of the company's paid advisors or consultants; if employed by a customer or supplier with a nontrivial business relationship; if employed by a foundation or university that receives grants or endowments from the company; if the person has any personal services contract with the company; if related to an executive or director of the company; or if an officer of a firm on which the company's chairman or chief executive officer also is a board member.

- The *company's long-term value growth* as judged by relevant long-term financial and economic performance indicators (e.g. 3-year or 5-year return on equity) in comparison to a group of its peers as well as a broader market such as the S&P 500.

- The overall *conduct of the company.* Directors bear ultimate responsibility for the success or failure of the company, and should be held accountable for actions taken that may not be in the company's best long-term interests. Such actions may include awarding excessive compensation to executives or themselves; approving corporate restructurings or downsizings that are not in the company's best long-term interest; adopting anti-takeover provisions without shareholder approval; refusing to provide information to which the shareholders are entitled; or other actions that may not be in the company's long-term best interests.

- The board's *responsiveness to shareholder concerns.* The fiduciary may wish to withhold votes from directors who fail to implement an appropriate proposal (one that is in the long-term interests of shareholders and is consistent with these Guidelines) that has been approved by a majority of shareholders in the past 12 months The CII maintains a publicly available list[4] of companies reporting majority votes on shareholder resolutions, including whether or not the resolution has been implemented, and other corporate governance research organizations maintain similar lists. To the extent that the information is available to the voting fiduciary, the fiduciary may take into account whether the company has taken, or has agreed to take, other actions to address the underlying concern raised by the proposal or has provided a

[4] The CII majority vote list is available on its web site at www.CII.org.

persuasive explanation to shareholders for its rationale for not implementing the action called for by the proposal.

- The *views of other important corporate constituents, such as employees and communities.* The trustees believe that in order to succeed over the long-term, businesses need to be responsive to important corporate constituents such as their employees and the communities in which they operate. When one of these important corporate constituencies makes its views known, it may indicate significant problems that are likely to affect the corporation's performance, and the voting fiduciary should give these concerns special consideration when evaluating director performance.

In voting on individual directors, the voting fiduciary should consider the following factors:

- *Independence of key committees.* The audit, compensation and nominating committees provide critical oversight roles over management and should include a higher standard of independence than that of the full board. It is expected that companies listed on U.S. stock exchanges will soon be required to have audit, nominating and compensation committees that are entirely composed of independent directors. The trustees believe this is the appropriate level of independence for these key board committees. The fiduciary should withhold votes from any director nominee serving on these key committees who is non-independent based on the independent director definition above.

- *Performance of key committees.* The fiduciary should take into consideration the performance of the key committees (audit, compensation and nominating committees), particularly with regard to advancing and upholding the principles established in these Guidelines. Factors to consider include specific actions of the committees (e.g. approving excessive executive compensation or failing to address auditor conflicts of interest) and the quality of committee disclosure. For example, as detailed in Section IV.B below the voting fiduciary may wish to withhold votes from members of the audit committee if the company's outside audit firm received more than half its fees from non-audit services.

- *Attendance records of incumbent directors.* In general, support should be withheld from directors who have failed to attend at least 75 percent of board and committee meetings without adequate justification. The SEC requires companies to disclose any incumbent director who attended less than 75 percent of the aggregate of board and applicable committee meetings in the last full fiscal year, and a failure to include information can be assumed to mean that all directors attended 75 percent of the meetings.

- The ability of the candidate(s) to devote *sufficient time and energy* to the oversight of the company in question. The CII recommends that directors with full time jobs serve on no more than three boards and that no individual should serve on more than five boards. These recommendations are generally in line with those of the National Association of Corporate Directors. Accordingly, the voting fiduciary should consider withholding votes for director nominees who are employed, or self-employed, on a full-time basis and who serve on boards at three other public companies, and for nominees who are retired and who serve on boards at five other public companies. Responsibilities known to be equivalent, such as serving on the board of major private or non-profit corporations, should also be taken into account to the extent that this information is disclosed by the company or otherwise made available to the voting fiduciary.

- *Director performance on other boards.* The voting fiduciary should consider withholding votes from directors where there is sufficient reason to believe that the director's performance on another public company board has been unacceptable. At Enron, for example, a study by a committee of Enron's own independent directors concluded that the board of directors as a group had failed in its oversight responsibilities, and subsequent congressional investigations reinforced these findings. The trustees do not believe that such directors are qualified to represent shareholders on any public company boards unless the individual director is able to provide shareholders with a persuasive explanation of what he or she did to protect shareholders in the particular situation.

2. Contested Election of Directors.

Contested elections for directors generally occur when a board candidate or slate runs for the purpose of seeking a significant change in corporate policy or control of seats on the board. The trustees believe that competing slates should be evaluated based upon the personal qualifications of the candidates, the quality of the strategic corporate plan they advance to enhance long-term corporate value, and their expressed and demonstrated commitment to the interests of shareholders and other key constituents (e.g. employees, customers and the communities in which a company resides). Specifically, in determining its votes in contested elections, the voting fiduciary should consider:

- the board independence and director and company long-term performance factors identified above;
- management's historical track record;
- background to the proxy contest;
- qualifications of director nominees (both slates);
- evaluation of the competing strategic corporate plans to enhance long-term corporate value, including impact on key constituents; and
- equity ownership positions of individual directors.

3. Board and Committee Size.

A board that is too large may function inefficiently; a board that is too small may allow the CEO to exert greater force. Proposals allowing the board to set board size may be supported if the board sets a range that it will not exceed. The Investor Responsibility Research Center reports that 92 percent of all boards have between five and 15 directors. Any proposal for fewer than five directors or more than 15 generally should not be supported.

4. Classified Boards.

The voting fiduciary's analysis should consider that classified, or staggered term, boards may reduce the ability of shareholders to annually hold directors accountable versus the potential benefit of discouraging transactions that may be detrimental to the enhancement of long-term corporate value. In conducting this analysis, the voting fiduciary should consider the board independence, and the director and company long-term performance factors outlined in Section IV.A.1 above, and whether the company has additional takeover defenses in place.

5. Director Liability and Director and Officer Indemnification.
Management proposals occasionally seek to amend a company's charter to eliminate or limit the personal liability of directors to the company and its shareholders for monetary damages for any breach of fiduciary duty to the fullest extent permitted by state law. While the trustees recognize that a company may have a more difficult time attracting and retaining directors if they are subject to personal monetary liability, the trustees believe the great responsibility and authority of directors justify holding them accountable for their actions.

In determining whether to support such proposals, the voting fiduciary should consider among other things the performance of the board, the independence of the board and its key committees, and whether or not the company has in place anti-takeover devices. Subject to a satisfactory review of these board accountability factors, the voting fiduciary may support liability-limiting proposals when the company persuasively argues that such action is necessary to attract and retain directors, but the voting fiduciary may generally oppose liability-limiting proposals. The voting fiduciary should also oppose proposals to reduce or eliminate directors' personal liability when litigation is pending against current board members. Shareholder proposals may seek to provide for personal monetary liability for fiduciary breaches arising from gross negligence and should generally be supported to strengthen the call for promoting personal director accountability.

Indemnification is the payment by a company of the expenses of directors who become involved in litigation as a result of their service to a company. Proposals to indemnify a company's directors differ from those to eliminate or reduce their liability because with indemnification directors may still be liable for an act or omission, but the company will bear the expense. Subject to a satisfactory review of the board accountability factors detailed above, the voting fiduciary may support these proposals when the company persuasively argues that such action is necessary to attract and retain directors. But the voting fiduciary generally should oppose indemnification when it is being proposed to insulate directors from actions they have already taken.

6. Shareholder Access to the Proxy for Director Nominations.
The trustees support shareholder proposals to enhance the ability of long-term shareholders to cost-effectively nominate and elect directors to represent their interests, so long as these efforts do not provide a tool that can be used to facilitate hostile takeovers by short-term investors. Accordingly, voting fiduciary should generally support shareholder proposals that provide shareholders access to the company proxy statement to advance non-management board candidates. Support for such proposals should be withheld if the access right could be used to promote hostile takeovers.

7. Proposals to Separate Chairperson and Chief Executive Officer.
The primary purpose of the board is to protect shareholders' interests by providing independent oversight of management, including the CEO. The chairperson's duty to oversee management is compromised when self-monitoring is required, and the trustees fear that combining the positions of chairman and CEO may give the CEO undue power to determine corporate policy. However, in certain circumstances, such as a small-cap company with a limited group of leaders, it may be appropriate for these positions to be combined for some period of time. The voting fiduciary should support shareholder proposals seeking to require that an independent director who has not served as an executive at the company shall serve as chairman of the board of directors.

8. Proposals to Establish a Lead Independent Director

At companies that have not adopted an independent board chairperson, the voting fiduciary should support the establishment of a lead independent director. In addition to serving as the presiding director at meetings of the board's independent directors, a lead director is responsible for coordinating the activities of the independent directors. At a minimum, a lead independent director helps to help set the schedule and agenda for Board meetings, monitors the quality, quantity and timeliness of the flow of information from management, and has the ability to hire independent consultants necessary for the independent directors to effectively and responsibly perform their duties.

9. Proposals Seeking Greater Board Independence.

Independence is critical for directors to carry out their duties to select, monitor and compensate management, and the voting fiduciary should generally support efforts to enhance board of director independence. This includes, but is not limited to, proposals to require:

- that at least two-thirds of a company's directors be independent;
- that 100% of the directors on key committees (nominating, compensation and audit) be independent[5];
- the company to adopt a stricter definition of director independence consistent with the definition of director independence under "Election of Directors" above; or
- the company to provide expanded disclosure of potential conflicts involving directors.

10. Term Limit Proposals.

The voting fiduciary should vote against proposals to limit terms of directors because they may result in prohibiting the service of directors who significantly contribute to the company's success and represent shareholders' interests effectively.

11. Proposals Seeking Broader Participation on the Board.

The voting fiduciary should support proposals requesting companies to make efforts to seek more women and minority group members for service on boards. A more diverse board of qualified directors benefits the company and shareholders. Another example of such diversity would be employee shareholders, and it is reasonable to support proposals that would allow for such representation.

12. Business Development.

Shareholders have introduced proposals asking for clarification on the role the board of directors, as representatives of the shareholders, play in developing business. The fiduciary should support proposals asking for such additional disclosure.

[5] The U.S. stock exchanges are expected to approve new listing standards that will require that listed companies have only independent directors on their nominating, compensation and audit committees. The new requirements would take effect two years after approval.

B. Auditors

Independent auditors play an essential role in the capital markets, helping to protect the integrity and reliability of corporate financial reporting. The independent audit and resulting opinion letter are intended to enhance investors' confidence that the financial statements on which they rely provide an accurate picture of a company's financial condition. Recent accounting scandals at companies such as Enron, WorldCom and Tyco illustrate the enormous consequences for investors when this audit process breaks down, and have focused investors' attention on the conflicts of interest that can compromise auditor independence.

The trustees believe that auditor independence is essential for the rendering of objective opinions on which investors can rely. Further, the trustees believe that a company's engagement of its audit firm to perform non-audit services (audit-related, tax and all other services) may compromise the independence of the audit firm, or give rise to questions and concerns about the integrity and reliability of the auditor's work. Both the type and amount of work performed for a company by its outside audit firm must be closely scrutinized. Real and perceived auditor conflicts are most serious when non-audit services constitute a significant percentage of the total fees paid by the company to the auditor, or when the nature of these non-audit services places the auditor in the role of advocate for the company or its executives (e.g. advising the company or its executives on tax avoidance strategies or executive compensation). The trustees also believe that an audit firm's independence can be compromised when the company has employed the same audit firm for a substantial period of time.

In response to requirements mandated by the Sarbanes-Oxley Act of 2002, the SEC recently adopted new rules to enhance the independence of auditors. The new rules prohibit audit firms from providing certain non-audit services, require a company's audit committee to pre-approve audit and permitted non-audit services, and require rotation of the lead audit partner, but not the audit firm, every five years. The new SEC rules also increase the disclosed categories of professional fees paid for audit and non-audit services from three to four.[6] Under the new requirements a company will be required to describe, in qualitative terms, the types of services provided under each of the three non-audit categories.

The trustees prefer that companies only engage their auditors to perform audit services. The trustees acknowledge, however, that the performance of certain non-audit services--audit-related services and routine tax services that do not involve advocacy--do not necessarily compromise the independence of the audit process. The trustees do not believe that auditors should be permitted to provide advice on tax avoidance strategies or any other non-audit service that places the auditor in the role of advocate for the company or its executives. Potential and real threats to the independence of the audit process are presented when the fees for permitted non-audit services are a significant portion of the total fees received by the audit firm.

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[6] Currently the SEC requires companies to breakout auditor fees into three categories: (1) Audit Fees, (2) Financial Systems Design and Implementation, and (3) All Other Fees. The new categories will be: (1) Audit Fees, (2) Audit-Related Fees, (3) Tax Fees, and (4) All Other Fees. Under the new requirements a company will also be required to describe, in qualitative terms, the types of services provided under the three categories other than Audit Fees.

1. Auditor Ratification.
The voting fiduciary should vote against ratification of the auditors when:

- there is reason to believe that the company's auditors have become complacent in the performance of their auditing duties;
- there has been a change in auditors from the prior years and it is determined that the cause is a disagreement between the company and the terminated auditor on a matter of accounting principles or practices, financial statement disclosure or auditing scope or procedure.
- the auditor provides advice on tax avoidance strategies, as disclosed in the qualitative discussion of tax services, or any other tax or other service that the voting fiduciary believes places the auditor in the role of advocate for the company or its executives;
- the fees for non-audit services (audit-related, tax services and all other fees)) account for a significant percentage of total fees. When fees for non-audit services are more than 20% of total fees there should be concern, and when non-audit fees exceed 50%of total fees it is inappropriate and a serious threat to auditor independence. In determining the appropriate threshold at a particular company, the voting fiduciary should consider the nature of the non-audit services provided (e.g. any level of "all other fees" is considered problematic) and the level of detail provided in the qualitative descriptions of non-audit fees; and
- a company has had the same audit firm for more than 7 years.

A vote against ratification of the auditor based on the above standards may raise concerns with board of director oversight, and the voting fiduciary should take this into consideration when evaluating the performance of the audit committee. When these concerns are serious, such as when the audit committee approves non-audit fees that are clearly excessive (i.e. more than 50% of total fees), the voting fiduciary may also consider withholding votes for directors serving on the audit committee (as noted in Section IV. A.).

2. Shareholder Proposals Relating to Auditors.
The voting fiduciary should support shareholder proposals to enhance auditor independence, including those that complement or strengthen the minimum acceptable standards established above. These could include, for example, shareholder proposals to limit or prohibit non-audit services, or to require audit firm rotation.

C. Executive and Director Compensation

A reasonable and just compensation system is fundamental to the creation of long-term corporate value, and the trustees support such compensation for all workers, including executives. However, the past two decades have seen an unprecedented growth in compensation only for top executives and a dramatic increase in the ratio between the compensation of executives and rank-and-file workers. By any standard, many of today's executive compensation packages are excessive. Too often directors have awarded compensation packages that go well beyond what is required to attract and retain executives, and have rewarded even poorly performing CEOs. These executive pay excesses come at the expense of shareholders as well as the company and its employees. Fund fiduciaries are therefore obligated to address the issue of excessive compensation.

Executive compensation packages are generally composed of annual salary, annual incentive awards, long-term incentive awards, stock options and other forms of equity compensation. The structure of a CEO's compensation package influences whether the CEO focuses on boosting the corporation's day-to-day share price or concentrates on building long-term corporate value. For this reason, the trustees believe that long-term incentive compensation should constitute more than 50% of an executive's total compensation, and pay-for-performance over the long term should be the benchmark for all executive compensation plans. Pay-for-performance means rewarding executives for meeting explicit and demanding performance criteria, *and* penalizing executives (by either reducing or withholding compensation) for failures to meet these goals as determined by the board of directors.

A well-designed executive compensation plan aligns the interests of senior management with the long-term interests of the company and its shareholders. Unfortunately, with the exception of certain equity compensation plans, shareholders rarely have the opportunity to vote on important components of executive compensation or on general plan design. Although the board of directors has a duty to faithfully represent the interests of shareholders when setting executive pay, senior executives may inappropriately manipulate the executive compensation process to their advantage. Executive compensation policies and plans should be created by fully independent directors--with the assistance of independent compensation consultants--and approved by shareholders.

In general, the trustees support compensation plans that provide challenging performance objectives and serve to motivate executives toward creating superior long-term corporate growth and value. The trustees oppose plans that adversely affect shareholders, that are excessively generous, that lack clear and challenging performance goals, or that adversely affect employee productivity and morale.

1. Stock Option Plans.
The trustees believe that using fixed-price stock options to compensate executives is detrimental to the corporation and its shareholders. Stock option grants promise executives all of the gain of share price increases with none of the risk of share price declines. As a result, they can encourage excessive risk taking by executives and can prompt executives to pursue corporate strategies designed to promote short-term stock price to the detriment of long-term corporate value. For these reasons, stock options are often not an appropriate form of compensation for senior executives, and the trustees support performance-based alternatives to stock options such as long-term incentive plans and performance-vesting restricted stock. If companies are to use stock options for executive compensation, the trustees believe certain safeguards must be in place. These necessary features in plan design include stock option expensing, performance-based stock options, share holding requirements, acceptable dilution levels, and a prohibition on retroactively repricing stock options.

When voting on management proposals relating to stock options (including proposals to adopt, amend, add shares to or extend the term of plans), the voting fiduciary should consider the criteria defined below (Items 1.1 through 1.9). The voting fiduciary should support shareholder proposals seeking to limit or reform the use of stock options in a manner consistent with these criteria (e.g. proposals requiring stock option expensing or shareholder approval for repricing or other changes to plan criteria).

1.1 Performance-Based.

The voting fiduciary should only support stock option plans that are truly performance-based. These include premium-priced options (which have a strike price greater than 100 percent of the fair market value on the date of grant), and those linked to a market or industry stock price index or other performance measure. Premium-priced stock options as well as options whose exercise is dependent on exceeding a market index ensure that management compensation is linked clearly to superior stock performance, rather than to stock increases due solely to a broad-based appreciation in the equity markets.

1.2 Expensing.

The voting fiduciary should only support the use of stock options if the stock options are fully expensed. Current accounting rules give companies the choice of reporting stock option expenses annually in the company income statement or as a footnote in the annual report. A failure to properly account for stock options as a compensation expense has promoted the excessive use of stock options for executive compensation at some companies. This practice also obscures and understates the cost of executive compensation.

1.3 Dilution.

Stock option plans dilute the earnings and voting power of shares outstanding. The amount of acceptable dilution varies among voting fiduciaries, but a vote should be cast against any proposal if total dilution of either outstanding voting power or outstanding shareholders equity is greater than 10 percent. There may be instances in which a slightly higher dilution rate may be in the best interests of shareholders, but these exceptions should be determined on a case-by-case basis. Higher levels of dilution may be acceptable for plans that are particularly broad-based or have especially challenging performance-based objectives.

1.4 Grant Rates.

The voting fiduciary should consider whether past equity compensation grants to senior executives are within reason and prudent. Providing repeated large grants to managers may offer a diminished incentive and needlessly dilute the company's shares. Accordingly, consideration should be given to the company's historical annual grant rate of options to executives. Equity compensation plans should not exceed an annual stock option grant rate of one percent of shares outstanding to senior executives. Higher grant rates may be acceptable for plans that are particularly broad-based or have especially challenging performance-based objectives. The voting fiduciary should also oppose plans that reserve a specified percentage of outstanding shares for award each year (known as an evergreen plan) instead of having a termination date.

1.5 Repricing.

The voting fiduciary should oppose any stock option plan that does not explicitly prohibit repricing, unless the company has adopted a policy against repricing. Similarly, the voting fiduciary should oppose the replacement of underwater stock options with new option grants at a lower exercise price. Stock options give executives the right to buy shares of stock at a specified price, usually the market price when issued. By "repricing" the option exercise price to a lower level after a share price decline, executives are rewarded for the poor performance of the company's stock, undermining the intent of stock option awards. Performance-based stock option plans that index the exercise price to a peer group or other measurement are not subject to this repricing provision so long as the performance benchmark is predetermined prior to the grant date and not subject to change retroactively.

1.6 Reloads.

The voting fiduciary should oppose any stock option plan incorporating a "reload" feature. A reload grant gives the recipient additional stock options to replace the options that have been exercised. Reloading options make it possible for the recipient to lock in increases in stock price with no attendant risk, a benefit not available to other shareholders. Stock option reloads also contribute to excessively large compensation packages and increase stock option dilution. Lastly, reload features transfer responsibility for new option grants from directors to the executive who is exercising his or her options.

1.7 Broad-Based.

The voting fiduciary should consider whether a proposed plan generally is available to other managers and employees in the company, or is targeted narrowly to the top executives of the company. Any plan that creates or exacerbates disparities in the workplace may adversely affect employee productivity and morale. Broad-based plans can provide a significantly greater improvement in employee productivity and company performance than those narrowly targeted to top managers. The voting fiduciary should generally oppose plans if a significant proportion (e.g. more than 10%) of option shares granted the previous year were issued to the top five executives.

1.8 Holding Period.

The trustees believe that executive should be required to hold a substantial portion of their equity compensation awards, including shares received from option exercises (e.g. 75% of their after-tax stock option proceeds), while they remain at a company. Equity compensation awards are intended to align management interests with those of shareholders, and allowing executives to sell these shares while they are employees of the company undermines this purpose. Given the large size of a typical annual equity compensation award, holding requirements that are based on a multiple of cash compensation may be inadequate.

1.9 Complexity.

The trustees oppose compensation plans that are needlessly complex, inconsistent and complicated, or plans that weaken performance criteria by providing directors with excessive discretionary power. The voting fiduciary should therefore oppose plans that allow pyramiding (using shares obtained from the exercise of each option to purchase additional shares covered under the option), gross-ups (in which the company provides cash or additional options to cover the tax-liability of options), or acceleration of the vesting requirements of outstanding awards. The voting fiduciary should also oppose plans that bundle several kinds of awards into one plan (known as "omnibus plans") or do not provide clear guidelines for the allocation of awards to senior executives.

2. Restricted Stock.

The voting fiduciary should support the use of performance-vesting restricted stock so long as the absolute amount of restricted stock being granted is a reasonable proportion of an executive's overall compensation. The best way to align the interests of executives with shareholders is through direct stock holdings, coupled with at-risk variable compensation that is tied to explicit and challenging performance benchmarks. Performance-vesting restricted stock both adds to executives direct share holdings and incorporates at-risk features. To reward performance and not job tenure, restricted stock vesting requirements should be performance-based rather than time-lapsing. Such plans should explicitly define the performance criteria for awards to senior executives and may include a variety of corporate performance measures in addition to the use of stock price targets. In addition, executives should be required to hold their vested restricted stock as long as they remain employees of the company.

3. Proposals on Base Compensation.
The voting fiduciary should support reasonable limits on base executive compensation. Annual salaries for executives and other forms of guaranteed pay should be the minimum necessary for retention and recruitment. In addition, section §162(m) of the Internal Revenue Code limits the tax deductibility of executive compensation in excess of $1 million that is not performance-based. The voting fiduciary should support this limitation and other proposals to establish reasonable levels of executive base compensation.

4. Proposals on Variable Compensation.
The voting fiduciary should support long-term incentive plans, annual bonus plans and other variable compensation plans that use explicit operating performance benchmarks. These plans can help promote the long-term success of a company by focusing executives on improving earnings per share, return on equity, and other quantitative measures of company performance. The voting fiduciary may also support routine amendment of these plans, with the exception of any amendment that seeks to lower the performance criteria. For example, the voting fiduciary should support proposals to remove pension surpluses from operating profits for the purpose of determining variable pay. Only true operating income should be considered in determining executive compensation, and the use of these figures distorts the principle of pay for performance.

5. Proposals on Executive Perks and Benefits.
The voting fiduciary should support enhanced disclosure and shareholder oversight of executive benefits and other perquisites. For example, executive pensions and deferred compensation plans can amount to significant liabilities to shareholders and it is often difficult for investors to find full disclosure of their terms. In general, the voting fiduciary should oppose the provision of any perquisite or benefit to executives that exceeds what is generally offered to other company employees. From a shareholder prospective, the cost of these executive entitlements would be better allocated to performance-based forms of executive compensation.

6. Golden Parachutes.
The voting fiduciary should support shareholder approval of severance plans or executive employment contracts that contain "golden parachutes." Golden parachutes are generous severance payments granted to executives that are contingent on a change of control in a company. These employment contracts can reward underperformance leading up to a change in control and are rarely justified in light of the significant compensation already awarded most executives. Also, the voting fiduciary should support proposals to eliminate any severance package for senior executives that provides for benefits not generally offered to other company employees. Any severance plan or stock option "change in control" vesting feature should be contingent upon the completion of a merger, rather than the lesser standard of shareholder approval of a merger.

7. Proposals Seeking Greater Transparency and Oversight.
The trustees generally believe that shareholders benefit from full disclosure of all forms of compensation received by senior executives. Requiring shareholder approval of important compensation matters also provides an important safeguard against excessive executive pay. The voting fiduciary should support proposals seeking to expand the disclosure of executive compensation or to enhance shareholders' voting rights on compensation matters. The voting fiduciary should also support proposals to enhance the transparency of the executive compensation process. Such proposals may include the adoption of compensation committee charters or supplemental reports on compensation practices.

8. Proposals Seeking Alternative Performance Measures.
The voting fiduciary should consider supporting shareholder proposals to link executive compensation to the company's achievement of goals that improve the company's long-term performance and sustainability, provided that the proposals seek that such criteria be evaluated *in addition* to the traditional financial measures of company performance in determining executive compensation. These alternative performance measures may include regulatory compliance with environmental laws, workplace health and safety regulations, nondiscrimination laws, international labor standards, measures of employee satisfaction, or other measures of a high-performance workplace.

9. Outside Director Compensation.
Shareholder evaluation of director compensation is especially important since directors are responsible for compensating themselves. The voting fiduciary should support compensating directors in a fashion that rewards excellent service and in a manner that does not compromise the independence of directors. To enhance director's independence from management, director compensation plans should be separate from executive compensation plans and should be voted on separately by shareholders. Excessively large compensation packages may also make directors less willing to challenge management out of fear of not being re-nominated. Direct stock ownership is the best way to align the interests of outside directors and shareholders. Accordingly, a significant proportion of director compensation should be in the form of stock. Directors should be subject to reasonable equity holding requirements. In addition to these conditions, director compensation plans should be evaluated using the same standards as apply to executive compensation plans.

D. Corporate Governance and Changes in Control

Issues in this category may have a significant impact on the value of plan investments: it will vary depending on the company and circumstances involved. The voting fiduciary must therefore review each issue in this category case-by-case and make a decision on the long-term economic best interests of plan participants and beneficiaries.

Some of these proposals will occur in the context of an impending or ongoing contest for corporate control, while others will have a direct effect on the likelihood of material transactions such as tender offers, leveraged buyouts, mergers, acquisitions, restructurings and spin-offs. In these situations, the voting fiduciary must make an independent and thorough cost/benefit analysis of the likely economic result of such transactions. The analysis must consider the long-term business plans of the competing parties. In determining how to vote, the voting fiduciary is not required to maximize short-term gains where disrupting the stability and continuity of the corporation is not consistent with the long-term economic best interests of plan participants and beneficiaries.[7] Measures originally designed to protect companies from takeovers may also serve to entrench management.

With regard to corporate governance proposals not in the context of an impending or ongoing contest for corporate control, the voting fiduciary must consider the impact of the vote on plan assets as well as the ability of shareholders to hold management accountable for corporate performance.

Issues in this category include but are not limited to:

1. Increasing Authorized Common Stock.
The voting fiduciary should support management proposals requesting shareholder approval to increase authorized common stock when management provides persuasive justification for the increase and the amount of the increase is reasonable. For example, the voting fiduciary may support increases in authorized common stock to fund stock splits that are in the shareholders' interest, or for a recapitalization. Stock authorizations that increase the existing authorization by more than 50% should generally be opposed, unless very specific criteria and/or extenuating circumstances are involved. The voting fiduciary may choose to oppose such proposals when the company intends to use the additional stock to implement a poison pill or other takeover defense.

2. Reverse Stock Splits.
The voting fiduciary may support a reverse stock split if management provides a reasonable justification for the reduced split and reduces authorized shares accordingly. Reverse stock splits exchange multiple shares for a lesser amount to increase the share price. Increasing share price is sometimes necessary to restore a company’s stock price to a level that will allow it to be traded on the national stock exchanges, and can thus help to maintain stock liquidity. Failure to reduce authorized shares as part of a reverse split, however, effectively results in an increase in authorized shares.

3. Preferred Stock.
The voting fiduciary should oppose requests to authorize preferred stock if the board has unlimited rights to set the terms and conditions of the shares. Preferred stock that gives the board of directors broad powers to establish voting, dividend and other rights without shareholder review, also known as blank-check preferred stock, can be used as an anti-takeover device.

4. Tracking Stock.
The voting fiduciary should oppose management proposals to issue tracking stocks designed to reflect the performance of a particular business segment. The trustees view tracking stocks as extremely problematic since they hold a high likelihood of creating substantial conflicts of interest between stockholders, board members and management as boards are placed in the precarious position of having to balance competing sets if interests under a single fiduciary authority. Tracking stocks, by definition, have no connection to real assets, production or capital, and, its holders have little to no voting rights and no claim on corporate assets in the event of bankruptcy.

[7] Joint Dept. of Labor/Dept. of the Treasury Statement of Pension Investments (January 31. 1989), reprinted in 16 Pens. Rep. (BNA) 215.

5. Reincorporation.

The trustees generally oppose proposals by companies to reincorporate to jurisdictions that will result in a weakening of shareholder rights or present other risks that outweigh potential benefits. This pertains to reincorporations from one state to another as well as to other countries. The trustees are particularly concerned with the recent wave of U.S. companies seeking to reincorporate to offshore tax havens since these jurisdictions typically have weaker shareholder legal protections that make it more difficult to hold directors and management accountable.

The voting fiduciary may support proposals to reincorporate from one state to another where satisfactory business reasons are specified and there is no significant negative impact on matters of corporate governance, shareholder rights, and management accountability. The threshold to approve proposals by U.S. companies seeking to reincorporate to a foreign jurisdiction is much higher, however, and the voting fiduciary should generally oppose such proposals unless the company is able to make a compelling case, supported by extensive disclosure, that reincorporation will (a) not harm or weaken shareholder rights or lessen management accountability, (b) contribute substantial, quantifiable and reliable benefits to the corporation’s long-term value; and (c) not adversely impact the company’s employees and the communities in which they live. The fiduciary should oppose reincorporation as a takeover defense or to limit director liability. The fiduciary should vote for proposals to block or prohibit companies from reincorporating in tax havens and support proposals urging companies to reincorporate in the U.S.

6. Poison Pills.

While the trustees support the legitimate use of shareholder rights plans, typically known as poison pills, the trustees believe shareholders should always be given the opportunity to vote on such plans. The voting fiduciary should oppose poison pill proposals by management that do not require management to submit the pill periodically, preferably every three years, to a shareholder vote, and should support shareholder proposals that ask a company to submit its poison pill for shareholder ratification.

In evaluating any poison pill proposal, the voting fiduciary must consider the impact of acquisition attempts that may be detrimental to the enhancement of long-term corporate value and the failure of most mergers and acquisitions to enhance long-term corporate value. In addition, the voting fiduciary should consider the threshold for triggering a poison pill, and should oppose any plan with a threshold of less than 20 percent of a company's shares.

7. Supermajority Voting Requirements.

The voting fiduciary should review supermajority proposals on a case-by-case basis, weighing the consideration that supermajority voting requirements may be used to undermine voting rights against the potential benefit, in some circumstances, of protecting the interests of minority or outside stockholders. Generally, the trustees oppose management proposals to require a supermajority vote and support shareholder proposals to lower supermajority voting requirements. The voting fiduciary should carefully scrutinize management proposals to lower the voting threshold for shareholder approval of management-initiated actions.

8. Dual Class Voting.
The Trustees oppose any voting system that entrenches company management at the expense of shareholders. The issuance of new classes of stock with unequal voting rights ("dual class voting") is often designed to enhance the voting rights of company insiders and is common at family controlled companies. The voting fiduciary should generally oppose proposals that limit shareholder power by issuing dual class shares. In recognition of the beneficial role that long-term investors can play in strengthening a company's corporate governance and management accountability, proposals that seek to enhance the voting rights of long-term shareholders should be given favorable consideration.

9. Confidential Voting and Independent Tabulation of the Vote.
The voting fiduciary's analysis must consider the interest of shareholders in assuring that proxy voting be protected from potential management coercion and management's use of corporate funds to lobby shareholders to change their votes. The right of employee and institutional shareholders to vote without pressure from management is crucial. The purpose of confidential voting is to protect shareholders from management pressure to change their votes *before* the shareholder meeting at which those votes are cast.[8] The fiduciary should support shareholder proposals that seek greater confidential voting. Confidential voting does not pertain to proxy vote disclosure after the shareholder meeting. To enable investors to monitor potential conflicts of interest by money managers who vote proxies on behalf of investors at the same companies to which they market other financial services, the trustees strongly support after-the-fact proxy vote disclosure by third-party fiduciaries to their clients, whether these clients are institutional investors such as pension funds or individual mutual fund shareholders.

10. Cumulative Voting.
The voting fiduciary's analysis must consider the fact that cumulative voting is a method of obtaining minority shareholder representation on a board and of achieving a measure of board independence from management control. Generally, the fiduciary should support shareholder proposals to restore cumulative voting and oppose management proposals to eliminate this feature.

11. Shareholders' Right to Call Special Meetings and Act by Written Consent.
In analyzing proposals to limit or eliminate the right of shareholders to call special meetings and act by written consent, the voting fiduciary must weigh the fact that these rights may enhance the opportunity for shareholders to raise issues of concern with the board of directors against their potential for facilitating changes in control. Generally the fiduciary should oppose any attempts to limit and eliminate such rights if they already exist in a company's by-laws, and should support shareholder resolutions that seek to restore these rights.

12. Mergers and Acquisitions.
In determining its votes on mergers and acquisitions, the voting fiduciary should consider the following factors:

- impact of the merger on long-term corporate value, including prospects of the combined companies;
- anticipated financial and operating benefits;
- offer price (cost vs. premium);

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[8] For a discussion of confidential voting, see Monks, Robert A.G. and Nell Minow. Corporate Governance. Malden, Massachusetts: Blackwell Publishers Inc., 1995.

- how the deal was negotiated;
- changes in corporate governance and their impact on shareholder rights; and
- impact on key constituents at both companies, including employees and communities.

13. Fair-Price Provisions.
The voting fiduciary's evaluation of the long-term costs and benefits of a fair-price provision must consider the fact that such provisions guard against the coercive pressures of two-tiered tender offers in which some shareholders, including plan participants in some instances, receive less value for their stock than other shareholders from a bidder who seeks to take a controlling interest in the company. However, the voting fiduciary also must consider the provision's potential for minimizing the company's debt and the resulting impact on the long-term value of holdings in the event the shareholders do not tender.

14. Greenmail Payments.
The voting fiduciary's analysis must consider the fact that greenmail discriminates against other shareholders and may result in decreased stock price. Where the voting fiduciary concludes that the greenmail payment lacks satisfactory long-term business justification (such as stopping an acquisition attempt that would be detrimental to the long-term economic best interests of plan participants and beneficiaries), the fiduciary must oppose the proposal.

15. Approving Other Business.
The voting fiduciary should oppose management requests to approve other business because this gives management broad authority to take action without shareholder consent even when shareholders have an interest in the issue.

E. Employee-Related Proposals

1. Employee Stock Purchase Plans.
The voting fiduciary generally should support employee stock purchase plans. These plans cover a large number of the company's employees and allow them to purchase the company's stock at a slight discount. The trustees support employee ownership in companies because it serves to link the interests of employees of the company with the interests of shareholders of the company, which benefits shareholders in the long run.

2. High-Performance Workplaces.
The voting fiduciary should generally support proposals encouraging high-performance workplace practices at companies. Such practices may include those identified in the U.S. Department of Labor's 1994 report *Road to High-Performance Workplaces*--employee training, direct employee involvement in decision making, compensation linked to performance, employment security and a supportive work environment--or may include other measures of performance, such as the extent to which a company uses part-time or contract employees to the exclusion of full-time paid employees. High-performance workplace practices can contribute to both a company's productivity and long-term financial performance. However, the voting fiduciary should review these proposals to ensure that they are in the shareholders' best interests and do not unduly interfere with the company's operation.

3. Pension Choice.
A number of companies have recently faced controversy as they converted traditional defined benefit plans into cash-balance plans. Traditional plan benefits accrue based on a percentage of base salary multiplied by the number of years of service, multiplied by the final five-year average base pay. Cash-balance plans reserve a fixed percentage of base salary plus interest and are portable. Conversions to cash-balance plans often hurt older workers and may be motivated by a company's desire to inflate its book profits by boosting surpluses in its pension trust funds. The trustees believe that such actions can have an extremely detrimental affect on employee morale, and that the fiduciary should generally support proposals seeking to restore employee choice on this matter.

F. Corporate Responsibility

The trustees believe that in order to succeed over the long-term, businesses need to treat employees, suppliers and customers well, to be environmentally responsible, and to be responsive to the communities in which they operate. A range of issues relating to how businesses fulfill these goals that can be addressed with what are called corporate responsibility, or social issue, shareholder proposals. In general, the fiduciary can support such shareholder proposals if they either contribute to the long-term economic best interests of plan participants and beneficiaries or will have no adverse effect on the long-term economic best interests of plan participants and beneficiaries. More disclosure from management to shareholders on most corporate responsibility issues is generally desirable. Many issues compete for management's attention, and shareholder support of proposals that request reports on particular issues may provide a useful focus.

1. Corporate Conduct, International Labor Standards and Human Rights.

These proposals call for the adoption and/or enforcement of principles or codes relating global labor standards, or for further reporting on the issues.

The trustees believe companies should adopt workplace practices covering basic labor and human rights standards for company-owned and supplier operations, in particular those that are based on principals of the United Nations' International Labor Organization's Fundamental Conventions, including freedom of association (Conventions 87 and 98), equality (Conventions 100 and 111), the abolition of forced labor (Conventions 29 and 105) and elimination of child labor (Conventions 132 and 182). Formulated through tripartite negotiations between representatives from governments, labor unions and businesses, the Fundamental ILO Conventions are widely recognized by labor and human rights groups and are used as benchmarks and the basis for laws by many countries around the world. Moreover, enforcing a global code or policy based on the Fundamental ILO Conventions can improve workplace relations, which in turn can increase productivity, improve quality, reduce workplace injuries, limit risk and liabilities associated with lawsuits, improve brand image, increase shareholder value and yield other economic benefits. Proposals calling on companies to adopt codes or policies based on the Fundamental ILO Conventions should be supported.

A large portion of both domestic and overseas manufacturing is done through contracting and subcontracting, rather than through facilities owned directly by the companies. This makes it possible for a company's products to be produced in conditions that violate international labor standards, with all of the attendant liabilities, without the company's knowledge unless it makes an effort to learn about its contractors' operations and insists in operating practices that conform to international standards as a condition for awarding the contract. For this reason, companies should establish a monitoring process that includes disclosure and independent verification of contractors' compliance with labor standards. The trustees support supplier standard resolutions that call for the corporation to take reasonable steps, or institute a review process, to ensure that it does not and will not do business with suppliers, either domestic or foreign, that manufacture products using forced labor, convict labor or child labor, or that fail to comply with all applicable laws and standards protecting their employees' wages, benefits, working conditions, freedom of association and other rights.

A company operating in a repressive environment, either directly or through its contracting relationships, has an obligation to keep shareholders informed of its efforts to counter repression and to demonstrate that it is not implicitly acquiescing in other parties' repressive practices. Taking such actions will help the company to protect its reputation and to reduce its vulnerability to lawsuits. For example, because of the pervasive involvement of Burma's military regime in the business sector and its widespread use of forced labor, companies that engage in joint ventures with the regime risk lawsuits and damage to their reputations. A number of companies have ceased operations in Burma, concluding that it is impossible to do business in the country without supporting the military government and its pervasive violations of human rights. Another country that is often targeted for such resolutions is China. Proponents note that now that China has been accepted into the World Trade Organization, which ends the leverage that had been provided by the annual congressional review of China's human rights situations, such proposals are of greater urgency. Proposals that address such issues should generally be supported.

Reports can also assist shareholders in assessing how the company plans to address some of the challenges inherent in doing business in countries where forced labor or child labor is common, where rights to organize and bargain collectively are severely restricted, or where environmental regulation and facilities are deficient. A review or report can shed needed light on a controversy and help investors to better understand management's position. It also could form the basis for further shareholder or company action if that is needed. Proposals that ask companies to prepare reports on their human rights policies, their operations in particular countries, or their impact on local groups, should generally be supported.

Shareholders often call for the adoption of the MacBride Principles, which deal specifically with Northern Ireland, on the grounds that U.S. companies operating abroad should support the equal employment opportunity policies that apply in facilities operating domestically. The voting fiduciary should generally support these proposals.

2. Environmental Issues.

Shareholder proposals on environmental issues are increasingly common. Proposals seeking the adoption of the CERES principles call for the adoption of principles that encourage the company to protect the environment and the safety and health of its employees. Many companies have voluntarily adopted these principles. The voting fiduciary generally should support these proposals, for they improve the company's public image and may improve its operations, both of which enhance shareholder value. Other proposals that seek responsible reporting on issues effecting the environment may be supported on a case-by-case basis.

3. EEO Standards.
In general the fiduciary should support proposals asking companies to report on diversity in the workplace, as long as those plans do not set arbitrary or unreasonable goals, or require companies to hire people who are not well qualified for their positions. The trustees believe that reporting to shareholders on affirmative action keeps the issue high on a company's agenda, reaffirms a commitment to equal employment opportunity, and bolsters its standing with employees and the public and thus its economic well-being. Proposals that seek to prevent discrimination on the basis of race, national origin, religion, gender, disability, or sexual orientation should generally be supported. Current federal law blocks discrimination on the basis of race, national origin, religion, gender, and disability, but not on the basis of sexual orientation. In the absence of a federal prohibition on discrimination based on sexual orientation, gay and lesbian employees are dependent on local laws and corporate policies for protection. Proposals urging companies to adopt a sexual orientation anti-bias policy should be supported.

4. Fair Lending.
These resolutions call for financial institutions to affirmatively comply with fair-lending regulations and statutes, institute or report on overall fair-lending policies or goals by the parent and financial subsidiaries of the corporation or disclose lending data to shareholders and the public. The trustees believe it is important for financial institutions to examine the risks inherent to their fair-lending compliance practices, to institute corrective steps and safeguards, if necessary, and to report to shareholders on their findings and activities in this regard. The fiduciary may generally support proposals seeking such actions.

5. Business Strategy.
Shareholders have introduced proposals asking boards of directors to examine the impact of particular business strategies on long-term corporate value in light of changing market conditions, and to report back to shareholders. The trustees generally support enhanced disclosure to shareholders on how the company addresses issues that may present significant risk to long-term corporate value. A pension fund, for example, sponsored a proposal requesting the board of a company that provides services normally supplied by government entities to report to shareholders on the long-term effect of this strategy in light of the inherently unprofitable nature of public goods as well as the added cost pressure on private providers resulting from "living wage" requirements. The fiduciary should generally support proposals seeking board review of business strategies that may not contribute to building long-term corporate value, so long as these proposals do not impose undue costs on the corporation.

6. Analyst Independence.
Recent investigations by the Securities Exchange Commission and the New York State Attorney General exposed widespread conflicts of interest involving investment banking practices at many financial services companies. The trustees believe that these conflicts have helped to undermine investor confidence in the capital markets in general and investor confidence in the financial services industry in particular. Several recent shareholder proposals have urged financial service companies to effectively manage investment banking related conflicts of interest by formally separating the company's investment banking business from the company's sell-side analyst research and IPO allocation process, or by taking other measures. The fiduciary should support such proposals.

V. Proxy Voting Guidelines and ERISA Fiduciary Issues

A. Overview of the Legal Standards

The Employee Retirement Income Security Act of 1974 (ERISA) regulates most private sector pension plans, as well as certain other benefit plans covering private sector employees. Anyone who qualifies as a "fiduciary" with respect to an ERISA benefit plan must meet certain standards of behavior when carrying out the fiduciary responsibilities to the plan and to the plan's participants and beneficiaries. Although public employee funds are governed by state laws and regulations rather than ERISA, the ERISA fiduciary principles often are found in state law as well.

Among the most important fiduciary responsibilities governed by ERISA's standards are the investment and management of plan assets. Whenever an ERISA plan invests in equities such as stock, the plan's assets include whatever voting rights accompany those stock shares. Stockholding by an ERISA plan therefore gives rise to continuing fiduciary responsibilities for responding to proxy solicitations and voting the plan's stock shares as part of ongoing asset management.

The fiduciary duties imposed by ERISA include certain requirements specifically listed in the statute, which may be summarized as follows:

- The duty to act **solely in the best interest of plan participants** (also referred to as the duty of loyalty).

- The duty to act **prudently**.

- The duty to **diversify** investments.

- The duty to act **in accordance with lawful plan documents**.

- The duty to refrain from certain improper dealings defined as **"prohibited transactions."**

These specific requirements, however, do not represent the only duties imposed on a fiduciary. Rather, ERISA incorporates basic principles derived from the common law of trusts, and the courts also apply those general fiduciary principles when deciding ERISA cases.

The following discussion will provide a brief overview of who is subject to ERISA fiduciary duties, what these fiduciary duties mean in practice and how the ERISA standards apply with respect to proxy voting in particular. This summary is designed to highlight relevant legal issues and concerns; it is not intended to provide advice on particular matters, and it cannot substitute for consultation with legal counsel on particular questions that may arise.

B. Who Is an ERISA Fiduciary?

Our review of fiduciary standards begins with the question of what makes a particular individual or entity a fiduciary with respect to ERISA benefit plans. The law on this subject is complex and highly fact-dependent. But with sound legal and financial advice, benefit fund trustees and other responsible parties can assure that those persons and entities who qualify as fiduciaries recognize and fulfill their responsibilities, including their duties in connection with proxy voting.

1. Named Fiduciaries.

ERISA requires that every employee benefit plan be established and maintained pursuant to a written agreement. That document must identify the fiduciary or fiduciaries responsible for controlling and managing the "operation and administration of the plan." ERISA §402(a), 29 U.S.C. §1102(a). For example, the trust agreement establishing a Taft-Hartley pension plan typically would designate the board of trustees as named fiduciaries. In an employer-sponsored plan, one or more corporate officials or a pension committee might be identified as the controlling fiduciaries. Plan documents also might designate an individual or firm as the administrator and named fiduciary.

ERISA allows the governing fiduciaries to allocate specific functions among themselves; for example, a board of trustees might establish an investment sub-committee to take charge of investing and managing plan assets. But even proper delegation of responsibilities will not relieve named fiduciaries of their own fiduciary duty to monitor the performance of their agents and service providers. Moreover, ERISA specifically provides that only named fiduciaries may have and exercise the authority to appoint an investment manager.

2. Statutory Fiduciaries

In addition to individuals or entities specifically named as fiduciaries in plan documents, ERISA imposes fiduciary status and liability on other parties based on their function and role with respect to the plan and its operations. The statute uses the following specific tests for fiduciary status (ERISA §3(21)(A), 29 U.S.C. §1002(21)(A)):

- A person becomes a fiduciary *to the extent* that the individual "exercises any discretionary authority or discretionary control respecting management" of the plan.

- A person becomes a fiduciary *to the extent* that the individual "exercises any authority or control respecting management or disposition" of plan assets.

- A person becomes a fiduciary *to the extent* that the individual "renders," or "has any authority or responsibility" to render, "investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property" of the plan.

- A person becomes a fiduciary *to the extent* that the individual "has any discretionary authority or responsibility in the administration" of the plan. Under the terms of the statute, the plan's retained investment manager, who "renders investment advice for a fee," automatically would qualify as a fiduciary in carrying out those functions. Indeed, ERISA expressly defines an investment manager as one who has "power to manage, acquire, or dispose of any asset of a plan," and the statute requires investment managers to acknowledge their fiduciary status in writing. Additionally, because plan assets include stock voting rights and because the exercise of such rights is part of asset management, individuals or firms would qualify as fiduciaries to the extent that they exercise "any authority or control" over proxy voting.[9]

3. De Facto Fiduciaries.

A party not ordinarily considered a fiduciary may become a fiduciary by acquiring or controlling fiduciary functions. For example, company and union officials typically would not become fiduciaries simply by negotiating over whether and how to provide benefits, but would acquire a limited fiduciary status by exercising power to appoint plan trustees. See *Landry v. ALPA*, 901 F.2d 404,414-15, 418 (5th Cir.), *cert. denied*, 498 U.S. 895 (1990); *Leigh v. Engle*, 727 F.2d 113, 133-35 (7th Cir. 1984), 858 F.2d 361, 364 (7th Cir. 1988), *cert. denied*, 489 U.S. 1078 (1989). Their fiduciary status and responsibilities may expand significantly, moreover, if they use their powers to dominate, or exercise discretionary control over, the general management or administration of a benefit plan. *See, e.g., Nedd v. UMWA.* 556 F.2d 190 ,209-210 (3d Cir. 1977), *cert. denied*, 434 U.S. 1013 (1978). Similarly, an employer who sponsors a welfare plan does not become a fiduciary simply by exercising the power to amend or terminate the plan. *Curtiss-Wright v. Schoonejongen*, 514 U.S. 73, 78 (1995). *See also Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432, 443-46 (1999). The employer, however, may be treated as a fiduciary to the extent that the employer takes on plan administration functions, including making significant representations or misrepresentations to beneficiaries. Varity Corp. v. Howe, 516 U.S. 489 (1996); *Hudson v. General Dynamics Corp*., 118 F. Supp. 2d 226 (D. Conn. 2000).

As a general matter, the routine technical services that actuaries and consultants normally provide to a plan should not make them fiduciaries. But Congress intended fiduciary status to attach in situations where a professional service provider's expertise leads less sophisticated plan personnel to rely on their consultant to such an extent-relinquishing their own independent discretion- that the outside professional actually exercises discretionary authority or control in the plan's management or administration. *See Schloegel v. Boswell*, 994 F.2d 266, 271-72 (5th Cir. 1993); *Olson* v. *E.F. Hutton & Co., Inc.*, 957 F.2d 622, 625-26 (8th Cir. 1992); *Pappas* v. *Buck Consultants, Inc.*, 923 F.2d 531, 536-38 (7th Cir. 1991). *See also Mertens* v. *Hewett Assocs.*, 508 U.S. 248, 262 (1993). Though fund attorneys and union officials do not customarily "render investment advice for a fee," their giving of investment advice on a regular basis pursuant to a mutual understanding, and with knowledge of the plan's reliance on their advice, could bring them within the scope of that statutory language. *See, e.g.*, 29 CFR §2510.3-2l.

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[9] Formal titles do not determine the status of other parties as statutory fiduciaries. Rather, in each case the courts and agency authorities will review each individual's actual authority and conduct, and as a general matter they apply the statutory definition broadly in order to protect the interests of plan participants. As one often-quoted court decision phrased the analysis, "If it Talks Like a Duck...and Walks Like a Duck...It is a Duck." *Donovan v. Mercer*, 747 F.2d 304, 308-09 (5th Cir. 1984). The Department of Labor has issued an Interpretive Bulletin, "Questions and Answers Relating to Fiduciary Responsibility" (IB 75-8, 29 CFR §2509.75-8) that attempts to provide general guidance on this subject. These DOL regulations identify certain positions that ordinarily would not be considered fiduciaries– assuming that they stay within the typical duties of their job title and do not assume the role of trustee or perform other fiduciary functions relating to the plan. For example, the DOL regulations indicate that the usual functions of a union or corporate officer, or of retained professionals such as attorneys, accountants and actuaries, should not make them plan fiduciaries. As discussed below, however, anyone in these positions could easily become a fiduciary as a result of circumstances, transactions and behavior.

4. A Note on Fiduciaries With Respect to Public Employee Funds.
ERISA does not apply to benefit plans maintained by state and local governments for public sector workers. Rather, fiduciary status and responsibilities with respect to state and local governmental funds are determined primarily by the statutes and common law of the 50 states, including county and municipal ordinances. Nonetheless, in litigation dealing with state and municipal workers' benefit funds, the state courts can and do look to ERISA standards and federal court decisions for guidance in interpreting and applying common-law trust principles.

C. What Are the Basic Fiduciary Duties?

The fiduciary duties imposed by ERISA originated in trust law, the legal regime that governed most benefit plans before ERISA's enactment in 1974, and the statute carries forward familiar common-law principles. But Congress recognized that satisfactory protection of workers' pensions and benefits required something more than traditional trust law. Thus, the courts are charged with developing a new "federal common law" of ERISA rights and responsibilities that takes into consideration the special nature and purpose of employee benefit plans. The Supreme Court explained that approach in *Varity Corp. v. Howe* (516 U.S. at 497):

> [W]e believe that the law of trusts often will inform, but will not necessarily determine the outcome of, an effort to interpret ERISA's fiduciary duties. In some instances, trust law will offer only a starting point, after which courts must go on to ask whether, or to what extent, the language of the statute, its structure, or its purposes require departing from common-law trust requirements. And in so doing, courts may have to take account of competing statutory purposes, such as Congress' desire to offer employees enhanced protection for their benefits, on the one hand, and, on the other, its desire not to create a system that is so complex that administrative costs, or litigation expenses, unduly discourage employers from offering welfare benefit plans in the first place.

With that general guidance in mind, the following sections discuss the fundamental fiduciary standards that trustees and other fiduciaries must meet in carrying out their functions with respect to the plan, including proxy voting responsibilities. (The discussion does not address the duty to diversify investments, as that particular standard does not govern fiduciaries' behavior regarding proxy voting).

1. The Duty of Loyalty.
ERISA reflects the traditional common-law principle that a fiduciary owes a duty of complete loyalty to trust beneficiaries. As stated in §404 (a)(1)(A) of ERISA (29 U.S.C. §ll04(a)(1)(A)), a fiduciary must carry out plan-related functions "solely in the interest" of the participants and beneficiaries of the plan, and "for the exclusive purpose" of providing benefits and defraying the plan's reasonable administrative expenses.

As one often-cited decision described the duty of loyalty, trustees must make decisions "with an eye single to the interests of the participants and beneficiaries," and they must "avoid placing themselves in a position where their acts [as corporate or union officers] will prevent their functioning with the complete loyalty to participants demanded of them as trustees of a pension plan." *Donovan v. Bierwirth*, 680 F.2d 263, 271 (2d Cir.), *cert. denied*, 459 U.S. 1069 (1982).

The Department of Labor has phrased the standard somewhat differently in an Interpretive Bulletin, stating that a fiduciary "must not *subordinate* the interests of the participants and beneficiaries in their retirement income to unrelated objectives. IB 94-2, 29 CFR §2509.94-2 (emphasis added).

Thus, while ERISA requires trustees to make the plan participants' and beneficiaries' interests in accruing and receiving retirement benefits paramount and controlling, the law does not necessarily prohibit a fiduciary from pursuing other secondary objectives, provided that those secondary goals are clearly subordinated to the interests of participants and beneficiaries. *See*, *e.g.*, *Donovan* v. *Walton,* 609 F.Supp. 1221 (S.D. Fla. 1985), *aff'd per curiam sub nom Brock v. Walton,* 794 F.2d 586 (11th Cir. 1986), *reh. denied*, 802 F.2d 1399 (11th Cir. 1986). As other court decisions have recognized, "the fact that a fiduciary's action *incidentally* benefits an employer does not necessarily mean that the fiduciary has breached his duty." *Trenton v. Scott Paper Co.,* 832 F.2d 806, 809 (3d Cir. 1988), *cert. denied,* 485 U.S. 1022 (1988). See also *Morse v. Stanley*, 732 F.2d 1139, 1146 (2d Cir. 1984).

But where a fiduciary faces a conflict that makes it "virtually impossible" to fulfill the overriding duty to plan participants and beneficiaries, the fiduciary "may need to step aside, at least temporarily," in order not to breach legal obligations. And other circumstances raising questions as to fiduciaries' true loyalties would require them "at a minimum to engage in an intensive and scrupulous independent investigation of their options to insure that they act in the best interests of the plan beneficiaries." *Leigh v. Engle*, *supra*, 727 F.2d at 125-29 (liability was predicated on use of plan assets in a corporate control contest, even absent financial loss to the plan).

The duty of loyalty also requires trustees and other fiduciaries to deal fairly and honestly with participants and beneficiaries. As the Supreme Court emphasized in the *Varity* decision, "[l]ying is inconsistent with the duty of loyalty owed to all fiduciaries and codified in §404(a)(1) of ERISA." 516 U.S. at 506, quoting from *Peoria Union Stock Yards Co. v. Penn Mutual Life Ins. Co.,* 698 F.2d 320, 326 (7th Cir. 1983). Even conduct short of active misrepresentation– such as failure to disclose all material information pertinent to a beneficiary's known needs– could in some circumstances be challenged as a breach of the duty of loyalty. *See Bixler v. Central Pennsylvania Teamsters Health* & *Welfare Fund,* 12 F.3d 1292 (3d Cir. 1993).

Questions often arise about the extent to which fiduciaries may take into account incidental or "collateral" benefits– such as creating jobs, increasing affordable housing or advancing other worthy outcomes– when investing and managing ERISA plan assets. In 1994, responding to numerous inquiries, the Department of Labor issued Interpretive Bulletin 94-1 to explain its position regarding the "collateral effects" of investments (29 CFR §2509.94-1). While the bulletin does not establish specific procedures for investment decision making, it states the general proposition that an investment is *not* deemed prudent if it would be "expected to provide a plan with a lower rate of return than available alternative investments with commensurate degrees of risk," or if it is "riskier than alternative available investments with commensurate rates of return."

Thus, the Labor Department's bulletin effectively embraces an "all things being equal" standard: if an otherwise prudent investment including "collateral" benefits is expected to yield an equal or superior risk-adjusted return when compared to suitable and available alternative investments, fiduciaries may consider those collateral benefits. The same reasoning seemingly would apply, by analogy, to other asset-management decisions. As explained below, consistent procedural prudence and documentation will help trustees and other fiduciaries comply with this ERISA standard when considering the collateral effects, if any, of their asset-management decisions, including proxy voting.

2. The Duty of Prudence.
ERISA requires fiduciaries to act with the "care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims." ERISA §404(a)(1)(B), 29 U.S.C. §1104(a)(1)(B). This standard is notably stricter than the common-law "prudent man" standard: ERISA fiduciaries are held to the standards of a person "familiar with such matters"– that is, someone knowledgeable in asset management and other plan-related business. Many union officials come into the position of benefit plan trustee with no specialized training or background in pensions and investments. By assuming a position of responsibility with a benefit fund, they effectively take on a duty to become knowledgeable in such matters and to seek professional assistance where appropriate. Good intentions on the part of inexpert trustees will not excuse negligence. *See, e.g.*, *Katsaros v. Cody*, 744 F.2d 270, 279 (2d Cir. 1984), cert. denied, 469 U.S. 1072. *Cf. Brock v. Robbins*, 830 F.2d 640, 647 (7th Cir. 1987) ("If trustees act imprudently, but not dishonestly, they should not have to pay a monetary penalty for their imprudent judgment as long as it does not result in a loss to the Fund").

The duty of prudence, like other fiduciary responsibilities, applies to all fiduciary acts relating to the ERISA plan, including the act of delegating to someone else a fiduciary function. Thus, trustees must exercise the care, skill and diligence of a prudent and knowledgeable person when selecting investment managers, proxy voting agents and other service providers, and they must meet the same standards of care in monitoring these agents' performance. Thorough and independent investigation, adherence to proper procedures and systematic oversight can be key factors in demonstrating prudence if a dispute arises: the legal analysis focuses heavily on the circumstances and process that preceded a particular decision or action, and the subsequent outcome in itself will not determine whether or not fiduciaries acted prudently. *See, e.g., Laborers Nat'l Pension Fund v. Northern Trust Quantitative Advisors, Inc.*, 173 F.3d 313, 317, 319 (5th Cir.), *cert.* denied, 528 U.S. 967 (1999); *Roth v. Sawyer-Cleator Lumber Co.*, 16 F.3d 915, 917-918 (8th Cir. 1994); *Ershick v. United Missouri Bank of Kansas City*, 948 F.2d 660 (10th Cir. 1991).

3. The Duty to Comply With Plan Documents.
ERISA fiduciaries must act "in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions" of ERISA. §404(a)(1)(D), 29 U.S.C. §1104(a)(1)(D). The basic plan documents include those that establish the trust and describe the content of the benefit plan– for example, the trust agreement, plan description, summary plan description and collective bargaining agreement. Plan documents also should include those used to engage service providers and set investment policies– for example, contracts with consultants, agreements with investment managers, statements of investment policy and proxy voting guidelines. The courts can and do hold fiduciaries to strict compliance with specific limitations contained in plan documents, such as limits on the percentages of particular kinds of investments.

Ideally, the trust agreement and other documents controlling the investment and management of plan assets should give the trustees and other fiduciaries sufficient flexibility to consider and take advantage of a wide range of opportunities suitable for the plan. The more detailed written statements of policy–such as investment and proxy voting guidelines–should set objectives and outline acceptable ranges for decisions, while at the same time not arbitrarily and unnecessarily tying the hands of managers and other agents in meeting fiduciary standards. Plan trustees should continually consult their plan documents to assure that decisions and actions conform to the requirements set for the plan. They must continually monitor their investment managers and other service providers to make sure that these agents comply with applicable policies and limitations. Additionally, plan trustees can and should review their governing documents and specific guidelines periodically to determine whether and how they should be revised to meet the needs of the plan's participants and beneficiaries.

4. The Duty to Avoid Prohibited Transactions.
The duty of undivided loyalty to plan participants and beneficiaries, under common law and under ERISA, includes the general obligation to refrain from self-dealing and conflicts of interest. Additionally, Congress took great care to protect plan assets from misuse and mismanagement by specifically prohibiting certain kinds of dealings deemed inherently problematic or susceptible to abuse. These prohibited conflicts and prohibited transactions are laid out in §§406(a) and (b) of ERISA, 29 U.S.C. §1106. Certain exceptions are provided under §408 and through the administrative process.

Section 406(a) forbids fiduciaries from causing the plan to engage in a list of "prohibited transactions" with any "party in interest." The definition of a "party in interest" includes plan fiduciaries, counsel to the plan, employees of the plan, service providers, contributing employers and employer associations, the union, any 50 percent owner of a contributing employer or of the union, the spouse or other defined relatives of any of the foregoing and several other categories of individuals and entities. *See* ERISA §3(14), 29 U.S.C. §1102(14). Proper monitoring of plan operations therefore would include careful screening of all transactions, including proxy voting and other shareholder activity, to identify and avoid improper dealings with "parties in interest."

The following direct or indirect transactions are forbidden by ERISA §406(a):

- The sale, exchange or leasing of any property between the plan and a party in interest.

- The lending of money or other extension of credit between the plan and a party in interest.

- The furnishing of goods, services or facilities between the plan and a party in interest.

- The transfer of any plan assets to, or the use of any such assets by or for the benefit of, a party in interest.

- The acquisition, on behalf of the plan, of any employer security or employer real property in violation of ERISA §407(a).

Additionally, §406(b) makes it unlawful for a fiduciary to:

- Deal with the assets of a plan in the fiduciary’s own interest or for the fiduciary's own account.

- Act on behalf of or represent a party whose interests are adverse to the interests of the plan or the plan's participants or beneficiaries in any transaction involving the plan.

- Receive any consideration for the fiduciary's own personal account from any party dealing with the plan in connection with a transaction involving the assets of the plan.

The penalties for engaging in prohibited transactions and other fiduciary breaches can be severe. Plan fiduciaries may be held personally liable to make good any losses and disgorge any profits resulting from a breach of their duties. The courts can order other equitable relief including, but not limited to, removal from the fiduciary position, disbarment from serving in future fiduciary positions, return of any compensation received from the plan, payment of attorney fees and costs and payment of civil penalties. *See* ERISA §409, 29 U.S.C. §1109. Pervasive violations with respect to a given ERISA plan could lead to a finding that the plan is not being operated in the exclusive interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries, thereby disqualifying the plan for IRS purposes. Short of disqualification, the plan could face substantial excise taxes.

D. What Procedures Can Be Used to Manage Assets in Compliance With Fiduciary Duties?

The assets of an ERISA fund, in whatever form they take, must be managed in accordance with the fundamental fiduciary duties described above. Within this fiduciary framework, as noted above, fund trustees have discretion to establish investment guidelines permitting a variety of investment vehicles, including but not limited to stock, bonds, CDs, treasury bills, real property, mortgages and commercial loans. Where an ERISA fund holds stock, the voting rights connected to those stock shares are also fund assets, and the exercise of those shareholder rights is considered a fiduciary act. The following sections note some of the procedures that ERISA fiduciaries use to fulfill their duties with respect to asset management and shareholder activity.

1. Investing and Managing Plan Assets.
The starting point for compliance with ERISA's fiduciary standards is "procedural prudence." That is, trustees should adopt the written policies, guidelines and procedures appropriate to governing asset management in consultation with experienced professionals. They should carefully document a thorough and independent investigation of the merits of their decisions concerning asset management–whether they are evaluating, selecting and regularly monitoring delegated investment managers, or handling investment decisions in-house. Trustees should systematically monitor-and document their monitoring of their own and other fiduciaries' compliance with plan documents and legal requirements.

The plan's minutes and records should show the trustees' ongoing compliance with fiduciary responsibilities by documenting, for example, the trustees' decision making in the sole interest of plan participants and beneficiaries; avoidance of conflicts of interest and individual recusals where necessary; regular screening for relationships that would raise prohibited- transactions issues; retention of written contracts for all service providers, as well as periodic reports and statements from those providers; regular monitoring of service providers' performance to fiduciary standards; and periodic review of basic trust instruments to assure compliance by trustees, investment managers and other agents.

2. Voting the Benefit Fund's Stock Shares.
Proxy voting is the main form of rank-and-file shareholder involvement in corporate matters such as director elections, corporate mergers and resolutions submitted at annual meetings. Though shareholders generally have the right to attend corporate annual meetings in person, most individual shareholders who care to vote on corporate matters will do so by assigning their votes to someone else to cast in response to a proxy solicitation.[10] The proxy voting process often amounts to little more than a formality, but in some cases corporations face real proxy contests in which shareholders give significant support to independent resolutions and candidates who challenge the incumbent management. Institutional investors such as pension funds can and do play an important role in such contests– indeed, in recent years pension funds have increasingly taken the lead in a variety of shareholder campaigns.

Employee benefit funds receive proxy solicitations continually as a result of their corporate stock investments. When responding to proxy solicitations, ERISA fiduciaries must comply with the applicable legal duties discussed above: loyalty, prudence, compliance with plan documents and avoidance of prohibited transactions. *See O'Neill* v. *Davis,* 721 F.Supp. 1013, 1015 (N. D. Ill. 1989) (reviewing a "question of first impression," the court agrees with the Secretary of Labor that ERISA and traditional trust law require the trustee to "use proper care to promote the interest of the beneficiary" when exercising shareholder voting rights). *Accord*, *Newton v. Van Otterloo,* 756 F.Supp. 1121, 1127-29 (N.D. Ind. 1991) (the ESOP Committee appointed by corporate management, having divided loyalties, violated ERISA by failing to "engage in an intensive and scrupulous independent investigation" as to voting in a contested corporate election. *Cf. Grindstaff v. Green,* 133 F.3d 416, 425 (6th Cir. 1998) (ESOP fiduciaries' voting of ESOP shares in manner that perpetuates their incumbency as corporate directors is not unlawful *per se*).

Most benefit fund trustees never have the opportunity to exercise these rights and duties directly, however, because their "blanket" delegation of asset-management responsibilities to professional investment managers automatically includes delegation of the responsibility for proxy voting.

Until recently, the investment manager community seemingly paid little or no attention to the interests and needs of ERISA funds in connection with proxy voting. Several years ago the U.S. Department of Labor highlighted the importance of proxy voting by issuing two formal Opinion Letters that explained the agency's position on how ERISA fiduciary standards apply in that area.[11] The Labor Department subsequently reiterated and expanded on its legal position in a 1994 Interpretive Bulletin, codified as IB 94-2, 29 CFR §2509.94-2. In particular, DOL has specifically confirmed that the assets of an ERISA plan include not only the shares of corporate stock owned by the plan, but also the *voting*

[10] The solicitation of proxies, by corporate management or by others, is subject to federal law and regulations administered by the Securities and Exchange Commission. The relevant SEC law and procedures governing proxy campaigns are not addressed in this overview.
[11] These documents, referred to as the "Avon letter" (February 23, 1988) and the "Monks letter" (January 23, 1990), have been reprinted and are publicly available for reference (Avon letter, 15 Pension Reporter 391; Monks letter, 17 Pension Reporter 244).

rights connected to those stockholdings. The voting of proxies, therefore, is part of the fiduciary responsibility of managing plan assets.

This means that, unlike an individual investor, an ERISA fiduciary may not simply ignore a proxy solicitation or vote automatically for corporate management. Instead, the fiduciary must:

- Look carefully at each proposal and dispute presented.
- Determine what, if any, impact the issue would have on the economic value of the investment.
- Cast a vote on those issues that do affect investment value.
- Vote in a manner consistent with the standards of loyalty, prudence and other fiduciary requirements described above.[12]

Moreover, fiduciary responsibilities include other forms of legitimate ownership activity, as the Department of Labor's Interpretive Bulletin 94-2 states [emphasis added]:

> [I]n certain situations it may be appropriate for a fiduciary to engage in activities intended to monitor or influence corporate management if the fiduciary expects that such activities are likely to enhance the value of the plan's investment.
>
> Although, within the corporate structure, the primary responsibility to oversee corporate management falls on the corporation's board of directors, the Department believes that active monitoring and communication with corporate management is consistent with a fiduciary's obligations under ERISA where the responsible fiduciary concludes that there is a reasonable expectation that such activities by the plan alone, or together with other shareholders, are likely to enhance the value of the plan's investment, after taking into account the costs involved. Such a reasonable expectation may exist in various circumstances, for example, where plan investments in corporate stock are held as long-term investments or where a plan may not be able to easily dispose such an investment [footnote omitted].
>
> Active monitoring and communication activities may concern a variety of issues, such as the independence and expertise of candidates for the corporation's board of directors or assuring that the board has sufficient information to carry out its responsibility to monitor management. Other issues might include consideration of the appropriateness of executive compensation, the corporation's policy regarding mergers and acquisitions, the extent of debt financing and capitalization, the nature of long-term business plans, the corporation's investment in training to develop its

[12] To the extent feasible and consistent with applicable foreign law, these fiduciary requirements apply to proxy voting at foreign as well as domestic corporations. With respect to securities issued by foreign corporations, DOL recognizes that the costs to the plan of voting a proxy may exceed the economic value, given the difficulties in ascertaining and following complex foreign laws, regulations and corporate practices. In such cases, ERISA fiduciaries may take those factors into account in determining whether to vote foreign stock proxies.

work force, other workplace practices and financial and non-financial measures of corporate performance. **Active monitoring and communication may be carried out through a variety of methods including by means of correspondence and meetings with corporate management as well as by exercising the legal rights of a shareholder**.

3. Determining Which Fiduciaries Have Proxy Voting Responsibilities.
Named fiduciaries, such as a board of trustees, are directly responsible for proxy voting if they have retained for themselves the authority to manage their plan's investments. As noted previously, however, ERISA permits named fiduciaries to delegate to one or more investment managers the immediate responsibility for managing plan assets. If that wholesale delegation of asset management functions does not specifically reserve proxy voting rights to the trustees, the delegated investment manager has the full authority and liability to make the proxy voting decisions for all stock shares entrusted to his or her management. In such cases, the investment manager must fulfill that responsibility and *may not allow anyone else* to execute or control that function.

Where the trustees as named fiduciaries handle asset management themselves, or where they have specifically reserved for themselves the right and responsibility for proxy voting while delegating other asset-management responsibilities to one or more investment managers, the trustees have the right to control the proxy voting functions themselves. Instead of voting proxies themselves, the trustees may delegate their retained proxy voting responsibility to other fiduciaries, such as specialized proxy voting agents selected and monitored in accordance with fiduciary standards.

4. Establishing Proxy Voting Guidelines.

4.1. Guidelines should advise, but not direct. To carry out their fiduciary responsibilities relating to proxy voting, trustees who govern ERISA funds should develop and monitor a set of proxy voting policies and/or proxy voting guidelines in the same fashion as they formulate and carry out a written investment policy. The Department of Labor has not issued regulations specifying what may be included in a set of proxy voting guidelines, but whoever is entrusted with responsibility for voting proxies must exercise discretion in each instance, in accordance with all the ERISA fiduciary standards. DOL's official position is that trustees who delegate proxy voting authority to investment managers may not lawfully vote those proxies themselves, and may not lawfully *direct* their managers' proxy voting decisions in specific matters. Thus, an ERISA fund's proxy voting guidelines should advise and inform without usurping or precluding individualized decision-making.

As DOL indicated in its Interpretive Bulletin 94-2, the trustees may formulate and enforce a formal proxy voting policy as long as the policy is framed as "general instructions" or "generally applicable guidelines," rather than "specific instructions to vote specific plan proxies a certain way." This means, for example, that the proxy voting policy may explain which factors and issues should be considered with respect to a list of identified proxy issues, based on an evaluation of the likely resulting benefit to the plan.

The AFL-CIO's Model Guidelines are designed to conform to these principles. They identify and explain factors that reasonably should be considered when voting on a number of different corporate "accountability" and "governance" issues. Experience has shown that investment managers often support corporate management in proxy contests because they ignore or fail to appreciate the impact of these issues on investment value and on plan participants' interests. A well-reasoned set of guidelines, demonstrating the application of fiduciary standards, can help make investment managers more responsive to these important concerns.

4.2. Guidelines and procedures should fit the benefit funds' structure for handling proxy voting. The AFL-CIO Model Guidelines follow a format appropriate for situations where proxy voting authority is delegated to one or more investment managers. Their substance is equally suitable for by trustees who retain in-house authority over proxy voting, or for use by funds that have retained a specialized proxy voting firm. The precise content of the written proxy voting policy and/or Guidelines for any given benefit plan, and the procedures for carrying out fiduciary responsibilities, would depend on whether the trustees directly exercise proxy voting authority, or delegate those functions to someone else. The following points recap the kinds of procedures needed for differing situations:

- ***Trustees who delegate asset management, including proxy voting authority, to investment managers***: When delegating general asset-management responsibilities to one or more investment managers, the plan trustees relinquish the immediate responsibility and the liability for making and executing related proxy decisions unless they specifically reserve to themselves the proxy voting authority. The investment manager with explicit or implicit proxy voting authority has the duty to make independent decisions in accordance with fiduciary standards, based on independent analysis. Plan trustees may not dictate or interfere with the manager's proxy voting decisions in specific cases, and the investment manager may not allow the trustees or any other party to usurp that decision-making function. The trustees may adopt a set of proxy voting guide- lines designed to educate and assist investment managers in evaluating corporate proposals and issues. Plan trustees may monitor the investment manager's performance in this area– including receiving and reviewing reports of proxy voting decisions– just as they monitor performance of other asset- management responsibilities.

- ***Trustees who directly manage assets and vote proxies in-house***: To the extent the trustees have direct investment-management functions, they may choose to handle proxy analysis and voting in-house along with their other asset-management responsibilities. In such a case, the trustees would adopt and follow general principles for evaluating the economic impact of recurring issues arising in proxy solicitations and proxy contests, together with procedures for carrying out the analysis and decision-making. As each proxy solicitation is received, it is analyzed in accordance with those proxy voting principles and the fiduciary requirements of law, and a decision is made on whether and how to vote. The trustees may consult with professional and technical advisors to assist them in their evaluation and decision-making.

- ***Trustees who manage assets in-house while delegating proxy voting authority to a proxy voting firm:*** Rather than carry out proxy analysis and voting themselves, trustees who manage assets in-house may choose to engage an outside firm to perform those functions. That proxy voting firm would serve as an investment manager and an acknowledged fiduciary with respect to the stock voting rights entrusted to it, and would take on full liability for satisfying the fiduciary standards of ERISA and for complying with the proxy voting guidelines adopted by the trustees. The proxy voting agent would report regularly to the trustees on all proxies received and all decisions made. While the trustees would remain responsible for monitoring the proxy voting agent's performance, they may not try to usurp or dictate that firm's decision making in particular cases.

- ***Trustees who reserve proxy voting authority, while delegating other asset management****:* Trustees who have specifically reserved for themselves the authority over proxy voting can establish proxy voting principles and perform those functions in-house, using procedures such as described above, or they may choose to use (and monitor the performance of) a designated fiduciary who serves as their proxy voting agent.

5. Exercising Other Shareholder Rights.
As the DOL's Interpretive Bulletin 94-2 explains, ERISA funds need not merely react to corporate or other proxy solicitations. They may instead choose to play a more active part in corporate affairs by, among other things, submitting their own proposals, soliciting proxy support for their positions and advocating corporate reforms initiated by others. Indeed, such participation could become particularly appropriate when the size of equity holdings and the prevalence of "indexed" funds make it infeasible simply to "exit" or avoid particular investments in response to management problems. Given the enormous pool of capital represented by benefit funds and other institutional investors, these forms of shareholder activism can have a significant positive impact.

As with other asset-management functions, however, benefit plans and trustees should make sure that when taking ownership actions– such as introducing corporate resolutions and pursuing proxy campaigns– they thoroughly analyze and decide on their policy positions in accordance with the ERISA fiduciary requirements and their plan's guidelines, discussed above. *See Leigh v. Engle,* and *Newton v. Van Otterloo, supra.*

Note that ERISA was not designed to facilitate campaigns by the contending parties in corporate control contests. *See Acosta* v. *Pacific Enterprises,* 950 F.2d 611 (9th Cir. 1991) (ERISA did not require a plan to make a list of participants available to board candidate soliciting support). *Accord, Hughes Salaried Retirees Action committee v. Adm. of Hughes Non-Bargaining Retirement Plan,* 72 F.3d 686, 693 (9th Cir. 1995) (ERISA does not require plan to provide participants a list of other participants' names and addresses for purpose of soliciting support for litigation). *See also In re Sears, Roebuck and Co. Securities Litigation,* 792 F.Supp. 977, 983-84 (E.D. Pa. 1992) (dicta) (ERISA prohibits expenditure of plan assets to subsidize mailing of a board candidate's proxy solicitation). Similarly, ERISA does not control a pension fund's rights as shareholder or the actual "mechanics" of corporate elections and proxy campaigns. *See Ershick* v. *United Missouri Bank, supra (*the plan's duties and liabilities upon attaining majority shareholder status are determined under state law). Rather, those matters are governed by a combination of state corporate law and federal securities law. Trustees should therefore explore these areas further with fund counsel to prepare for a more active ownership role.