The Missing 60%: What can investors do to secure improved climate voting by asset managers?

Holding asset managers to account on climate change resolution voting: A legal guide for pension funds and educational institutions

A route to better voting

In 2015 and 2016, shareholder resolutions were tabled at eight oil, gas and mining companies asking for better disclosure on their resilience to the risks associated with climate change. Climate risks include business risks associated with increased carbon regulation as the world transitions to a substantially lower carbon economy in line with the Paris Agreement. Climate change presents a systemic risk for asset owners and improved disclosure from companies that are most exposed to the risks is crucial to enable investors to manage the risk to their own portfolio.

But there was a stark discrepancy in the AGM voting. Many investors voted in opposite directions on the same subject matter at different companies' AGMs. Where the resolutions were supported by company management (BP, Shell, Statoil, Anglo American, Rio Tinto and Glencore), they achieved near unanimous support from shareholders. Where the resolutions were opposed by management (Exxon and Chevron), only around 40% of shareholders voted in favour. This was despite the content and subject matter of the resolutions being substantially the same (although not identical).

60% of shareholders (assuming – which is likely - that most of the relevant institutional investors hold shares in all seven companies) had swung from supporting the resolutions to voting against them. The natural conclusion to draw is that this 60% ("the Missing 60") were simply rubber stamping the company management's recommendations. It also appears that it was (on the whole) the US-based asset management companies that tended to support management at the US AGMs.

This shouldn't happen. Asset owners and asset managers should not automatically support the board (a principle enshrined in the UK Stewardship Code). Further, trustees of UK pension funds and other trust-based endowment funds have a (fiduciary) duty to act in the best (financial) interests of their beneficiaries. It is difficult to see how trustees could conclude that having their shares voted in support of the resolutions at six of the companies was in the best interests of their members, whilst it was in their best interests to have their shares voted against them at the two US companies.

Can trustees intervene?

When this issue is raised with pension funds and universities, many respond that they do not have control over how shares are voted. The shares are often held by asset managers and the pension funds have delegated the right to vote the shares to the asset manager, in their sole discretion.

This does not need to be the case. By making small adjustments to their contractual arrangements (the mandate or equivalent) with their asset managers, trustees can substantially increase their legal leverage to have a say (and even have the final say) on how their scheme's or institution's shares are voted in particular AGMs. In addition, trustees can generate meaningful change simply by acting as intelligent consumers, asking more questions and demanding better transparency, both before and during the mandate period. This will help trustees to comply with their legal obligations to act in the best interests of their beneficiaries.

Taking steps to enforce accountability

Any trustee interested in taking up the suggestions made in this briefing should raise these issues with their investment consultants at their next meeting. The investment consultant should be able to advise on how best the pension fund can improve control of how their voting rights are exercised in the particular circumstances of the fund. Trustees may wish to seek legal advice on how best to strengthen the terms of their contractual relationships with their asset managers. Even if the investment mandate is not yet due for renewal, it is important for trustees to signal to their investment manager that they are not happy with their current arrangement and ask for improved transparency for the remainder of the mandate period.

This paper sets out a number of practical steps that UK trustees can take to ensure that they have a proper say in shareholder votes, and that their votes are never again part of the Missing 60%.

1. Demand transparency

One of the common complaints levied against asset managers is that clients often do not know how shares will be voted until long after a particular vote has taken place. We are regularly asked whether asset owners have legal rights to demand better disclosure of voting intentions in advance. We are also asked whether asset owners have any legal rights to demand disclosure of the reasons why an asset manager decided to vote with management after the event.

(a) Seek disclosure of voting intentions in advance

The best way that trustees can ensure that their asset manager will make advance disclosure on how they intend to vote at any particular AGM, if requested to do so, is by adding a clause to the written mandate (the contract that governs the pension fund’s legal relationship with the asset manager) that legally requires the asset manager to disclose how they plan to vote on a particular issue at a particular AGM if asked to do so by the trustees (this is not the same as requiring asset managers to make a blanket disclosure of all voting intentions all the time. It should be restricted to particular issues at particular AGMs when the trustees ask for that specific information).

The clause should address the agreed timeframe for disclosure to ensure that the trustees have sufficient time to respond to the disclosure before the vote takes place. The clause can also require the trustees to keep the information confidential if necessary (although some institutional investors were happy to openly and publicly declare their voting intentions in advance of some of the climate disclosure resolutions, a development that should be welcomed).

In addition, trustees may also want to request copies of all relevant, current proxy voting guidance documents issued by the asset manager. This should help the pension fund to understand how the asset manager generally approaches its voting responsibilities.

Pension funds should also ask asset managers with equity holdings in UK listed companies for a copy of their statement on compliance with the UK Stewardship Code.

The UK Stewardship Code contains provisions on disclosing voting policies and voting activities. Principle 1 of the UK Stewardship Code requires signatories to "*publicly disclose their policy on how they will discharge their stewardship responsibilities.*" Principle 6 requires signatories to "*have a clear policy on voting and disclosure of voting activity*".

The Code operates on a "comply or explain" basis. Signatories to the Code are required to publish a statement setting out their commitment to the principles of the Code, and providing an explanation for any principles that they choose not to comply with.

The Stewardship Code normally only applies to "signatories". Most large asset management companies that operate in the UK (including the large US managers) are signatories to the Code. A list of signatories is available on the Financial Reporting Council's (FRC) website.

In the case of asset managers, however, even non-signatories are required to publish a statement setting out the nature of their commitment to the Code. This is required by the Financial Conduct Authority's COBS 2.2.3R. Accordingly, all regulated asset managers should publish a statement explaining whether or not they adhere to the principles of the Code. Trustees should examine a copy of this statement before mandating any particular company.

Key things trustees may want to look for in these documents are:

- Whether climate change or climate risk feature at all;

- What approach the asset manager takes on shareholder proposals, in particular: (a) do the guidelines (and past voting patterns) reveal a tendency to support management on shareholder proposals, or are proposals genuinely considered on their own individual merit; (b) to what extent does the asset manager rely on recommendations made by their proxy voting service provider; and (c) what is their approach to stock lending and recalling stock for voting?

Trustees may also want to ask asset managers to provide examples of when they have voted with or against management on shareholder resolutions and controversial issues before agreeing to mandate them.

(b) Seek reasons to justify the voting decision

Trustees can seek to compel asset managers to provide reasons to justify voting decisions in future by adding a provision to the written mandate requiring reasons to be provided when requested by the client.

In addition, principle 6 of the Stewardship Code requires signatories to "*have a clear policy on … disclosure of voting activity".* Principle 7 requires them to "*report periodically on their stewardship and voting activities*".

The Code also states that signatories should maintain a clear record of their stewardship activities, "*asset managers should regularly account to their clients or beneficiaries as to how they have discharged their responsibilities. Such reports will be likely to comprise qualitative as well as quantitative information. The particular information reported and the format used, should be a matter for agreement between agents and their principals*", and asset owners (which includes investment trusts and collective investment vehicles) should report at least annually to those to whom they are accountable on their stewardship policy and its execution.

These provisions clearly enable trustees to know *how* the shares were voted (after the event). Do they also require asset managers to disclose *why* they voted a particular way on a particular proposal? In our view, the requirement to "*regularly account to their clients…as to how they have discharged their responsibilities*" will, in some circumstances, include an obligation to explain why shares were voted in a particular way if clients ask for an explanation.

For example, if an asset management company voted in favour of the BP and Shell shareholder resolutions, but against the Chevron and Exxon resolutions, there is a good argument that the asset manager's account to their client as to how they have discharged their responsibilities should include an explanation as to why the asset manager considered it appropriate to vote in favour of the former two and against the latter two if asked to do so by the client.

We recommend that trustees directly ask their asset managers how they voted in respect of each of the BP, Shell, Exxon and Chevron climate disclosure resolutions. If the manager simply supported company management in each case, trustees should ask for proper reasons to justify the decisions.

2. Influence future votes

Beyond seeking greater transparency on voting intentions and reasons, we are often asked what pension funds can do to better influence the way in which their asset managers vote on particular issues.

The answer to this question is likely to vary depending on whether the assets in question are held in a segregated account or in a pooled or mutual funds.

(a) Segregated accounts

Schemes and institutions with investments held in segregated accounts are likely to have greater legal leverage in respect of how shares are voted than those invested in pooled or mutual funds.

For UK pension funds, regulation 2 of the *Occupational Pension Scheme (Investment) Regulations 2005* requires UK pension funds to prepare a Statement of Investment Principles (SIP). This must include the pension fund's "*policy (if any) in relation to the exercise of the rights (including voting rights) attaching to the investments*". Under section 36(5) of the *Pensions Act 1995*, any asset manager to whom day-to-day investment decisions have been delegated by a UK pension fund, must *"exercise their powers of investment with a view to giving effect to the principles contained in the statement under section 35, so far as reasonably practicable*".

This means that asset managers acting for UK pension funds must act in accordance with their pension fund client's SIP "*so far as reasonably practicable*", including following any policy set out in the SIP on exercising voting rights. Where the pension fund's assets are held in a segregated account, it should generally be "*reasonably practicable*" for asset managers to follow the pension fund's voting policy.

For this to work, it is essential that the pension fund has a strong voting policy set out or referred to in the SIP. Pension funds that are unsure how to do this may want to look at examples from other funds (such as the Environment Agency Pension Fund) and discuss the options with their advisors.

The Pension's Regulator (TPR) makes similar recommendations in its 2016 Guide to Investment Governance for DC schemes: "*Where practicable you may wish to agree specific voting criteria with your investment managers."*

In terms of having a say in a particular vote (i.e. beyond simply having voting guidelines), some asset managers have a policy of seeking input from clients with segregated accounts on voting decisions. Trustees should ask asset managers to fully explain their policy on this before signing any mandate.

The best way, however, of ensuring the trustees have the final say on how their scheme or institution's shares in segregated accounts are voted is to include terms in the written mandate to that effect. For example, the mandate might generally allow fund managers to vote the fund's shares in their discretion with a reserved right for the trustees to vote them themselves (or via a specialist service provider) if the trustees choose to do so. Alternatively, the mandate might require asset managers to refer specific types of resolutions – e.g. environmental or climate change resolutions – to the trustees for instructions on how to vote. If an asset manager fails to comply with these terms, they will be in breach of contract.

(b) Pooled or mutual funds

Where a scheme or institution is invested in a pooled or mutual fund the most direct way to influence voting is to select a product or manager that allows the trustees to vote shares (via a proxy voting form) held in the pooled or mutual fund in proportion to the scheme or institution's level of investment in the fund. The number of votes allocated to the scheme or institution will be calculated based on the number of units held in the fund. Trustees should specifically ask their asset managers to do this.

Where the scheme or institution is not currently invested in a fund that allows voting control in this way, the trustees may wish to explore the possibility of finding a fund or manager that does offer this facility. Alternatively, the trustees may also want to consider taking some of the following more indirect steps to improve the voting record of the asset manager:

(i) Address apparent conflicts of interest

Research suggests a tendency of asset managers to support company management on voting decisions where the asset manager undertakes business for company pension funds (see e.g. Ashraf et al (2010), Taub (2012), Cvijanovic et al (2014)). The suggestion is that asset managers who manage assets for pension funds are more likely to support management on shareholder proposals generally (not just at client companies) so as to avoid losing current or future pensions (or other) business.

Principle 2 of the UK Stewardship Code requires signatories to have "*a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed*". It goes on to state that, "*conflicts of interest will inevitably arise from time to time, which may include when voting on matters affecting a parent company or client. Institutional investors should put in place, maintain and publicly disclose a policy for identifying and managing conflicts of interest with the aim of taking all reasonable steps to put the interests of their client or beneficiary first. The policy should also address how matters are handled when the interests of clients or beneficiaries diverge from each other.*"

The FCA Handbook (which regulates asset managers operating in the UK) also requires regulated asset managers to take all reasonable steps to identify conflicts of interest and to establish, implement and maintain an effective conflicts of interest policy. Asset managers may also owe fiduciary duties to their clients under English common law to avoid and/or properly manage conflicts of interest.

Trustees should explore how a particular asset manager addresses potential conflicts of interest between its business development objectives and its stewardship activities before signing a mandate. In particular, trustees should ask how the asset manager addresses the inherent tendency of asset managers to support company management where the asset manager undertakes pensions business. Trustees should also request copies of relevant policies and processes on managing conflicts of interest and ask whether the policies have been independently verified in accordance with an international standard or a UK framework such as AAF 01/06 (and ask to see a copy of that independent verification).

In addition, trustees may want to strengthen the terms in the investment mandate governing conflicts of interest. Many investment mandates contain provisions requiring fund managers to disclose conflicts of interest to trustees promptly if the manager is unable to manage them effectively. Trustees may want to consider how these provisions can be strengthened to ensure that they cover relevant conflicts of interest that may arise in the voting context.

(ii) Include voting in manager searches and mandates and discuss voting in manager reviews

Whilst schemes and institutions invested in pooled and mutual funds may not always be able to directly dictate how shares held in the fund are voted, they can still ask for detailed information on voting policies and voting behaviour as part of their process for selecting fund managers (see Section 1 above).

Terms can also be added to mandates requiring asset managers to discuss some votes with the trustees (even if the pension fund does not have the final say in how the vote is exercised), and trustees can require voting to be reported on and explained at each manager review.

(iii) Adopt common voting policies across the pool/mutual fund

Investors in pooled or mutual funds may also want to consider seeking to adopt common voting policies across the pooled or mutual fund. If enough investors in a particular fund adopt the same voting policy, the asset manager may find it harder to justify not following it. Arguably, every investor in the fund might need to adopt the policy before the asset manager can be said to be legally bound by it, but the adoption of common voting policies will help to send a strong signal to the asset manager on how the majority of the investors in the fund expect voting to be handled.

(iv) Challenge the asset manager to comply with UNPRI standards

Many asset managers are signatories to the UN Principles of Responsible Investment (UNPRI). If the asset manager is a signatory, trustees may wish to challenge their asset manager on particular voting decisions on the basis that the decision is not in line with the asset manager’s commitments under UNPRI. If the manager is not a signatory, trustees may want to consider appointing an alternative manager who is a signatory.

Principle 2 of UNPRI states, "*we will be active owners and incorporate ESG issues into our ownership policies and practices*." Principle 3 states, "*we will seek appropriate disclosure on ESG issues by the entities in which we invest*". Arguably a failure to support appropriate climate change disclosure resolutions is a failure to comply with Principle 3 of UNPRI.

Fiona Reynolds, the managing director of UNPRI has observed that "*it is disappointing that what are very sensible climate resolutions did not gain enough investor support within the US oil and gas majors.*"

(v) Check that an independent opinion on voting process has been obtained

The UK Stewardship Code states that asset managers should obtain an independent opinion on their engagement and voting processes having regard to an international standard or a UK framework such as AAF 01/06.

It goes on to state that the existence of such assurance reporting should be publicly disclosed. If requested, clients should be provided access to such assurance reports.

Some asset managers do not currently comply with this guidance, choosing instead to audit their processes internally only. Trustees should request a copy of any assurance reports obtained by their asset manager.

(vi) Challenge the asset manager to comply with its public statements on climate change

Some asset managers have published additional reports and statements on climate risk (beyond the policies and statements required by law or codes). Trustees may want to request copies of any policies or reports the asset manager has published on climate change and climate risk.

These public statements can then be used to encourage asset managers to vote in a particular way on particular shareholders proposals, to avoid inconsistency between their public statements on climate change and their actual voting activity.

The new LGPS pools

The Local Government Pension Scheme (LGPS) is currently in the process of arranging itself in eight "pools". Each pool will work together to invest collectively and to pool stewardship activities. This has the potential to deliver significant benefits on voting accountability if pools are sufficiently ambitious.

It will be the pools (rather than the individual authorities) that are responsible for selecting, monitoring and deselecting asset managers. The size of the assets under management at the pool level will give the pools substantial commercial weight when selecting managers and negotiating better terms on voting in mandates.

The size of the pools also means they are more likely to be able to hold investments in segregated accounts, giving the pool greater say on how the voting rights attached to those investments are exercised.

Voting and stewardship policies will also generally be developed at the pool level. The pools could become powerful voices in corporate stewardship if they are sufficiently ambitious in setting their stewardship and voting policies, and in monitoring their implementation by asset managers.

Stewardship of the stewards

Finally, asset management companies are often publicly listed companies. Schemes and institutions holding shares in these companies may wish to consider engaging in stewardship activities with these companies (i.e. engaging with them as shareholders rather than as clients) to seek better transparency and stewardship accountability for clients.

This could include filing shareholder resolutions where appropriate. For example, Stephen M Silberstein Revocable Trust filed a shareholder resolution at BlackRock (in the US) which called for BlackRock to report on its proxy voting guidelines and how they influence its pay votes. Similar shareholder resolutions were also filed in the US at T.Rowe Price and Franklin Resources. The T.Rowe Price resolution asked the company to incorporate climate change into their proxy voting policies. Further resolutions are currently being tabled at JP Morgan, Blackrock and BNY Mellon. Pension funds may wish to support these resolutions and/or consider tabling other resolutions in the future.

If resolutions are filed in a country where they are legally binding, the investment company will be legally required to comply with it. This is subject to the requisite level of support being achieved – in the UK, for example, the threshold is 75% consensus.

Action for pension fund members

Many UK pension funds are not currently doing enough to control how and when their shares are voted.

If pension fund members (beneficiaries) are concerned that their pension fund is not being forceful enough in its stewardship approach to the issues covered in this briefing, members may want to write to their fund to raise these issues, provide them with a copy of this briefing and ask them to do more. Recipients of these letters should be the board of trustees for trust-based schemes, the administering authority or pool for LGPS funds, or the independent governance committee for contract-based schemes. NGOs like ShareAction can provide information and tools to pension fund members to assist with this engagement process.

Pension fund trustees have a duty to act in the best interests of members, and pension funds that are signatories to the UK Stewardship Code should publish a statement on their compliance with the Code including the principles set out in this briefing. If your pension fund is not a signatory to the Code, they should be encouraged to become one.

Your pension fund is investing your money and you are entitled to be reassured that they are engaging in appropriate stewardship activities to protect your investments from climate risks.

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Legal action?

If trustees have concerns as to whether the voting process or decision adopted by their asset manager in respect of the Exxon and/or Chevron climate disclosure resolutions (or any other resolutions) complied with the laws and codes set out in this paper, the trustees may wish to seek legal advice as to whether they can (i) move their investments to a different asset manager with a better voting record and policy (i.e. bring the mandate to an end), and/or (ii) lodge a complaint (anonymously or otherwise) with an appropriate financial regulator in respect of that conduct.

ClientEarth is continually monitoring the activities of asset managers in relation to climate risk. Where asset owners identify failures in relation to the management of climate risk by asset managers, we encourage you to let us know so that we can assist with addressing these concerns.

Legal Disclaimer:

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If asset owners, asset managers or pension fund members are concerned that they or others may be in breach of the laws or Codes described in this briefing, you may wish to seek legal advice on the possible consequences of that breach.

If pension schemes or institutions are interested in revising the terms of their mandates with their asset managers in line with the suggestions made in this briefing, they should seek legal advice on how best to do so in the particular circumstances applicable to their scheme.