A Framework for the DOL's New Proxy Voting Rule

The U.S. Department of Labor (DOL) has finalized a rulemaking that pertains to proxy voting and the exercise of other shareholder rights with respect to employee benefit plans subject to the U.S. Employee Retirement Income Security Act of 1974, as amended (ERISA).[1] The rule applies to plans directly, as well as to commingled investment funds that hold "plan assets."[2] Plan sponsors, investment advisers registered with the U.S. Securities and Exchange Commission (SEC), and other service providers that either exercise shareholder rights on behalf of plans or who appoint those who do should pay particular attention to this final rule.[3]

As with the DOL's recent *Financial Factors* rulemaking, this rule's genesis was probably the DOL's concern over the striking growth of environmental, social & governance (ESG) investing. Engagement with a company's board, for example, is a popular method used by managers to address ESG concerns. But both rules apply much more broadly, including to those managers and mandates that do not take ESG factors into account. Neither this rule nor the Financial Factors rule, is limited to ESG.

The exercise of shareholder rights, including proxy voting, has long been considered fiduciary conduct under ERISA. This rule retains that characterization and defines the scope of responsibilities. In doing so, the rule supersedes DOL Interpretive Bulletin 2016-01 and the relevant portions in DOL Field Assistance Bulletin 2018-01.

As discussed more fully below, fiduciaries of plans and plan asset vehicles will need to review their proxy voting policies and practices regarding their use of proxy advisors, especially when those advisors offer voting recommendations or their platforms pre-populate votes.[4] With this rule, proxy advisory firms continue to face increased scrutiny from U.S. regulators, notably the SEC and DOL, over their practices and influence.

From a substantive standpoint, the rule compels fiduciaries to only exercise shareholder rights, including proxy voting, if they are undertaken solely in accordance with the economic interests of the plan and its participants and beneficiaries. This entails the fiduciary discerning some economic benefit to the plan, beyond the plan merely being a shareholder, resulting from the exercise of shareholder activities by the plan alone or together with other shareholders.[5] Fiduciaries may consider the longer-term consequences and potential economic impacts from the exercise of such rights, even if they are not currently readily quantifiable, which should strengthen (or at least not hinder) proxy voting and engagement related to material ESG issues.[6] Importantly, a discernible economic benefit to the plan must be initially identified to pass muster under the rule, even if the shareholder activity does not result in a direct or indirect cost to the plan.

In the DOL's view, for example, a fiduciary may have to vote against a shareholder proposal that would result in the issuer incurring direct or indirect costs if such proposal did not also describe "a demonstrable expected economic return" to the issuer. On the other hand, "the costs incurred by a corporation to delay a shareholder meeting due to lack of a quorum is an example of a factor that can be appropriately considered as affecting the economic interest of the plan."

The costs of proxy voting and other shareholder rights must also be considered, as they too affect the economic interest of the plan. These costs may include direct costs to the plan, such as expenditures for analyzing portfolio companies and the matters to be voted on, determining how the votes should be cast, and ultimately submitting proxy votes to be counted. Moreover, the DOL notes that "[i]f a plan can reduce the management or advisory fees it pays by reducing the number of proxies it votes on matters that have no economic consequence for the plan that also is a relevant cost consideration."[7] Indirect costs are also relevant. For example, the fiduciary should consider the opportunity costs of the exercise of shareholder rights, such as opportunity costs for the client resulting from restricting the use of securities for lending to preserve the right to vote.[8]

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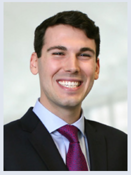

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The rest of the rule is more process-oriented, which speaks to how fiduciaries can satisfy these substantive obligations in practice.

First, fiduciaries need to evaluate material facts that form the basis for any particular proxy vote or other exercise of shareholder rights. Here, fiduciaries should consider material information that is known by, available to, or reasonably should be known by the fiduciary. In this respect, the DOL pointed to the fact that, under recent SEC guidance, clients of proxy advisory firms may become aware of additional information from an issuer that is the subject of a voting recommendation, and that an ERISA fiduciary would be expected to consider the relevance of such additional information if material.

Second, fiduciaries must maintain records on proxy voting activities and other exercises of shareholder rights. For fiduciaries that are SEC-registered investment advisers, the DOL intends that these recordkeeping obligations would be applied in a manner that aligns to similar proxy voting recordkeeping obligations under the U.S. Investment Advisers Act of 1940, as amended (Advisers Act).

Third, and as applicable, fiduciaries must exercise prudence and diligence in the selection and monitoring of (i) investment managers charged with proxy voting and (ii) proxy advisory firms selected to advise or otherwise assist with exercises of shareholder rights, such as providing research and analysis, recommendations regarding proxy votes, administrative services with voting proxies, and recordkeeping and reporting services. The fiduciary should consider the qualifications of the service provider, the quality of services being offered, and the reasonableness of fees charged in light of the services provided. ERISA fiduciaries should also ensure that, when considering proxy recommendations, they are fully informed of the potential conflicts of interest of proxy advisory firms and the steps such firms have taken to address them (*e.g.*, reviewing proxy advisor conflict of interest disclosures, *etc.*). Finally, fiduciaries should review the proxy voting policies and/or proxy voting guidelines and the implementing activities of the service provider; this requirement, however, does not require use of custom policies.

Fiduciaries may adopt proxy voting policies pursuant to a safe harbor and, if so, review them periodically for compliance with the rule (*e.g.*, every two years). These policies may not preclude (i) submitting a proxy vote when the fiduciary prudently determines that the matter being voted upon is expected to have a material effect on the value of the investment or the investment performance of the plan's portfolio (or investment performance of assets under management in the case of an investment manager) after taking into account the costs involved, or, conversely, (ii) refraining from voting when the fiduciary prudently determines that the matter being voted upon is not expected to have such a material effect after taking into account the costs involved. The rule specifically provides two safe harbors, either or both of which may be utilized when deciding whether to vote. The safe harbors are not the exclusive means to satisfy the rule or represent minimum requirements.

1. **Safe Harbor #1**: A policy to limit voting resources to particular types of proposals that the fiduciary has prudently determined are substantially related to the issuer's business activities or are expected to have a material effect on the value of the investment. The reference to the value of the investment rather than the plan's total investment is intended to make clear that the evaluation could be at the investment manager level dealing with a pool of investor's assets or at the aggregate plan level. The DOL expects that proposals relating to corporate events (e.g., mergers

and acquisitions, dissolutions, conversions, or consolidations), buybacks, issuances of additional securities with dilutive effects on shareholders, or contested elections for directors, are the types of votes that would materially affect the investment.

2. **Safe Harbor #2**: A policy of refraining from voting on proposals or particular types of proposals when the plan's holding in a single issuer relative to the plan's total investment assets is below a quantitative threshold that the fiduciary prudently determines, considering its percentage ownership of the issuer and other relevant factors, is sufficiently small that the matter being voted upon is not expected to have a material effect on the investment performance of the plan's portfolio (or investment performance of assets under management in the case of an investment manager).

In response to concerns raised by some commenters, the safe harbors in the final rule are intended to be flexible enough to clearly enable fiduciaries to vote to establish a quorum of mutual fund shareholders or on other fund matters. On this point, the DOL noted that fiduciaries may also adopt voting policies that consider the detrimental effect on the plan's investment due to the costs (direct and indirect) incurred related to delaying a shareholders' meeting. The rule envisions fiduciaries having considerable flexibility in fashioning proxy voting policies and the opportunity to deviate from the policies in certain instances.

Proxy advisors remain top-of-mind for the DOL. The safe harbors are intended to provide fiduciaries the ability to operationalize the rule without having to seek recommendations on a vote-by-vote basis from proxy advisors. The rule prohibits fiduciaries from adopting a practice of following the recommendations of a proxy advisory firm without first determining that such firm or service provider's proxy voting guidelines are consistent with the fiduciary's obligations under the rule.[9] As with the SEC, the DOL expects fiduciaries, under certain circumstances, to conduct a more particularized voting analysis than what may be conducted under the general guidelines. The DOL acknowledged that some plans rely on proxy advisory firms' pre-population and automatic submission mechanisms for proxy votes but noted that adopting such a practice for all proxy votes effectively outsources their fiduciary decision-making authority.

The rule continues to recognize and account for the fact that an investment manager of a plan asset pooled investment vehicle may be subject to an investment policy statement that conflicts with the policy of another plan investor. In this case, compliance with ERISA requires the investment manager to reconcile, to the extent possible, the conflicting policies (assuming compliance with each policy would otherwise be consistent with ERISA). In the case of proxy voting, the investment manager generally must vote (or abstain from voting) the relevant proxies to reflect such policies in proportion to each plan's economic interest in the investment vehicle. Investment managers of pooled funds, however, typically develop an investment policy statement and require participating plans to accept the investment manager's proxy voting policy as a condition to subscribe, which remains permitted under the rule. The investment manager's policies would need to comply with this rule, and the fiduciary responsible for the plan's subscription in the fund would be obligated to assess whether the investment manager's policies are consistent with this rule before subscribing in the fund.[10]

As noted above, the rule does not directly apply to investment vehicles that do not hold plan assets, such as mutual funds. The rule, for example, does not require ERISA fiduciaries to scrutinize a mutual fund's voting practices in which the plan has an investment. The DOL does, however, contemplate that ERISA fiduciaries will consider the mutual fund's voting policies as part of its overall consideration of the mutual fund as a prudent investment in accordance with the Financial Factors rule. Thus, fiduciaries should consider whether the investment fund's voting policies are expected to have a material effect on the risk and/or return of an investment.

The rule's compliance date is Jan.15, 2021, subject to the following:

- All fiduciaries should begin to review their proxy voting policies and practices in light of the new rule, especially plan investment committees and investment managers of separate accounts.
- Fiduciaries that are investment advisers registered with the SEC must comply by Jan.15, 2021, with respect to the requirements to (i) evaluate material facts that form the basis for any particular proxy vote or other exercise of shareholder right and (ii) maintain records on proxy voting activities and other exercises of shareholder rights. The DOL intends that these requirements align with existing obligations under the Advisers Act, including Rules 204-2 and 206(4)-6 thereunder and the 2019 SEC Guidance and 2020 SEC Supplemental Guidance. Other types of fiduciaries have until Jan. 31, 2022, to comply with these requirements.
- All fiduciaries shall have until Jan. 31, 2022, to comply with the requirements that they not adopt a practice of following the recommendations of a proxy advisory firm or other service provider without a determination that such firm or service provider's proxy voting guidelines are consistent with the rule. Fiduciaries of pooled investment vehicles also have until that date to confirm the fund's proxy voting policies with the rule.

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[1] The rule does not apply to the exercise of shareholder rights on behalf of non-ERISA plans, such as IRAs and governmental plans.

[2] Investment companies registered under the U.S. Investment Company Act of 1940, as amended, do not hold plan assets and thus not subject to ERISA or this rule. Hedge funds and other commingled vehicles that fail to satisfy one of the exceptions set forth in the DOL's plan assets regulation, on the other hand, are subject to ERISA and this rule. Similarly, bank-maintained collective investment trusts are subject to ERISA and this rule.

[3] The rule does not apply to proxy voting that is passed through to participants and beneficiaries with accounts holding such securities in an individual account plan.

[4] Firms that agree to act as "investment managers," within the meaning of Section 3(38) of ERISA, should ensure the investment management agreement is clear on who has the responsibility to exercise shareholder rights on behalf of the plan. When the authority to manage plan assets has been delegated to an investment manager, the investment manager has exclusive authority to vote proxies or exercise other shareholder rights, except to the extent the plan, trust document, or investment management agreement expressly provides that the responsible named fiduciary has reserved to itself (or to another named fiduciary so authorized by the plan document) the right to direct a plan trustee regarding the exercise or management of some or all of such shareholder rights.

[5] The proposed rule included a requirement that the fiduciary consider only factors that they prudently determine will affect the economic value of the plan's investment based on a determination of risk and return over an appropriate investment horizon consistent with the plan's investment objectives and the funding policy of the plan. The DOL eliminated this condition because of its potential compliance costs and that it may not be apparent that a particular vote will affect the plan's investment return. A similar revision was made to the final Financial Factors rulemaking; thus, even the DOL admits fiduciaries need not be clairvoyant in evaluating how an investment decision, or the exercise of shareholder rights, on some basis (ESG or not) will materially affect the plan's return in the future. Instead, fiduciaries should follow a thoughtful, prudent process in reaching the position that an investment, or the exercise of rights appurtenant to such investment, is in the economic interests of the plan.

[6] As with the Financial Factors rulemaking, the DOL cautioned fiduciaries against taking too elastic an interpretation of economic benefits that could flow to the plan, by noting that "vague or speculative notions that proxy voting may promote a theoretical benefit to the global economy that might redound, outside the plan, to the benefit of plan participants would not be considered an economic interest under the final rule."

[7] The DOL also noted that it would "not be appropriate for plan fiduciaries, including appointed investment managers, to incur expenses to engage in direct negotiations with the board or management of publicly held companies with respect to which the plan is just one of many investors." It is questionable whether this assertion is supported by the rule itself.

[8] The DOL acknowledged that multiple investment managers may be responsible for managing a plan's assets, and accordingly revised the rule to permit each investment manager to apply the rule to its specific mandate. The DOL noted, however, that "where the plan's overall aggregate exposure to a single issuer is known, the relative size of an investment within a plan's overall portfolio and the plan's percentage ownership of the issuer, may still be relevant considerations in appropriate cases in deciding whether to vote or exercise other shareholder rights."

[9] The fiduciary selecting and using a proxy advisor, therefore, must review the proxy advisor's voting guidelines against this rule in addition to separately determining whether a specific recommendation necessitates a particularized analysis. The review of the proxy advisor proxy voting guidelines should be addressed at the outset of the relationship with the proxy advisor and when the proxy advisor updates its guidelines (*e.g.*, annually).

[10] Uniform policies utilized by the investment manager across client accounts are still permissible under the rule, provided the policies comply with this rule.