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The DOL Finalizes Regulation Imposing New Obligations for Plan Sponsors and Asset Managers in Connection with Proxy Voting and Other Exercises of Shareholder Rights by ERISA Plans

On December 11, 2020, the U.S. Department of Labor (DOL) adopted a final rule amending the investment duties regulation under ERISA to address how plan fiduciaries should exercise shareholder rights, including proxy voting. The DOL indicated that it adopted this rule to address the use by plan fiduciaries of non-pecuniary factors in proxy voting decisions as well as what it has described as a “misconception” among plan fiduciaries that they must generally always vote proxies, even when doing so does not result in a benefit to the plan.

Together with the ESG rule the agency finalized at the end of October (see our Alert [here](#)), this latest rulemaking reinforces the principle that financial factors impacting plans and their participants and beneficiaries should be the only considerations driving fiduciary decision-making.

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While the final rule moves away from the prescriptive approach the agency proposed in September in favor of a more principles-based design, it still imposes new mandates that will likely have the practical effect of discouraging both proxy voting by ERISA plan fiduciaries as well as the use of proxy advisers and other service providers to assist them with exercising their shareholder rights. The final rule also imposes additional obligations on asset managers who manage ERISA plan assets.

The DOL's Prior Guidance

The DOL has addressed proxy voting and the exercise of shareholder rights by ERISA plan fiduciaries on numerous occasions in the past, and it has consistently expressed the view that these activities were part of the fiduciary obligation involved in prudently managing plan investments. The DOL's prior sub-regulatory guidance (e.g., Interpretive Bulletins 94-2, 2008-02 and 2016-01) has set out that a fiduciary's duty is to vote those proxies that are prudently determined to have an economic impact on the plan after the costs of research and voting are taken into account. In the preamble to the proposed rule, the DOL stated that it believed a misunderstanding had taken hold that a plan fiduciary must exercise its right to vote a proxy in nearly all circumstances. From the DOL's perspective, a perceived duty to vote proxies and exercise other shareholder rights in all circumstances could impose costs on plans that exceed the economic benefits that result. Moreover, the DOL pointed to a significant increase in the number of environmental and social shareholder proposals over the last decade as an area where a plan's voting costs could exceed the attendant benefits. It also referenced the shift from direct plan ownership of equity interests in companies to indirect holdings through mutual funds as a justification for less frequent proxy voting by plans.

In general, proxy voting and other forms of shareholder engagement are relatively low-cost activities that do not involve a significant expenditure of funds by individual plan investors, especially if the activities are undertaken by institutional investment managers who are managing plan assets. Moreover, investment managers often engage consultants, such as proxy advisory firms, to reduce the individual plan costs of researching proxy matters and exercising shareholder rights. But in spite of the general understanding of these low costs, President Trump issued an executive order in April 2019 calling for the DOL to undertake a review of existing guidance on the fiduciary responsibilities associated with proxy voting to determine whether any such guidance should be rescinded, replaced or modified. In response, the DOL released this rule as a way to reduce what the agency considered to be “unnecessary” expenditures of plan assets on matters that were not economically relevant to the plan.

Overview of the Final Rule

Increased Burden on Plan Fiduciaries under Investment Duties Regulation

The final rule expands on the investment duties regulation under ERISA section 404(a)(1) by providing guidance on how fiduciaries should approach shareholder rights, including the voting of proxies. The proposed rule had set out a highly prescriptive framework where fiduciaries were required to assess each proxy or similar exercise of a shareholder right to determine whether voting would have an economic impact on the plan. If the fiduciary found such an impact, then it would be required to vote or act. If it did not find an economic impact, then it would be required not to vote. In a key change from the proposal, the final rule jettisons this new required fiduciary determination and instead states explicitly that the fiduciary duty to manage shareholder rights appurtenant to shares of stock does not require the voting of every proxy or the exercise of every shareholder right, and allows fiduciaries to act based on this principle. The rule enumerates the various obligations a plan fiduciary must fulfill when exercising shareholder rights in order to satisfy its prudence and loyalty duties under ERISA:

- **Act Solely in Accordance with the Plan’s Economic Interests:** Act solely in accordance with the economic interest of the plan and its participants and beneficiaries.
 - In the preamble to the final rule, the DOL cautioned fiduciaries not to take an overly expansive view as to what constitutes an economic interest. In particular, “vague or speculative notions that proxy voting may promote a theoretical benefit to the global economic that might, redound...to the benefit of plan participants” would not be considered an economic interest for purposes of the final rule.
- **Consider Costs:** Consider any costs involved in voting or taking action.
 - Such costs could include direct costs to the plan, including expenditures for organizing proxy materials; analyzing portfolio companies and the matters to be voted on; determining how the votes should be cast; and submitting proxy votes to be counted.
- **Not Subordinate Participants’ Financial Interests to Non-Pecuniary Objectives:** Do not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to any non-pecuniary objective, or promote non-pecuniary benefits or goals unrelated to those financial interests of the plan’s participants and beneficiaries.
 - The DOL modified the final rule provision to clarify that a fiduciary still must not exercise proxy voting and other shareholder rights with the goal of advancing non-pecuniary goals unrelated to participants’ and beneficiaries’ financial interests even when doing so would not result in increased costs to the plan or decrease the value of the investment.
- **Evaluate Material Facts:** Evaluate material facts that form the basis for any particular proxy vote or other exercise of shareholder rights.
 - The intent of this provision is to ensure that in making informed proxy voting decisions, fiduciaries should consider information material to a matter that is known or that is available to and reasonably should be known by the fiduciary.
- **Maintain Records:** Maintain records on proxy voting activities and other exercises of shareholder rights.

- In response to commenters' concerns about costly and prescriptive recordkeeping requirements, the DOL removed more specific and onerous record retention requirements from the proposed rule, but documentation is still required and must be maintained.
- **Exercise Prudence and Diligence in Selecting Proxy Voting and Similar Service Providers:** Exercise prudence and diligence in the selection and monitoring of persons, if any, 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.
 - According to the DOL, this is essentially a restatement of the general fiduciary obligations that apply to the selection and monitoring of plan service providers, articulated in the context of fiduciary and other service providers that advise or assist with exercises of shareholder rights.

Impact on Investment Managers for Pooled Vehicles Holding the Assets of Multiple Employee Benefit Plans

The final rule requires the manager of any pooled vehicle or fund that holds the assets of multiple plans subject to ERISA (i.e., a fund that is deemed to hold plan assets under ERISA) to reconcile the proxy voting policies of each investing plan to the extent possible. Alternatively, an investment manager may develop its own investment policy statement governing proxy voting and shareholder actions, and require participating plans to accept the investment manager's investment policy statement, including any proxy voting policy, before they are allowed to invest. As a practical matter, this means asset managers of ERISA funds may need to develop new, detailed proxy voting policies for ERISA investors to review and sign onto.

Delegations of Authority to Investment Managers or Proxy Advisory Firm

The final rule affirms prior DOL guidance on the ability of a fiduciary to delegate responsibility for exercising shareholder rights. Where 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 another fiduciary has reserved the right to direct a plan trustee regarding the exercise of such rights. When a plan fiduciary has delegated its proxy voting authority to an investment manager, the plan fiduciary must prudently monitor proxy voting decisions that the investment manager makes to ensure they are consistent with the fiduciary's obligations described above. However, the DOL removed from the final rule the requirement for the plan fiduciary to obtain documentation of the decision-making process behind proxy voting and recommendations made by third parties.

The final rule also makes clear that a fiduciary may 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 fiduciary's obligations described above.

Safe Harbor Approach: Implementation of Proxy Voting Policies

Plan fiduciaries are permitted to adopt and follow policies on proxy voting. The final rule includes the following two safe harbor approaches that can be adopted, although a fiduciary could prudently determine other criteria for deciding in advance the types of proposals on which to focus:

- **Only Vote on Proposals of Corporate Significance:** 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.

- **Refrain from Voting When the Plan’s Holdings Are Minimal Relative to the Plan’s Total Investment Holdings:** A policy of refraining from voting on proposals or types of proposals when the size of the plan’s holdings in the securities carrying the right to vote are below quantitative thresholds that the fiduciary prudently determines, considering its percentage ownership of the issuer and other relevant factors, are sufficiently small that the outcome of the vote is unlikely to have a material impact on the investment performance of the plan’s portfolio (or assets under management in the case of an investment manager).
 - Even though the preamble to the proposal solicited comment on whether a maximum cap should be identified (the DOL offered a five-percent cap for consideration), ultimately, the agency decided to omit any specific threshold from the final rule.

These permitted practices are intended to be applied flexibly rather than in a binary “all or none” manner, and may be used either independently or in conjunction with each other. Furthermore, since the fiduciary’s overarching duty is to act in the best interest of participants and beneficiaries, a fiduciary may override the policies if it prudently determines that the matter being voted upon would have an economic impact on the plan after taking into account the costs involved. Finally, if the plan fiduciary relies on the safe harbors, it would have to review such voting policies or parameters periodically (the frequency is not specified under the final rule).

Proxy Voting Rights Passed Through to Plan Participants

The final rule confirms that these amendments to the investment duties regulation do not apply to voting, tender, and similar rights with respect to such securities that are passed through pursuant to the terms of an individual account plan to participants and beneficiaries with accounts holding such securities.

Effective Dates

The amendments will generally take effect thirty (30) days after publication of the final rule in the Federal Register.

However, the DOL has provided later applicability dates for certain portions of the final rule. In particular, fiduciaries other than registered investment advisers will have until January 31, 2022 to comply with the following requirements:

- evaluating material facts that form the basis for any particular proxy vote or other exercise of shareholder rights; and
- maintaining records on proxy voting activities and other exercises of shareholder rights.

In addition, all fiduciaries will have until January 31, 2022 to comply with these provisions:

- not adopting a practice of following the recommendations of a proxy advisory firm or other service provider without a determination that such firm’s voting guidelines are consistent with the standards set forth in the amendment; and
- voting by investment managers for pooled vehicles holding the assets of multiple employee benefit plans.

Implications

The final rule generally takes a more principles-based approach and eliminates a number of the potentially burdensome documentation mandates that were included in the proposal. Despite these changes, we expect that the final rule will still reduce the frequency of proxy voting by plan fiduciaries and limit the reliance by fiduciaries on proxy advisory firms and

service providers. Moreover, plan fiduciaries and asset managers will want to revisit their proxy voting policies (or adopt them if they do not already have such policies in force) so as to ensure that their proxy voting activities fall within the safe harbors provided in the final rule or otherwise comply with the rule.