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DOL Issues Final Proxy Voting Rule

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On December 16, the Department of Labor (the "Department") published its final regulation addressing the fiduciary duties that apply to proxy voting and the exercise of other shareholder rights in connection with investments held by ERISA-covered plans. 29 CFR §2550.404a-1(e); 85 Fed. Reg. 81658 (Dec. 16, 2020) (the "Final Rule") (attached). The Final Rule represents several significant changes to the Department's proposed proxy voting regulation, issued just over three months ago (the "Proposed Rule"). 85 Fed. Reg. 55219 (Sept. 4, 2020). The Department received over 300 written comment letters as well as 6,700 form letter submissions in response to the Proposed Rule.

The Final Rule reiterates the Department's long-held view that when voting (or not voting) proxies, plan fiduciaries must consider the economic significance of the issue on the plan's investment. But it explicitly rejects the broader set of considerations that it had previously articulated in Interpretative Bulletin 2016-01 ("IB 2016-01").

Below we summarize the long history of the Final Rule and its specific requirements. We also discuss the effective date and the prospects for Final Rule under the Biden Administration.

I. History

The Department has a long history of providing its views on the duty of fiduciaries when it comes to the voting of proxies on securities held by plans. It has been consistent in its view that the voting of proxies is a fiduciary obligation. However, the Department's more granular positions have shifted over time based on the particular administration's policy goals. Democratic administrations have tended to provide more leeway to fiduciaries in their proxy voting determinations while Republican administrations have taken a more restrictive approach.

For example, the Department issued guidance under the Bush Administration that, among other things, made it clear that plan fiduciaries should only consider factors related to the economic value of the plan investment when voting proxies. Interpretive Bulletin 2008-02. Under the Obama Administration, the Department issued

Interpretive Bulletin 2016-01, believing that the Bush Administration's guidance led to a misunderstanding that "may have worked to discourage ERISA plan fiduciaries who are responsible for the management of shares of corporate stock from voting proxies and engaging in other prudent exercises of shareholder rights."

In 2019, President Trump issued the Executive Order on Promoting Energy Infrastructure and Economic Growth. That Executive Order directed the Department to "complete a review of existing [Department] guidance on the fiduciary responsibilities for proxy voting to determine whether any such guidance should be rescinded, replaced, or modified to ensure consistency with current law and policies that promote long-term growth and maximize return on ERISA plan assets." In September of this year, the Department issued the Proposed Rule in response to the President's directive. The Department's justification for the Proposed Rule was its belief that prior proxy voting guidance has resulted in fiduciaries incurring proxy voting costs exceeding the resulting benefits to plans. Moreover, supported by securities issuers', the Department was concerned that plan fiduciaries may be over-relying on the advice of third parties, such as proxy advisory firms, without prudent consideration of that advice and the party offering it. In the Proposed Rule, the Department also intended to harmonize its proxy voting guidance with the SEC's recently published proxy voting rules for registered investment advisers. 85 Fed. Reg. 55223.

II. Summary of the Final Proxy Voting Rule

The Department articulated three main reasons for its new proxy rule-making: (1) its understanding that some plan fiduciaries have considered incorporating non-pecuniary factors into proxy decisions, (2) a history of fiduciaries' misunderstanding of the Department's sub-regulatory guidance, and (3) its concern that plans may be over-relying on proxy firms without ensuring that their recommendations are in the economic interests of the plan. 85 Fed. Reg. 81662.

The Final Rule contains a number of changes from the Proposed Rule, but the most significant may be the shift from a rules-based or prescriptive approach to a principles-based approach to proxy voting guidance. 85 Fed. Reg. 81662. The Department eliminated specific rules requiring and/or prohibiting the voting of proxies in certain circumstances and instead adopted principles that focus on ensuring that each fiduciary employs a prudent process when deciding whether and how to vote proxies or exercises other shareholder rights. 85 Fed. Reg. 81663.

A. DOL Confirms Basic Principles and Articulates a Six-Part Test

The Final Rule confirms several fundamental principles regarding an investment fiduciary's duties with respect to proxy voting and the exercise of shareholder rights –

- The fiduciary duty to manage plan assets that are shares of stock includes the duty to manage any shareholder rights associated with those shares, including the right to vote proxies. 2550.404a-1(e)(1).
- A fiduciary must act prudently and solely in the interest of participants when deciding whether and how to exercise shareholder rights. 2550.404a-1(e)(2)(i).
- This duty to manage shareholder rights does not require the voting of every proxy or the exercise of every shareholder right. §2550.404a-(e)(1)(ii).

In the preamble to the Final Rule, the Department expanded on the application of these general principles and explained that the following activities would generally be inappropriate under the duties of loyalty and prudence –

- A fiduciary's use of plan assets to further policy-related or political issues, including ESG issues, through proxy resolutions that are not "solely in accordance with the economic interests of the plan and its participants and beneficiaries."
- A fiduciary's use of plan assets "to further policy or political issues through proxy resolutions that are not likely to enhance the economic value of the investment in a corporation …" In fact, DOL indicated that a fiduciary might be required to vote against a shareholder proposal that requires a corporation "to incur costs, either directly or indirectly, without the proposal including a demonstrable expected economic return to the corporation…"
- A plan fiduciary's incurring "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.

- A plan's funding of "advocacy, press, or mailing campaigns on shareholder resolutions, call special shareholder meetings, or initiate or actively sponsor proxy fights on environmental or social issues relating to such companies, unless these activities (alone or together with other shareholders) are appropriate" under the six-part test in the Final Rule. 85 Fed. Reg. 81665.

In addition to the above-described general principles, the Final Rule sets out a six-part test that a fiduciary should follow in order to satisfy its duties of prudence and loyalty when deciding whether to exercise – and in exercising – the right to vote proxies and other shareholder rights. §2550.404a-1(e)(2)(ii).

***1. A fiduciary must act solely in accordance with the economic interests of the plan and its participants.* §2550.404a-1(e)(2)(ii)(A).**

- The Department cautioned against "overly expansive" interpretations of the plan's "economic interests" such as "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…" 85 Fed. Reg. 81666.
- The costs incurred by a corporation to delay a shareholder meeting due to a lack of a quorum is a factor that can be considered as affecting the plan's economic interests. 81666
- The Department also noted 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 be relevant considerations in deciding whether to vote or exercise other shareholder rights. 85 Fed. Reg. 81667.

2. The fiduciary must take into account any costs involved. §2550.404a-1(e)(2)(ii)(B).

- According to the Department, relevant costs could include "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" as well as extraordinary costs relating to particular proxies, including those of foreign issuers. Reductions in plan management fees as a result of a reduction in voting on matters that have no economic consequence might also be a relevant consideration. Lastly, DOL noted identified as potentially relevant to a proxy decision "[o]pportunity costs in connection with proxy voting … such as foregone earnings from recalling securities on loan or if, as a condition of submitting a proxy vote, the plan will be prohibited from selling the underlying shares until after the shareholder meeting." 85 Fed. Reg. 81667.

3. The fiduciary may not subordinate the interests of participants and beneficiaries in their retirement income to any non-pecuniary objective, or promote non-pecuniary goals unrelated to the financial interests of the plan and its participants. §2550.404a-1(e)(2)(ii)(C).

- Importantly, in adopting this third element of the test, it was DOL's intent to "avoid suggesting that a fiduciary may exercise proxy voting and other shareholder rights with the goal of advancing non-pecuniary goals unrelated to the financial interests of the plan's participants and beneficiaries so long as it does not result in increased costs to the plan or a decrease in value of the investment." 85 Fed. Reg. 81667.

4. The fiduciary must evaluate the material facts that form the basis of the proxy vote or exercise of shareholder rights. §2550.404a-1(e)(2)(ii)(D).

- In response to comments on the Proposed Rule, the Department eliminated in the Final Rule the requirement that the fiduciary "investigate" material facts and instead now requires that the fiduciary "evaluate" such facts. In this regard, DOL indicated that it did not intend that fiduciaries conduct their own investigation of material facts in every case, but instead wanted to ensure that the fiduciary "consider information material to a matter that is known or that is available to and reasonably should be known by the fiduciary." 85 Fed. Reg. 81668.
- In this regard, the Department noted that fiduciaries who become aware of additional information from an issuer which is the subject of a voting recommendation by a proxy firm would be expected to consider the relevance of that information as part of "the facts that form the basis" of the proxy firm's vote. 85 Fed. Reg. 81668.

5. A fiduciary must maintain records on proxy voting activities and other exercise of shareholder rights. §2550.404a-1(e)(2)(ii)(E).

- Like all fiduciary decisions, documentation of proxy voting decisions is part of a prudent process. And, like other fiduciary activities, "the extent of the documentation needed to satisfy the monitoring obligation will depend on individual circumstances, including the subject of the proxy voting and its potential economic impact on the plan's investment." DOL intends that the Rule's recordkeeping requirement for fiduciaries that are registered investment advisers should "be applied in a manner that aligns to similar proxy voting recordkeeping obligations under the Advisers Act." 85 Fed. Reg. 81669.
- In response to comments on the Proposed Rule, DOL adopted a less prescriptive approach to the recordkeeping requirement, eliminating the requirement that managers document the basis for each vote. 85 Fed. Reg. 81669

6. The fiduciary must act prudently and diligently in selecting or monitoring persons chosen to advise or assist with proxy voting or shareholder rights, such as providers of research, administrative services, recordkeeping and reporting. §2550.404a-1(e)(2)(ii)(F).

- In the preamble to the Final Rule, the Department described this element of the six-part test as "essentially a restatement of the general fiduciary obligations that apply to the selection and monitoring of plan service providers…" As DOL has articulated in previous guidance, fiduciaries must assess the qualifications of the provider, the quality of services offered, and the reasonableness of fees charged in light of the services provided, and the selection process should avoid self-dealing, conflicts of interest or other improper influence. 85 Fed. Reg. 81669. Because it did not intend to impose stricter monitoring obligations in the case of proxy advisers, DOL eliminated the requirement that advisers document the rationale for their decisions. 85 Fed. Reg. 81670.
- "In considering any proxy recommendation, fiduciaries should assure that they are fully informed of potential conflicts of proxy advisory firms and the steps such firms have taken to address them. Furthermore, to the extent applicable, fiduciaries will be expected to review the proxy voting policies and/or proxy voting guidelines and the implementing activities of the person being selected." 85 Fed. Reg. 81669.

B. Special Considerations for Investment Managers and Proxy Voting Advisers

In recognition of "the more significant role" played by proxy voting firms, the Final Rule specifically addresses the oversight of such firms by appointing fiduciaries.

Where voting has been delegated to a manager or adviser, the named fiduciary must monitor the proxy voting "and determine whether such activities are consistent with" the fiduciary duties described by the Department, including the duties of prudence and loyalty, the six part test and the rules re proxy voting policies. §2550.404a-1(e)(2)(iii).

- The Department clarified in the Preamble to the Final Rule that it did not "intend to create a higher standard for a fiduciary's monitoring of an investment manager's proxy voting activities than would ordinarily apply under ERISA with respect to the monitoring of any other fiduciary or fiduciary activity." The Final Rule therefore eliminates the Proposed Rule's requirement that the manager document the rationale for each proxy voting decisions. 85 Fed. Reg. 81670.

Lastly, the Final Rule provides that a fiduciary may not adopt a policy or practice of following the recommendations of a proxy adviser without determining that the adviser's voting guidelines are consistent with the fiduciary's obligations as described in the six-part test. §2550.404a-1(e)(2)(iv).

C. DOL Identifies Two "Safe Harbor" Proxy Voting Policies

In the Final Rule, the Department adopted two "safe harbors" for permissible policy voting policies ("Safe Harbors"). A fiduciary is permitted to adopt voting policies describing specific parameters "prudently designed to serve the plan's economic interests." The following two policies may be adopted, provided they are developed prudently, solely in the interest of participants and in accordance

with the six-part test discussed earlier. §2550.404a-1(e)(3)(i). Each would constitute a "safe harbor" method for satisfying the adopting fiduciary's duties of prudence and loyalty in deciding whether to vote (but not with respect to *how* to vote).

- 1st Safe Harbor Policy: This policy may limit voting to specific "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." 2550.404a-1(e)(3)(i)(A). These might include "proposals relating to corporate events (mergers and acquisitions transactions, dissolutions, conversions, or consolidations), corporate repurchases of shares (buybacks), issuances of additional securities with dilutive effects on shareholders, or contested elections for directors…" 85 Fed. Reg. 81672. Notably, the Final Rule references "the value of the investment" rather than *the plan's* investment to clarify that the manager's decision could be made at a pooled fund level or at an individual plan level. 85 Fed. Reg. 81672.
- 2nd Safe Harbor Policy: This policy may provide that shares will not be voted on proposals or particular types of proposals where the plan's interest in the issuer is below a specified percentage of the plan's total investment assets (or the plan's assets under management by the fiduciary). The threshold must be sufficiently small that the matter being voted upon is not expected to have a material effect on the plan's investment performance (or the performance of the plan's assets under the fiduciary's management). 2550.404a-1(e)(3)(i)(B).

DOL intends that these Safe Harbors "be applied flexibly rather than in an "all or none" manner, and may be used either independently or in conjunction with each other." 85 Fed. Reg. 81672.

Lastly, the Final Rule emphasizes that no voting policy adopted by a fiduciary may preclude voting when the fiduciary determines that the issue is expected to have a material effect on the investment value or performance net of costs, or refraining from voting when it determines that it won't have such an effect net of costs. §2550.404a-1(e)(3)(iii). And, it reiterates that any proxy voting policy must be monitored. §2550.404a-1(e)(3)(ii).

D. Pooled Vehicles are Specifically Addressed

Consistent with current guidance, the Final Rule specifically addresses proxy voting by plan asset investment funds in which multiple plans investment. It provides that section 404(a)(1)(D) of ERISA requires the manager of such a pooled fund to "reconcile, insofar as possible, the conflicting policies" of the fund's participating plans, and, if possible, vote proxies in proportion to ownership of plans in the vehicle. However, as does current guidance, the Final Rule recognizes the more common approach to pooled fund proxy voting – a manager may adopt a voting policy for the pooled fund and require plans to accept that policy as a condition of participation in the fund. The Department cautioned that, in that case, the fiduciary of each plan must conclude that the pooled fund's proxy policy is consistent with Title I and the Final Rule before deciding to participate in the fund. §2550.404a-1(e)(4)(ii).

II. Effective or "Applicability" Date

The Final Rule applies to exercises of shareholder rights on or after January 15, 2021. §2550.404a-1(g)(3). However –

- Fiduciaries other than investment advisers subject to the SEC's proxy voting rules for registered investment advisers until January 31, 2022 to comply with two of the requirements of the six-part test: the requirement to evaluate material facts forming the basis of a proxy decision and the requirement to maintain records on proxy voting decisions.
- All fiduciaries have until January 31, 2022 to comply with the requirements relating to (i) the selection of proxy advisers and (ii) the implementation of proxy policies for pooled funds.

The Department indicated that the additional one year to come into compliance was designed to give fiduciaries additional time in making any modifications with respect to their use of proxy advisory firms and other service providers and for reviewing any proxy voting policies of pooled investment vehicles by investment managers. 85 Fed Reg. 81676.

III. Observations

As discussed earlier, the Final Rule provides that, in deciding whether to exercise a shareholder right, such as a proxy, a fiduciary "must act solely in accordance with *the economic interests* of the plan and its participants" and may not "promote non-pecuniary benefits or goals" unrelated to the financial interests of plan participants. And, in the preamble, DOL emphasized that advancing non-

pecuniary interests through the exercise of shareholder rights would be prohibited even when that action would not result in an increase in costs to the plan or a decrease in value of the plan's investment." 85 Fed. Reg. 81667.

This apparent *per se* prohibition on any consideration of non-pecuniary factors in the voting of proxies appears inconsistent with the at least theoretical possibility that a fiduciary could consider such factors in making an initial investment selection, as articulated in the Department's recent final amendment to the "investment duties" regulation under section 404 of ERISA. 29 CFR 2550.404a-1 ("ESG Rule"). Under the ESG Rule, if a fiduciary is unable to distinguish between alternative investments based on pecuniary factors (admittedly a circumstance the Department views as a "rare" event), the fiduciary would be permitted to consider non-pecuniary factors as a tie-breaker provided the fiduciary complies with the ESG Rule's documentation requirements.

This and other aspects of the Final Rule on proxy voting will likely be reviewed by the Biden administration. Democratic administrations have generally sought a more permissive approach with respect to proxy voting and the exercise of shareholder rights, so it is likely that incoming Biden Administration will revisit the Final Rule, along with the ESG Rule. Because the Final Rule will be effective before the start of the new administration, any changes to the rule will have to go through the notice and comment rulemaking process. However, the next administration could issue interim guidance that, for example, limits enforcement of aspects of the Final Rule. Regardless, fiduciaries should be mindful of the final rule's upcoming effective date and proactively address any potential future challenges.

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