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September 2020

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September 2020 | Authored by: Steven W. Rabitz, Andrew Oringer and Aryeh Zuber

OVERVIEW

The U.S. Department of Labor (the "DOL") on August 31, 2020 proposed a regulation (the "Proposed Proxy Regulation") that would apply to how fiduciaries under the Employee Retirement Income Security Act of 1974 ("ERISA") should consider decisions with respect to the voting of proxies and other exercises of shareholder rights associated with investments made by plans that are subject to ERISA ("Plans"). The Proposed Proxy Regulation comes on the heels of a separate proxy-related initiative (the "2019 SEC Guidance")[1] of the Securities and Exchange Commission (the "SEC") and a proposed DOL regulation under the prudence and loyalty rules relating to environmental, social and governance ("ESG") factors (the "Proposed ESG Regulation"). The Proposed Proxy Regulation can in some ways be viewed as complementing and bolstering some of the key policy objectives of the SEC's initiative and the Proposed ESG Regulation. We generally discussed ESG considerations in the ERISA context in a prior May 15, 2020 OnPoint, and discussed the Proposed ESG Regulation in a prior June 30, 2020 OnPoint.

While there are aspects of the Proposed Proxy Regulation that could focus and therefore simplify a fiduciary's duty regarding proxy voting, the Proposed Proxy Regulation is not short on potentially new significant compliance burdens. New obligations would extend not just to investment committees and others at the Plan sponsor charged with hiring investment managers, but also to Plan trustees with proxy-related responsibilities, and to third-party investment managers charged with voting proxies and exercising other shareholder rights.

In summary, the Proposed Proxy Regulation:

- states that a Plan fiduciary *must* vote on matters it determines would have an economic impact; and *must not* vote on matters it determines would not;
- reinforces the DOL's belief that the consideration of non-pecuniary factors, including ESG-related matters, can result in breaches of ERISA's fiduciary duties;
- approves safe harbors that would *allow a* Plan fiduciary not to vote on matters that the fiduciary believes will only have a marginal impact, or economic benefit to the Plan, particularly where the Plan's economic interest is de minimis;

1 SEC, Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, 84 Fed. Reg. 47420 (Sept. 10, 2019).

- *requires* that Plan fiduciaries (including discretionary investment managers) demonstrate the basis for particular proxy votes and other exercises of shareholder rights and investigate material facts that form the basis for any particular proxy vote; and

- casts skepticism on the use of proxy-advisory services unless their recommendations conform to the standards of the Proposed Proxy Regulation.

When these points are viewed in the aggregate, if the Proposed Proxy Regulation is finalized as proposed, Plan fiduciaries may find that they are constrained from voting on many items, and fiduciaries could be forced to adopt an approach in which they may not vote unless they justify the cost and the vote is on matters the Plan fiduciary determines would have an economic impact to the Plan. Reflecting this shift in approach, the DOL specifically stated in the preamble accompanying the Proposed Proxy Regulation (the "Preamble") that it expects Plan fiduciaries only to vote on matters "that are substantially related to the company's business activities or that relate to corporate events (mergers and acquisitions transactions, dissolutions, conversions, or consolidations), corporate repurchases of shares (buy-backs), issuances of additional securities with dilutive effects on shareholders, and contested elections for directors, where plans' exposure to the stock is sufficiently large to justify the expenditure."

RELATIONSHIP TO CERTAIN PRIOR GUIDANCE

The Proposed Proxy Regulation and the Proposed ESG Regulation seek to amend the same regulation that governs prudence regarding investment decisions. The Preamble makes this connection explicit by stating that "[b]oth this proposal and the [Proposed ESG Regulation] are amendments to [29 C.F.R. §] 2550.404a-1" – the basic regulation governing prudence.

The Preamble reflects the connection between the two proposed rules, stating that a primary purpose of the Proposed Proxy Regulation is to correct a "misunderstanding that fiduciaries must research and vote all proxies" and "expend their assets unnecessarily on matters not economically relevant to the plan." The Preamble specifically points to "voting policies [that] are becoming more complex, as investors continue to add to the list of factors they consider in their review and analysis of governance practices, including board independence, board accountability, diversity, myriads of executive compensation factors, shareholder rights, and environmental and social factors."

The DOL had previously relied on sub-regulatory guidance with respect to proxy and ESG-related matters, which guidance tended to vacillate at the margins under successive Democratic and Republican administrations. However, as it did in the Proposed ESG Regulation, the DOL has signaled a willingness to solidify greater permanence in this area by proposing actual new regulatory language. In the regulatory-impact analysis of the Preamble, the DOL notes that a regulation offers "more certainty than sub-regulatory guidance and is subject to public notice and comment. And unlike guidance, a substantive regulation sets forth binding requirements." While, as discussed further below, the DOL under successive administrations has put its own vacillating gloss on basic principles governing economically targeted investments first outlined by the DOL in 1994, the DOL has never before sought expressly to enshrine the required treatment of ESG considerations in actual regulatory language.

The Preamble also states that, although the "Department has tried to convey in its prior sub-regulatory guidance that fiduciaries need not vote all proxies," the DOL "recognizes that addressing these issues in the form of a notice and comment regulation will help safeguard the interests of participants and beneficiaries in their plan benefits." Despite the similarity in approach of the Proposed ESG Regulation and the Proposed Proxy Regulation with respect to using new regulatory language, however, a potential source of contrast between them could be that the damages for a

breach of fiduciary duty relating to decisions regarding in what to invest may be easier to quantify than purported damages flowing from a voting-related breach of fiduciary duty.

In addition, the Proposed Proxy Regulation would vacate Interpretive Bulletin ("IB") 2016-1. IB 2016-1 had indicated that, in "voting proxies, the responsible fiduciary [must] consider those factors that may affect the value of the plan's investment and not subordinate the interests of the participants and beneficiaries in their retirement income to unrelated objectives."[2]

BACKGROUND

Section 404 of 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 a like character and with like aims." Section 404 also requires fiduciaries to act "solely in the interest of . . . participants and beneficiaries" and "for the exclusive purpose of providing benefits . . . and . . . defraying reasonable [administrative] expenses." These requirements are applicable not only to identification of the investments of the Plan, but also the broader management of Plan assets, which can include decisions related to the voting of proxies and other exercises of shareholder rights.

The DOL issued guidance in 1988 known as the "Avon Letter."[3] The Avon Letter provided that "the fiduciary act of managing plan assets that are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock" and that named fiduciaries are required "to periodically monitor the activities of the investment manager with respect to the management of plan assets." The DOL subsequently indicated that this duty also includes the monitoring of decisions made and actions taken by investment managers with regard to proxy voting and that such decisions must be made solely in the best interest of Plan participants.[4]

Over the years, the DOL has issued further guidance on fiduciaries' duties in respect of the voting of proxies and other exercises of shareholder rights. As has been the case with the DOL's considerations regarding ESG, the basic principles identified by the DOL have, to some extent, generally remain unchanged, but there have been changes at the margins in tone and emphasis over successive presidential administrations. As the DOL states in the Preamble, the combined impact of this guidance had "resulted in a misplaced belief among some stakeholders that fiduciaries must always vote proxies, subject to limited exceptions, in order to fulfill their obligations under ERISA."

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2 President Trump issued an Executive Order in 2019 that directed the DOL to "complete a review of existing Department of Labor 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." The Executive Order indicated that this was to be undertaken to "advance the principles of objective materiality and fiduciary duty, and to achieve the policies." "Executive Order on Promoting Energy Infrastructure and Economic Growth," available at https://www.whitehouse.gov/presidential-actions/executive-order-promoting-energy-infrastructure-economic-growth/. The Executive Order emphasizes "support for American ingenuity, the free market, and capitalism" in expanding and accelerating access to the country's energy resources. This Executive Order is not cited in the Preamble.

3 Letter from Alan D. Lebowitz, Deputy Assistant Secretary of Labor to Helmuth Fandl, Chairman of the Retirement Board of Avon Products, Inc. (Feb. 23, 1988).

4 See Letter from Alan D. Lebowitz, Deputy Assistant Secretary of Labor to Robert Monks, Institutional Shareholder Services, Inc. (Jan. 23, 1990).

Thus:

- In 1994, in IB 94-02, the DOL noted that fiduciaries may engage in shareholder activity designed to influence corporate management if the fiduciary concludes that voting proxies is likely to enhance the value of the Plan's investment, after taking into account the costs involved in voting. Understanding that fiduciaries also have a duty of loyalty, the DOL was careful to note that ERISA does not permit fiduciaries to subordinate the economic interests of the Plan to unrelated objectives in voting proxies or exercising other shareholder rights. (The Proposed ESG Regulation sounds in a similar tone.)

- Under a Republican administration, the DOL in 2008 issued IB 2008-02, which repealed and replaced IB 94-02. The revised guidance required Plan fiduciaries only to vote proxies if they conclude that the vote is more likely than not to result in an increase in the Plan's investment relative to the expenses incurred in taking the action. Arguably, this guidance permitted fiduciaries to balance costs with benefits in deciding the extent to which such voting decisions should be made.

- Under a Democratic administration, the DOL in 2016 replaced IB 2008-2 with IB 2016-01. While this guidance to a large extent reestablished the principles of IB 94-02, there were some changes that provided some additional flexibility to Plan fiduciaries. The DOL was concerned that IB 2008-01 could be read too broadly so that fiduciaries would fail to "exercis[e] shareholder rights, including voting of proxies, unless the plan has performed a cost-benefit analysis and concluded in the case of each particular proxy vote or exercise of shareholder rights that the action is more likely than not to result in a quantifiable increase in the economic value of the plan's investment." The DOL indicated that a Plan fiduciary should instead focus on whether the Plan's vote, either alone or together with votes of other shareholders, is expected to have an effect on the value of the Plan's investment, and compare that with the additional cost of voting shares. As in prior guidance, however, the DOL also cautioned that if a potential investment requires that a fiduciary spend an inordinate expenditure of resources to vote shares, then the fiduciary should consider whether the difficulty in voting shares is reflected in the market price. Unlike prior guidance, however, a fiduciary was not required to engage in a cost-benefit analysis before voting on behalf of a Plan. Rather, the fiduciary was required only to consider whether the issue up for vote would have an effect on the value of the Plan's investment and weigh that against the cost of voting shares – an arguably narrower undertaking.

- In Field Assistance Bulletin ("FAB") 2018-01, issued under the current Republican administration, the DOL indicated that IB 2016-1 was "not intended to signal that it is appropriate for an individual plan investor to routinely incur significant 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." The DOL also noted that "[IB 2016-01] was not meant to imply that plan fiduciaries, including appointed investment managers, should routinely incur significant plan expenses to, for example, fund 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." FAB 2018-01 also mentioned that IB 2016-01 "should be read in the context of the DOL's observation that proxy voting and other shareholder engagement typically does not involve a significant expenditure of funds by individual plan investors because the activities

are generally undertaken by institutional investment managers that are appointed as the responsible plan fiduciary."[5]

STATED REASONS FOR GUIDANCE

The Preamble states that the totality of previous guidance has left market participants with the "misplaced belief" that fiduciaries always are required to vote proxies, subject to limited exceptions, in order to comply with ERISA. The DOL notes that it "has tried to convey in its sub-regulatory guidance that fiduciaries need not vote all proxies" and that a "fiduciary's duty is only 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." The DOL notes, however, that "a misunderstanding that fiduciaries must research and vote all proxies continues to persist, causing some plans to expend their assets unnecessarily on matters not economically relevant to the plan."

The DOL states that knowing when to vote and not vote itself results in the potential expenditure of considerable resources which may not outweigh the potential benefits.[6] The concern has been "amplified" by ESG proposals and the DOL believes "it is likely" that "many of these proposals have little bearing on share value or other relation to plan interests."[7]

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5 The origins of pension-fund involvement in corporate decision-making preceded even this see-saw. The Preamble makes note of a 1985 Senate hearing which highlighted the "pivotal role" that pension funds were being forced to play in takeover attempts, and an ensuing 1985 DOL report which suggested that the trend had reached "epidemic proportions." Testimony of Robert Monks, Department of Labor's Enforcement of the Employee Retirement Income Security Act, Hearings before the S. Subcomm. on Oversight of Gov. Mgmt., S. Hrg. 99-310 (June 25-26, 1985), at 5 (1985 ERISA Hearings); Office of Pension and Welfare Benefit Programs, Summary of Conclusions from Public Hearings (Jan. 1985) ("1985 DOL Report"), included in 1985 ERISA Hearings, at 454, 498 ("Projections are that ERISA plans will hold more than half of all the equity securities in the United States before the turn of the century. Perhaps not entirely by coincidence, take-over fever reached epidemic proportions in 1984."). The concern at that time was that ERISA somehow mandated that plan fiduciaries were required to sell to the highest cash bidder, while there was also a concern that money managers might be incentivized not to vote against anti-takeover provisions because of conflict of interest concerns. See Testimony of Ian Lanoff, 1985 ERISA Hearings, at 26 (former administrator of the DOL's benefits office testifying that "some representatives of corporate America have blamed the pension plans for always taking the short-term view in takeover situations, and always tendering. And they somehow construe this as being required by ERISA or their fiduciary responsibilities."); 1985 DOL Report, included in 1985 ERISA Hearings, at 498; Joint Department of Labor/Department of Treasury Statement of Pension Investments (Jan. 31, 1989), reprinted in 16 Pens. & Ben. Rep. (BNA) 215 (Feb. 6, 1989).

6 The Preamble states that the DOL "recognizes that because the decision regarding whether a proxy vote will or will not affect the economic value of a plan's investments is critical in triggering a fiduciary's obligations under ERISA to vote or abstain from voting, fiduciaries may need to conduct an analytical process which could in some cases be resource-intensive . . . and that these activities may often burden fiduciaries out of proportion to any potential benefit to the plan." The DOL also states that current practices on voting proxies may "impose costs on plans that exceed the consequent economic benefits to them."

7 The Preamble goes on to say: "From 2011 through 2017, shareholders submitted 462 environmental proposals and 841 social shareholder proposals, and resubmitted at least once 41 percent of environmental and 51 percent of social proposals. These proposals increasingly call for disclosure, risk assessment, and oversight, rather than for specific policies or actions, such as phasing out products or activities. Support for environmental and social proposals grew between 2004 and 2018. Few received majority support, but the number of environmental proposals winning majority support ticked up sharply in 2018. By one count, the number of such proposals submitted or resubmitted grew from approximately 130 in 2000 to more than 240 by 2016, before falling to approximately 180 in 2018. The Department is aware, however, that in 2019, the SEC proposed a rule amendment that could have the effect of reducing the overall number of shareholder proposals that appear on issuer proxy statements." (Citations omitted.)

In addition, as indicated above, the DOL believes that this problem has been exacerbated by the fact that since 1988 the amount and types of shareholder proposals "have increased substantially," and that "voting policies are becoming more complex, as investors continue to add to the list of factors they consider in their review and analysis of governance practices, including board independence, board accountability, diversity, myriads of executive compensation factors, shareholder rights, and environmental and social factors." Addressing third-party proxy-advisory firms, the DOL states that it "has reason to believe that responsible fiduciaries may sometimes rely on third-party advice without taking sufficient steps to ensure that the advice is impartial and rigorous." (We have discussed a number of considerations relating to proxy-advisory firms in our April 17, 2020 OnPoint.)[8]

The DOL's concerns about an improperly inferred duty "always" to vote proxies would seem to highlight an apparent uneasiness about the increasing power and influence of proxy advisors and their use of ESG and other metrics that may not be in Plans' best interests. In referring to earlier 1988 guidance under the "Avon Letter," the DOL expressly notes that it is "concerned that some fiduciaries and proxy advisory firms—in part relying on the Avon Letter—may be acting in ways that unwittingly allow plan assets to be used to support or pursue proxy proposals for environmental, social, or public policy agendas that have no connection to increasing the value of investments used for the payment of benefits or plan administrative expenses, and in fact may have unnecessarily increased plan expenses."

The DOL also questions "whether third-party proxy advice is impartial, sufficiently rigorous, and consistent with ERISA's fiduciary duties, as would be necessary to reliably advance ERISA investors' interests" or "whether proxy advisory firms' practices are sufficiently transparent for investors to be able to determine whether their interests are being advanced." The DOL further notes that "some stakeholders also question whether the market for proxy advice is too concentrated and insufficiently competitive, which could impair investors' access to quality, affordable advice." The DOL recognizes that these firms sometimes "inappropriately provide the same recommendations to investors with different duties or obligations." Finally, the DOL notes that "[u]niform voting policies for clients with different investment strategies and objectives have also been noted as a problem."[9]

While the emphasis on ESG seems to dovetail with that of the Proposed ESG Regulation, it is not the only stated reason for the Proposed Proxy Regulation. More fundamentally, the DOL also indicates that "research regarding whether proxy voting has reliable positive effects on shareholder value and a plan's investment in the corporation has

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8 SEC Issues Guidance on Investment Advisers' Use of Proxy Firms and Application of Proxy Rules to Voting Recommendations; Proposes to Narrow Certain Exemptions to Proxy Rules. See also Mark D. Perlow, Michael L. Sherman, Andrew L. Oringer, Neema Nassiri, Ken Winterbottom and Ari Abramowitz, Investment Lawyer, *SEC Issues Guidance on Investment Advisers' Use of Proxy Firms and Application of Proxy Rules to Voting Recommendations; Proposes to Narrow Certain Exemptions to Proxy Rules-Part 1* (July 2020).

9 The Preamble highlights the SEC's recent proxy initiative noting that "where an investment adviser undertakes proxy voting responsibilities on behalf of multiple funds, pooled investment vehicles, or other clients, it should consider whether it should have different voting policies for some or all of these different funds, vehicles, or other clients, depending on the investment strategy and objectives of each." 2019 SEC Guidance, 84 Fed. Reg. 47420, at 47423. The SEC's guidance in turn suggests that investment advisers:

> should consider whether voting all of its clients' shares in accordance with a uniform voting policy would be in the best interest of each of its clients. In particular, where an investment adviser undertakes proxy voting responsibilities on behalf of multiple funds, pooled investment vehicles, or other clients, it should consider whether it should have different voting policies for some or all of these different funds, vehicles, or other clients, depending on the investment strategy and objectives of each. For example, a growth fund that targets companies with high growth prospects may have a different perspective on certain matters submitted to shareholders than an income or dividend fund that seeks to generate an income stream for shareholders in the form of dividends or interest payments. [internal citations omitted]

yielded mixed results." The Preamble further notes that there has been an increase in the percentage of corporate America's stock held by, and Plan assets managed by, institutional investors and a broader diversification of ERISA plan assets. However, despite these other reasons for the regulation, the ESG dynamic is clearly near the forefront: the Preamble explains that one of the fallouts from the Avon Letter was that it presented Plan fiduciaries "with an ambiguous duty that in practice was often very difficult to discharge without the assistance of third-party proxy advisory firms." And, as the Preamble seems to indicate, it may well be the influence of these firms that has stoked the DOL's concerns about the pursuit of nonpecuniary goals.

The SEC has recently adopted changes relating to proxy voting and to proxy-advisory firms in the 2019 SEC Guidance. While the 2019 SEC Guidance is applicable to registered investment advisers under the Investment Advisers Act of 1940, the Preamble states that "the SEC's actions would not apply to ERISA fiduciaries that are outside of the SEC's jurisdiction." Presumably, persons like insurance companies or banks or trust companies may be fiduciaries but may not necessarily be subject to the Investment Advisers Act of 1940. The Preamble further notes that the DOL "views the SEC's guidance as reasonable direction for the diligence that ERISA plan fiduciaries should perform when reviewing and assessing a proxy advisory firm," but also adds that "the SEC standards do not necessarily capture all the actions that ERISA may require as a result of that review and assessment."[10] While the SEC allows investment advisers and clients to contract on the matters on which an investment adviser would vote, the DOL states expressly that, regardless of any contractual arrangement, fiduciaries "must not vote in circumstances where plan assets would be expended on shareholder engagement activities that do not have an economic impact on the plan, whether by themselves or after the costs of engagement are taken into account."

OVERVIEW OF THE PROPOSED PROXY REGULATION.[11]

No Duty Always to Vote. The Proposed Proxy Regulation states that there is "no fiduciary mandate under ERISA always to vote proxies appurtenant to shares of stock" and that there is "no presumption that abstaining from voting proxies appurtenant to shares of stock is a per se fiduciary breach." Rather, fiduciaries "must vote proxies in a

10 In the 2019 SEC Guidance, the SEC stated that an investment adviser is not required to vote proxies "if an investment adviser and its client have agreed in advance to limit the conditions under which the investment adviser would exercise voting authority" and more directly confirmed that, "[i]f an investment adviser does accept voting authority, it may agree with its client, subject to full and fair disclosure and informed consent, on the scope of voting arrangements, including the types of matters for which it will exercise proxy voting authority." The Preamble states that the "Department [therefore] believes that it would be appropriate to consider updating its regulations to ensure more consistent conduct by all plan fiduciaries." It is noted that the SEC has also provided guidance on how parties may contract with respect to an investment adviser's proxy-related responsibilities (see generally 84 Fed. Reg. 47420, 47421-23), and on when an investment adviser may utilize a proxy advisor's electronic vote management system that "pre-populates" with suggested voting recommendations and/or for voting execution services, SEC Release No. IA-5547, Supplement to Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers (July 22, 2020).

The SEC permits an investment adviser to choose not to vote a proxy "where the adviser determines that the cost to the client of voting the proxy exceeds the expected benefit to the client," but noted that in this regard "the investment adviser may not ignore or be negligent in fulfilling the obligation it has assumed to vote client proxies and cannot fulfil its fiduciary responsibilities to its clients by merely refraining from voting the proxies." 2019 SEC Guidance, 84 Fed. Reg. 47420 at 47426.

11 Governmental and other plans that are not subject to ERISA may be subject to similar state, local or non-US rules. In some cases, other jurisdictions adopt a quasi-ERISA approach to fiduciary issues. It remains to be seen how non-ERISA regulators would react to an initiative such as the Proposed Proxy Regulation, if finalized as proposed. Many investment management agreements in respect of governmental plans often require the investment manager to abide by prudence conditions that may be substantially similar to those of ERISA.

manner that is in the best interest of the plan, and the Proposed Proxy Regulation is "designed to reflect these principles while permitting fiduciaries to execute such duties in a cost-efficient manner."

As the Preamble further indicates in its regulatory-impact analysis, "if the proposal has no or negligible implications for the value of the plan's investment, it would be better for the plan to simply refrain from voting than to incur even small costs making this determination." The Preamble further notes that "[e]ven if the proposal has substantial implications for the company, the cost of voting still may be higher than the potential benefit to the plan, especially if each fiduciary separately must collect and analyze the information necessary to reach an appropriate conclusion." The DOL specifically recognizes that "the cost may be lower if the fiduciary can rely on recommendations from the company's management on proposals where the interests of the plan and management are aligned."

A stated goal of the Proposed Proxy Regulation is to allow fiduciaries to "focus on where they can add value the most." The Proposed Proxy Regulation therefore indicates that a Plan fiduciary's responsibility is "only 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," and further provides that "fiduciaries must perform reasonable investigations, understanding that certain proposals may require a more detailed or particularized voting analysis."

Adoption of Prescriptive and Proscriptive Categories for Voting. The Proposed Proxy Regulation generally requires that a fiduciary "must" vote proxies only when a compelling economic value for the Plan is at stake. In addition, the Proposed Proxy Regulation stipulates that a fiduciary "must not" vote proxies where that is not the case.

Specifically, the Proposed Proxy Regulation says a fiduciary "must not" vote a proxy unless it determines that the matter being voted upon would have an economic impact on the Plan after considering only factors that the fiduciary prudently determines "would not 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 and taking into account the costs involved." The Preamble states that "these provisions are intended to reflect the fact that there will be circumstances when fiduciaries are required to vote a proxy and there will be circumstances when a fiduciary is required not to vote a proxy."

How Fiduciaries Decide Whether Something is a "Must" or a "Must Not." The Proposed Proxy Regulation states that when deciding whether or not to vote on a given matter, the Plan fiduciary must:

- act "prudently and solely in the interests of the participants and beneficiaries and for the exclusive purpose of providing benefits;"
- "act solely in accordance with the economic interest of the plan and its participants and beneficiaries considering 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;"
- "consider the likely impact on the investment performance of the plan based on such factors as the size of the plan's holdings in the issuer relative to the total investment assets of the plan, the plan's percentage ownership of the issuer, and the costs involved;"

- not "subordinate" the interest of the plan "to any non-pecuniary objective, or sacrifice investment return" and not take "additional investment risk to promote goals unrelated to those financial interests of the plan's participants and beneficiaries or the purposes of the plan;"[12]

- use proxy advisors only where they provide services in conformity with the Proposed Proxy Regulation;

- maintain records on proxy voting activities and other exercises of shareholder rights, including records that demonstrate the basis for particular proxy votes and exercises of shareholder rights; and

- 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.

Critically, however, the regulatory-impact analysis in the Preamble states:

> The expenditure of plan resources is generally warranted *only* when proposals have a meaningful bearing on share value or when plan fiduciaries have determined that the interests of the plan are unlikely to be aligned with the positions of a company's management. In general, such proposals include those that are substantially related to the company's business activities or that relate to corporate events (mergers and acquisitions transactions, dissolutions, conversions, or consolidations), corporate repurchases of shares (buy-backs), issuances of additional securities with dilutive effects on shareholders, and contested elections for directors, where plans' exposure to the stock is sufficiently large to justify the expenditure. [Emphasis added.]

Permissive Constraints. The DOL recognizes that the decision whether or not a given matter is one for which the fiduciary "must" vote or "must not" vote is "critical" and that "fiduciaries may need to conduct an analytical process which could in some cases be resource-intensive (requiring, among other things, organizing proxy materials, diligently analyzing portfolio companies and the matters to be voted on, determining how the votes should be cast, and submitting proxy votes to be counted)." Because "these activities may often burden fiduciaries out of proportion to any potential benefits to the plan," the Proposed Proxy Regulation offers "potential options" that are "intended to reduce the need for fiduciaries to consider proxy votes that are unlikely to have an economic impact on the plan, thereby allowing plans to focus resources on matters most likely to have an economic impact."

A fiduciary "may adopt proxy voting policies that encompass one or more of the permitted practices, and the fiduciary may then apply those proxy voting policies to proxy votes." In doing so, these optional "permitted practices" will help fiduciaries more cost-effectively comply with their obligations under the Proposed Proxy Regulation.

The Preamble notes, however, that such permissive abstentions would only apply to those matters which the fiduciary "prudently determined are unlikely to have a significant impact on the value of the plan's investment, subject to any conditions determined by the fiduciary as requiring additional analysis because the matter being voted upon concerns a matter that may present heightened management conflicts of interest or is likely to have a significant economic impact on the value of the plan's investment." Neither the Preamble nor the Proposed Proxy Regulation otherwise expressly addresses abstentions from voting. In this regard, it is noted that an increase in abstentions

12 The language here is similar to language used in the Proposed ESG Regulation.

could have wide-ranging consequences and have an impact on a variety of legal and other issues affecting corporate governance (e.g., quorum-related issues).

In particular, such limiting practices would effectively allow a Plan fiduciary to ordinarily "follow the recommendations of a corporation's management." The Preamble indicates that a permissive policy would allow a Plan fiduciary to "maintain a proxy voting policy that relies on the fiduciary duties that officers and directors owe to a corporation based on state corporate law." The DOL explains that "[c]orporate directors owe their own fiduciary duties to their corporation, and can be subjected to shareholder lawsuits for breach of those duties."[13] In addition to the reliance on corporate fiduciary duties, the Preamble adds that "empirical observations indicate that nearly all management proposals are approved with little opposition."

DISCUSSION

Non-Pecuniary (Including ESG) Matters. The emphasis on economic value and the proscription on subordinating the Plan's interest to any "unrelated goals" is consistent with the Proposed ESG Regulation. The DOL would likely regard both of these proposals as working in tandem. The impacts will likely be felt not only at the Plan sponsor fiduciary level, but also by investment managers and proxy advisory firms.

Selection of and Monitoring of Proxy Advisory Firms. The Proposed Proxy Regulation would not generally permit a fiduciary to adopt a practice of following the recommendations of a proxy advisory firm or other service provider without appropriate supervision and a determination that the service provider's proxy voting guidelines are consistent with the economic interests of the Plan. Specifically, the Proposed Proxy Regulation requires "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." And, while the Preamble makes clear that fiduciaries may "reasonably delegate their proxy voting authority to investment managers," it also states that ERISA "requires fiduciaries to monitor proxy voting decisions made by their investment managers" and that fiduciaries that use such firms are "responsible for ensuring that the proxy advisory firm's practices with respect its services to the ERISA plan are consistent with the prudence and loyalty obligations that govern the fiduciary's proxy voting actions."

The Preamble goes on to say that "it is the view of the Department that, consistent with the duty to monitor, fiduciaries should require documentation of the rationale for proxy-voting decisions so that fiduciaries can periodically monitor proxy-voting decisions made by third parties." The Preamble also expects that fiduciaries "shall require such investment manager, proxy voting firm, or other advisor to document the rationale for proxy voting decisions."

When it comes to selecting a proxy advisory firm, the Preamble states that "[f]iduciaries must be aware that conflicts of interest can arise at proxy advisory firms that could affect vote recommendations. For example, in certain instances a proxy advisory firm may issue proxy voting recommendations while the company that is the subject of such recommendations is a client of the firm's consulting business." The Preamble advises that "diligence should include assessing whether the proxy advisory firm is able to competently analyze proxy issues, identify and address potential conflicts of interest, and adhere to the plan's proxy voting policy guidelines." In addition, the DOL cautions fiduciaries

13 The Preamble cites to *Aronson v. Lewis,* 473 A.2d 805 (Del. 1984) (citing *Loft, Inc. v. Guth,* 2 A.2d 225 (Del. Ch. 1938), aff'd, 5 A.2d 503 (Del. 1939)) ("The existence and exercise of this power carries with it certain fundamental fiduciary obligations to the corporation and its shareholders.").

that "[p]articular attention must be given to proxy advisory firms that provide both proxy advisory services to investors and consulting services to issuers on matters subject to proxy resolutions." The Preamble cites to SEC authority applicable to investment managers that can be used to investigate such conflicts.[14] The regulatory-impact analysis also notes that there are effectively three proxy advisory firms and that services are "highly concentrated among the two leading proxy advisory firms, Institutional Shareholder Services, Inc. (ISS) and Glass, Lewis & Co., LLC (Glass Lewis). Clients of proxy advisory firms include investment advisers, banks, and insurers that may be voting ERISA plan shares."

A Plan fiduciary will be required to assure that any proxy advisor it selects itself is guided in its recommendations by the factors a Plan fiduciary would be required to consider. If the proxy advisor takes into consideration ESG and other factors that may not be relevant to the Plan's pecuniary interest, then the fiduciary may be unable to rely on the proxy advisor for that decision.

"Demonstrate the Basis for" and "Investigate Material Facts that Form the Basis of . . ." The Proposed Proxy Regulation requires that the Plan fiduciary "demonstrate the basis for particular proxy votes and exercises of shareholder rights." It also requires that fiduciaries "investigate material facts that form the basis for any particular proxy vote." It is uncertain whether the DOL envisions such demonstrations on a proxy-vote-by-proxy-vote basis or, in keeping with the broader goal of avoiding undue costs and misallocation of resources, on a wider or principled basis.

The Preamble suggests that "fiduciaries must be prepared to articulate the anticipated economic benefit of proxy-vote decisions in the event they decide to vote." The Preamble states that "fiduciaries should require documentation of the rationale for proxy-voting decisions so that fiduciaries can periodically monitor proxy-voting decisions made by third parties. . . . [W]here the authority to vote proxies or exercise shareholder rights has been delegated to an investment manager pursuant to ERISA section 403(a)(2) or a proxy voting firm or other person performs advisory services as to the voting of proxies, plan fiduciaries shall require such investment manager, proxy voting firm, or other advisor to document the rationale for proxy voting decisions or recommendations sufficient to demonstrate that the decision or recommendation was based on the expected economic benefit to the plan, and that the decision or recommendation was based solely on the interests of participants and beneficiaries in obtaining financial benefits under the plan." The DOL separately states that, "[w]hen an investment manager's rationale on a vote for recurring issues is to follow a uniform internal policy, the manager should document the reasons for any vote that goes against the policy, which would generally only require a brief explanation directly in the proxy-voting record."

Documentation on a decision-by-decision basis would no doubt be extraordinarily burdensome, if not have a chilling effect on many investment managers' ability to comply with their fiduciary duties.[15] The DOL itself recognizes that the "cost may be lower if the fiduciary can rely on an impartial, expert third-party adviser who specializes in such matters and provides similar services to many shareholders." In addition, to take such a case-by-case basis for investment managers would likely exacerbate the concerns the DOL expressed regarding Plan fiduciaries broadly: "in their efforts to decide whether or how to vote Plan shares—and where applicable, to vote them—and exercise other

14 The SEC has issued guidance on the elements an investment adviser should consider in retaining or continuing to retain a proxy advisory firm, including the process an investment adviser should take to review and assess a proxy advisory firm's policies and procedures for identifying and addressing conflicts of interest. See 2019 SEC Guidance 84 FR 47420, at 47425.

15 SEC guidance indicates that determinations should occur "before the votes are cast," and it may not always be practicable for a fiduciary to make a pre-vote determination of best interest with respect to every proposal on a cost-effective basis.

shareholder rights, [the Plan fiduciary] may impose costs on plans that exceed the consequent economic benefits to them."

It would appear, therefore, at least as a matter of the DOL's stated policy, that because "voting costs sometimes exceed[ ] attendant benefits," a more general or principled-based approach would be better tailored to achieve the DOL's stated policy goals. The Preamble's regulatory-impact analysis sets forth an estimate by the DOL that "responsible plan fiduciaries would take 30 minutes to conduct research and 10 minutes to document each vote." (The Proposed Proxy Regulation does not address how costs should be measured when an investment manager in the aggregate, but maybe not on an individual Plan-by-Plan basis, has enough Plan assets to make a difference on proxy voting for a particular issuer.)

The Proposed Proxy Regulation would require an "investment manager [to whom the responsibility of voting has been delegated] or proxy advisory firm to document the rationale for proxy voting decisions or recommendations sufficient to demonstrate that the decision or recommendation was based on the expected economic benefit to the plan." The precise manner in which this requirement would be satisfied in practice is unclear.

Impacts on Investment Managers, in General. When investment managers with respect to Plan assets are charged with voting proxies, they will be faced with the same challenges as Plan investment committees. The extent to which any existing allocation on the responsibility of proxy voting between Plan investment committees and investment managers may change is yet to be determined. As the Preamble indicates, "responsible fiduciaries might increase their demands for asset managers to implement separate policies customized for particular ERISA plans or for ERISA plans generally, such as policies that align with the proposed permitted practices." Acknowledging the fact that investment managers may have duties to both Plan and non-Plan clients, the Preamble also notes that such conflicts "may be mitigated in the case of investment managers subject to the SEC's jurisdiction by the fact that federal securities law requires investment advisers to make the determination in their client's best interest and not to place the investment adviser's own interests ahead of their client's."[16]

If the Proposed Proxy Regulation is finalized as proposed, many investment managers will likely need to consider when they "must" vote and when they "must not" vote when involving Plan assets. They will also need to think seriously about adopting policies that constrain their voting in situations which the DOL has indicated it may be more costly than beneficial.

The DOL states that the costs associated with many of the compliance burdens associated with the Proposed Proxy Regulation, and in particular the documentation requirements, "will reside with, and most of the required activities will be performed by, third-party asset managers, as is already common practice." The Preamble's regulatory-impact analysis notes that such firms "are often large and provide the relevant fiduciary services for a large number of plans" and that the DOL "believes that the availability of economies of scale limit the costs of this proposal." The Preamble states that Plans "must also assess and monitor an investment manager's use of any proxy advisory firm, including

16 The Preamble cites to Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 FR 33669, at 33673 (July 12, 2019) (discussing an adviser's obligation to make a reasonable inquiry into its client's financial situation, level of financial sophistication, investment experience and financial goals and have a reasonable belief that the advice it provides is in the best interest of the client based on the client's objectives) and the 2019 SEC Guidance, 82 FR 47420 (clarifying investment advisers' duties when voting shareholder proxies). The Preamble also cites to Rule 206(4)-6 under the Investment Advisers Act of 1940, and the general policies designed to treat accounts fairly and to vote proxies in the best interest of clients.

any review by the manager of the advisory firm's policies and procedures for identifying and addressing conflicts of interest."[17]

Proxies Voted by Investment Managers of Pooled Investment Funds. Where an investment manager provides discretionary management services to a pooled investment vehicle such as a bank collective trust or hedge fund constituting the assets of one or more Plans, it is possible that the investment manager may have conflicts in associating the proxy policies of investing Plans. The Proposed Proxy Regulation confirms that an investment manager is required to "reconcile, insofar as possible, the conflicting policies" and "reflect such policies in proportion to each plan's economic interest in the pooled investment vehicle." The Proposed Proxy Regulation will allow an investment manager of such a pooled fund to "require [investing plans] to accept the investment manager's investment policy, including any proxy voting policy, before they are allowed to invest." Investment managers may need to consider carefully how their proxy voting policies are thus disclosed, and investing Plans will be required to "assess whether the investment manager's investment policy statement and proxy voting policy are consistent with [ERISA and the Proposed Proxy Regulation] before making an investment."[18]

Plans May Proscribe Voting on Matters That Are not Significant. The Proposed Proxy Regulation allows a fiduciary to adopt a proxy voting policy that "focus[es] its resources only on particular types of proposals that the fiduciary has prudently determined are likely to have a significant impact on the value of the plan's investment, such as proposals relating to corporate events (mergers and acquisitions transactions, dissolutions, conversions, or consolidations), corporate repurchases of shares (buy-backs), issuances of additional securities with dilutive effects on shareholders, or contested/ elections for directors."[19] By the same token, those policies may also actively constrain participation in voting.

- **Per Se Proscriptions Based On Marginal Importance or Ability to Affect Outcome.** For example, a policy could outright limit a fiduciary's ability to participate in "voting recommendations of management of the issuer on proposals or particular types of proposals that the fiduciary has prudently determined are unlikely to have a significant impact on the value of the plan's investment, subject to any conditions determined by the fiduciary as requiring additional analysis because the matter being voted upon may present heightened management conflicts of interest or is likely to have a significant economic impact on the value of the plan's investment." These policies could make clear that no resources be spent on "uncontested elections of directors and ratification of independent auditors" and "nonbinding proposals, unless it is aware that such a proposal will somehow still have an economic impact on the value of the plan's investment." However, even though the Preamble suggests that such a policy could proscribe limitations on nonbinding proposals, it is caveated by the

17 The Preamble notes that the DOL "views the SEC's guidance as reasonable direction for the diligence that ERISA plan fiduciaries should perform when reviewing and assessing a proxy advisory firm."

18 The SEC's rules for the consideration of multiple accounts, including pooled investment vehicles with differing investment objectives and strategies will need to be considered in the case of registered investment advisers. Under SEC guidance, an investment adviser "should consider whether it should have different voting policies for some or all of these different funds, vehicles, or other clients, depending on the investment strategy and objectives of each. For example, a growth fund that targets companies with high growth prospects may have a different perspective on certain matters submitted to shareholders than an income or dividend fund that seeks to generate an income stream for shareholders in the form of dividends or interest payments." 2019 SEC Guidance, 84 Fed. Reg. 47420, at 47423.

19 The Preamble notes that "empirical observations indicate that nearly all management proposals are approved with little opposition" with the implied conclusion that voting in such cases is superfluous.

proviso that implies that a Plan fiduciary may have to vote "if it is aware that such a proposal will somehow still have an economic impact on the value of the plan's investment."

- **Plan's Quantitative Position.** The Preamble also permits "refraining from voting on proposals or particular types of proposals when the plan's holding of the issuer relative to the plan's total investment assets is below quantitative thresholds 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 unlikely to have a material impact on the investment performance of the plan's portfolio." The Preamble suggests that 5% is sufficiently low enough to be regarded as being unlikely to have such a material impact, although the DOL specifically asks for comment on the point.

- More fundamentally, the Preamble notes that fiduciaries "should look to financial practices and existing regulations regarding quantitative measures of materiality." In this way, "specific quantitative upper limit[s] for the threshold (i.e., a cap) . . . may help fiduciaries by reducing the circumstances when borderline cases might result in plans performing individual cost/benefit analyses to decide whether to vote proxy proposals, a likely inefficient use of plan resources."

- It is noted that, depending on the size of a given Plan, this particular proscription may have varying degrees of relevance. For investment managers, the Preamble indicates that a similar standard could be used where the fiduciary prudently determines that the Plan's holding of the issuer is sufficiently small that the matter being voted upon is unlikely to have a material impact on the investment performance the assets of the Plan. The Preamble also points out that "a fiduciary declining to submit any proxy votes for holdings below a prudently determined quantitative materiality threshold may modify the policy in advance to allow proxy voting if needed for the portfolio holding to achieve a quorum for its shareholders' meeting." (It is not immediately clear how any quantitative approach would be applied in the context of a pooled fund of multiple Plan investors.)[20]

- **Must Be Reviewed Every Two Years.** Those that adopt this permissive policy would be required to "review any proxy voting policies adopted . . . at least once every two years."

Selection of Proxy Experts. Regarding proxy advisory firms, the Plan fiduciary may not "adopt a practice of following the recommendations of a proxy advisory firm or other service provider without appropriate supervision and a determination that the service provider's proxy voting guidelines are consistent with the economic interests of the plan." The Plan fiduciary must 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, taking into consideration the factors discussed above.

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20 This quantitative materiality policy might be in tension with an RIA's fiduciary duties under the Investment Advisers Act. While the SEC has stated that there may be cases where it is in the client's best interest not to vote proxies, the SEC did not affirmatively endorse such a broad-based approach. See 2019 SEC Guidance 84 Fed. Reg. 47420, at 47423 ("[a] client and its investment adviser may agree that the investment adviser would not exercise voting authority in circumstances under which voting would impose costs on the client, such as opportunity costs for the client resulting from restricting the use of securities for lending in order to preserve the right to vote" and may agree that the adviser should not vote "where the cost of voting the proxy exceeds the expected benefit to the client" and in "[c]ircumstances under which casting a vote would not reasonably be expected to have a material effect on the value of the client's investment.").

Guidelines Available to Plan Participants. "To facilitate transparency, the Department also reminds fiduciaries that proxy voting guidelines must be made available to plan participants, either as a separate document or by including them in the plan's existing investment policy statement."

Retention of Voting Responsibility by Plan Named Fiduciary. The Preamble states that the Proposed Proxy Regulation does not change established practice that "the responsibility for exercising shareholder rights lies exclusively with the plan trustee, except to the extent that either (i) the trustee is subject to the directions of a named fiduciary . . . or (2) or the power to manage and vote proxies has been delegated by a named fiduciary to one or more investment managers[.]" The Proposed Proxy Regulation refers to the roles of a trustee to the extent subject to the directions of a named fiduciary or an investment manager delegated authority under Section 403(a)(2) of ERISA.[21]

The Proposed Proxy Regulation places emphasis on the balance between Plan costs and Plan benefits. However, where an employer retains for itself the responsibility to vote proxies and does not pass associated costs on to the Plan, the application of the Proposed Proxy Regulation raises interesting considerations. Where costs are borne by the employer, there is the question as to whether there could be an actionable fiduciary breach under the Proposed ESG Regulation for pursuing a non-pecuniary goal. By contrast, under the Proposed Proxy Regulation, a fiduciary might not be permitted to pursue a social goal by voting a proxy even if by hypothesis there would be no expenditure or other cost to or diminution in the value of the assets of the Plan.

COMMENT PERIOD

Comments on the Proposed Proxy Regulation are due on October 5, 2020 (i.e., 30 days following September 4, 2020, the date on which the Proposed Proxy Regulation was published in the Federal Register). The notice period is short, and the current 2020 election cycle may well have an impact on timing. Nevertheless, as with other recent initiatives by the DOL, we would expect substantial comments given the breadth and depth of the Proposed Proxy Regulation.

CONCLUSION

The Proposed Proxy Regulation is portrayed by the DOL as a needed attempt appropriately to prioritize decision-making by Plan fiduciaries on matters over which the Plan fiduciary may have an impact as contrasted with those which relate to non-pecuniary goals. In so doing, the Proposed Proxy Regulation follows in the footsteps of the Proposed ESG Regulation by serving to advance other important policy objectives of the DOL, but may give rise to a set of rules under which voting by Plan fiduciaries is in some ways effectively limited.

Ultimately, though, the scope of the new proposal is broad. Taken in its totality, the Proposed Proxy Rule, if adopted as proposed, may establish a regime under which a Plan fiduciary will not be permitted to vote in matters that are beyond certain high-level corporate decisions, unless the fiduciary can justify the costs to the Plan involved on the

21 Section 2550.404(e)(4)(i) of the Proposed Proxy Regulation provides:

> The responsibility for exercising shareholder rights lies exclusively with the plan trustee except to the extent that either (1) the trustee is subject to the directions of a named fiduciary pursuant to ERISA section 403(a)(1), or (2) or the power to manage, acquire, or dispose of the relevant assets has been delegated by a named fiduciary to one or more investment managers pursuant to ERISA section 403(a)(2).

matter under consideration and the fiduciary determines it would have an economic impact to the Plan. It would appear that ESG related matters would face substantial additional scrutiny.

The Proposed Proxy Regulation would likely have a significant impact on and engender significant challenges for the operation of Plan sponsors and investment committees, third-party investment managers and proxy-advisory firms. The Proposed Proxy Regulation deals in prescriptions and proscriptions. If the Proposed Proxy Regulation is finalized, affected parties will need to be informed about this potential universe of "off limits" items, on the one hand, and required items, on the other. The interplay between any final proxy regulation and more general ESG regulation from the DOL, as well as more recent SEC guidance on proxy voting, could present complex and important challenges.

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If you would like to discuss the Proposed Proxy Regulation, or any other aspect of ERISA's fiduciary rules, please contact any of the Dechert lawyers listed below or any Dechert lawyer with whom you regularly work.

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