THE WAGNER LAW GROUP

LAW ALERT
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DOL's Proxy Voting Regs Confirm Fiduciaries Need Not Vote on Every Proxy Proposal but Must Limit Voting Decisions to Economic Interests

By Kim Shaw Elliot

The Department of Labor ("DOL") issued final regulations on December 11, 2020 about fiduciary duties for proxy voting, in its attempt to clarify many prior misunderstandings. Key among the DOL's guidance in this final rule is its express statement that fiduciaries need not vote on every proxy proposal and its pronouncement that decisions to vote proxies must be limited to consideration about economic interests. Non-pecuniary, social interests play no part in the fiduciary decision-making process about proxy voting.

This new rule will likely be reviewed by the Biden administration but it generally becomes effective prior to the inauguration, on January 15, 2021. The DOL could choose to follow a non-enforcement policy for the regulation but any formal changes to the rule must be preceded by the normal notice and comment procedures. As with other DOL regulatory actions taken in the closing months of the Trump administration, we will monitor events to see if a non-enforcement policy is put in place.

Overview

Issuing the final rule as part of ERISA Section 404 regulations, the DOL confirmed that the fiduciary duty to manage plan assets that are shares of stock includes managing voting proxies and other shareholder rights. The authority lies squarely with the plan trustee, unless the trustee is a directed trustee regarding this subject or the authority has been delegated to a 3(38) investment manager. Plan documents, including the investment management agreement, may state that the responsible plan fiduciary has reserved to itself the right to vote proxies.

As with any other fiduciary responsibility under ERISA, deciding whether to vote proxies or exercise other shareholder rights must be determined prudently, solely in the interest of participants and beneficiaries, and for the exclusive purpose of providing benefits and defraying the reasonable expenses of administering the plan. It is the DOL's view that none of these fiduciary responsibilities, either individually or in the aggregate, require a fiduciary to vote every proxy or exercise every shareholder right.

Other shareholder rights may include the right to inspect an issuer's corporate record books and participating in corporate actions taken by the issuer, as well as decisions about actions that are separate from proxy voting, such as decisions about stock splits, tender offers, exchange offers on bond issues, and mergers and acquisitions. This does not include proxy votes for the shares of stock held by mutual funds although it does for the shares in the mutual funds themselves.

The DOL employs a "principles-based" approach in the final regulations, leaving the specifics to be evaluated on the facts and circumstances of each plan. This responds to several comments criticizing the proposed regulations as being too prescriptive in nature. Additionally, the DOL "also took note of the issues and concerns identified during the U.S. Securities and Exchange Commission's (SEC's) ongoing proxy reform initiative" and aligned with the SEC's recent Guidance Regarding Proxy Voting Responsibilities of Investment Advisers.

Six Standards for Fiduciary Decision-making:

In deciding whether and how to vote proxies or exercise other shareholder rights, the fiduciary must:

1. **Act solely in the economic interest of the plan and its participants and beneficiaries.** The DOL declined to specify how to assess an economic interest. It cautioned, however, against applying an overly expansive view of what is an economic interest, writing that "vague or speculative notions that proxy voting may promote a theoretical benefit to the global economy that might redound, outside the plan, to the benefit of plan participants would not be considered an economic interest under the final rule."

2. **Consider the costs involved.** Relevant costs are a function of the particular facts and circumstances of a plan. While not offering specific rules about costs, the DOL explained that 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 a proxy or exercise other shareholder rights.

   A fiduciary may consider direct costs to the plan, such as 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. If a plan can reduce the management or advisory fees it pays by reducing the number of proxies it votes on matters that have no economic consequence for the plan, that also is a relevant cost consideration.

3. **Not subordinate participants' and beneficiaries' interests in retirement income or financial benefits to any non-pecuniary objective, nor promote non-pecuniary benefits or goals.** Attempts to advance political or social objectives at the expense of investment returns are not permitted. Plan fiduciaries must consider only the best interest of plan participants and their beneficiaries, not any benefit to corporate management or "vague notions of societal good." The DOL noted that while environmental, social and governance ("ESG") factors may be important to private investors or to corporate boards, they have no place when exercising fiduciary duties regarding investments held by plans.

   "From a fiduciary perspective, the relevant question is not whether a factor under consideration is "ESG," but whether it is a pecuniary factor relevant to the exercise of a shareholder right or to an evaluation of the investment or investment course of action."

4. **Evaluate material facts that form the basis for any particular proxy vote or exercise of rights.** In a helpful modification of the proposed regulations, evaluating material facts does not require that fiduciaries conduct their own investigations of material facts. Known or available information should be considered.

5. **Maintain records.** Maintaining records and documenting fiduciary decisions are basic elements of prudence. Specific types of records were not listed in the rule but recordkeeping should be based on the particular circumstances. While a duty to record the basis for exercising any shareholder rights was not included in the final DOL regulations, this is likely required under Rule 204-2 of the Investment Advisers Act ("Advisers Act") as part of an adviser's obligation to record any recommendation made to a client.

6. **Exercise prudence and diligence in selecting and monitoring advisors and service providers who assist with proxy voting or exercising other shareholder rights.** These are basic fiduciary obligations when hiring any service provider. They apply equally to selecting and monitoring persons to advise or otherwise assist with exercising shareholder rights, providing research and analysis, recommendations about proxy votes, administrative services for proxies and recordkeeping and reporting services.

As is always the case, fiduciaries should assess the qualifications of the provider, the quality of services offered, and the reasonableness of fees charged in light of the services provided. The process also must avoid self-dealing, conflicts of interest or other improper influence. In considering any proxy recommendation, fiduciaries should assure that they are fully informed of potential conflicts of proxy advisory firms and the steps taken to address those conflicts. They should also review the proxy voting policies periodically. If a fiduciary determines that the recommendations and other activities of the provider are not being carried out in a manner consistent with those policies and/or guidelines, then the fiduciary will be expected to take appropriate action in response.

The DOL expressed particular concern about proxy voting advisers, a matter of concern to the SEC as well in its 2020 regulatory guidance applicable to proxy voting advisers. A plan fiduciary cannot blindly follow an adviser's recommendation regarding proxies without determining that its guidelines are consistent with the economic interests of the plan.

Proxy Voting Policy May Guide the Decision to Vote- or Not Vote- Proxies

A plan may adopt policies, following either of two approaches, to guide a fiduciary when considering the decision to vote a proxy. Either method must satisfy ERISA Section 404 and the six standards addressed above. The policy may require that the authority to vote be exercised pursuant to specific parameters prudently designed to serve the plan's economic interests. The two approaches, which the DOL regards as safe harbors, are:

1. The policy may limit voting to particular types of proposals substantially related to the issuer's business activities or that will have a material effect on the value of the investment. Voting is not required if it is determined that the result cannot influence the outcome in a way that will benefit the plan.
2. A policy may also restrain a fiduciary from voting on proposals when the plan's holding in a single issuer, compared to its total assets, is below a threshold amount determined to be sufficiently small that the vote is not expected to have a material effect on the investment performance of the plan's portfolio.
3. The proposed regulations included a safe harbor for voting with management on matters that are not economically significant to the plan. The DOL did not include it in the final regulations.

Any proxy voting policy must be periodically reviewed, although the period is not specified. (A requirement in the proposed regulations that the policy be reviewed at least once every two years was removed). No proxy voting policy may preclude a fiduciary from voting when he or she prudently concludes that the matter being voted on will have a material effect on the value of the investment or the investment performance of the plan's portfolio, after considering the costs. Conversely, a policy cannot restrain a fiduciary from not voting when the fiduciary concludes that the vote will not produce a material effect.

Investment Managers of Pooled Investment Vehicles Seek Consistency

Investment managers may advise pooled investment vehicles such as mutual funds and exchange traded funds which have investors that include plans with different proxy voting policies. In those cases, the manager may vote the proxies in proportion to each plan's economic interest in the investment. Alternatively, the investment manager may require that each plan that invests must accept the investment policy statement of the manager.

New Regs Do Not Apply to Participant-directed/"Pass-through" Voting

The new regulation does not apply to voting rights passed through to participants and beneficiaries in participant-directed plans and plans that have self-directed brokerage windows. In those cases, however, the plan fiduciary may not simply accept participant direction and be relieved of liability. ERISA Section 403(a)(1) states that the trustee may follow participant direction only if the direction is proper, in accordance with the plan terms and does not otherwise violate ERISA.

Effective Date

The new regulation is generally effective January 15, 2021, 30 days after its publication in the Federal Register on December 16, 2020. Fiduciaries who are not registered investment advisers are given a little extra time and have until January 31, 2022 to (i) evaluate material facts that form the basis for the exercise of shareholder rights and (ii) meet the requirement to maintain records.

All fiduciaries have until January 31, 2022 to comply with (i) the requirement to review service provider proxy voting guidelines; and (ii) the requirement applicable to investment managers of pooled investment funds. Plans have until April 30, 2022 to make any necessary changes regarding qualified default investment alternatives.

The final regulations supersede prior guidance issued in Interpretive Bulletin 2016-01 and Field Assistance Bulletin 2018-01, in connection with proxy voting.

A Few Thoughts

1. **Check advisory agreements for proxy voting authority.** The regulation makes it clear that responsibility for proxy voting lies with the trustee. Many plan governing documents grant the trustee authority to delegate that responsibility to others such as investment managers. Many investment advisory agreements, in turn, specify that the client/plan sponsor/trustee reserves to itself the right to vote proxies, thereby clarifying that the manager has not been delegated this task nor has assumed responsibility for it. We suggest that both plan sponsor fiduciaries and investment advisers review their advisory contracts so that each understands his or her role.
2. **Maintain records for recommendations.**As noted above, any registered investment adviser must record the basis for making any recommendation about voting proxies. This is a good practice for any fiduciary to follow.
3. **While the final regulation does not require an ERISA fiduciary to adopt a proxy voting policy, registered investment advisors who do exercise that authority must adopt and implement written policies and procedures.** See Rule 206(4)-6 of the Advisers Act.
4. **Should plan sponsors and investment advisers pass the right to vote all proxies to plan participants?** Administrative and technological innovations are expanding rapidly, especially with the growth of participant-level services, including managed accounts. These programs often include a "do it on your own" program. Perhaps it is time to consider adding participant-directed proxy voting to these programs, taking advantage of what relief may be available to the plan fiduciaries as well as save expense. In the absence of the regulation, individuals may consider non-economic factors.
5. **Watch for clarification about fiduciary responsibility for voting proxies for shares of mutual funds held by a plan.**This final regulation has a clear impact on proxy voting and shareholder rights concerning stock holdings of individual companies. It does not apply to voting proxies for stock held in mutual funds, EFTs and other investment companies, because the underlying assets of investment companies are not plan assets. What standards, then, apply to voting proxies for the shares of the mutual funds themselves? The DOL noted in the preamble that, "The safe harbors in the final rule are also sufficiently flexible to permit a fiduciary to adopt voting policies that would permit proxy voting for fund shares while refraining from voting other types of shares." It continued to explain that policies may consider the economic detriment to a plan's investment that may result from costs incurred because a shareholders' meeting was delayed because of the inability to gain a quorum

6. **Should fiduciaries adopt their own proxy voting policies?** Just as investment policy statements can guide decision-making for selecting and monitoring investments in a plan, a proxy voting policy may better define the plan sponsor/trustee's parameters for decision-making about proxy voting. With known guardrails, a fiduciary may operate within the safety of a compliance path, reduce the chance for errors outside of the rules, and thereby reduce the risk of breaching any fiduciary responsibilities.

The attorneys of The Wagner Law Group would be pleased to assist fiduciaries who wish to adopt a proxy voting policy or have questions about this release.

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