

DOL PROPOSES NEW RULE ON PROXY VOTING DUTIES – POTENTIAL IMPLICATIONS FOR INVESTMENT MANAGERS AND OTHER ERISA FIDUCIARIES

Date: 15 October 2020

Asset Management and Investment Funds Alert

By: Kristina M. Zanotti, Robert L. Sichel

On 4 September 2020, the U.S. Department of Labor (DOL) published a new proposed rule on “Fiduciary Duties Regarding Proxy Voting and Shareholder Rights” (the Proposal).¹ The Proposal would codify existing DOL guidance that the fiduciary duty to manage plan assets that are shares of stock includes the fiduciary duty to manage shareholder rights appurtenant to those assets, such as the right to vote proxies. However, the Proposal also offers some new, and at times ambiguous, guidance that could change how responsible fiduciaries approach matters such as proxy voting.

DOL has long expressed the position that voting proxies (along with the exercise of other shareholder rights) is a fiduciary duty subject to the prudence and exclusive benefit standards of the Employee Retirement Income Security Act (ERISA).² However, DOL determined its sub-regulatory guidance was insufficient and accordingly decided to issue the Proposal to address “significant changes in the way ERISA plans invest and in the investment world.”³ DOL, through the Proposal, also seeks to correct a “persistent misunderstanding” that ERISA fiduciaries are required to vote all proxies. Because this alleged misunderstanding has continued, despite sub-regulatory guidance that describes when fiduciaries have the obligation to refrain from voting,⁴ and because DOL is concerned about the increased cost to plans of research and voting all proxies given the greater amount and types of shareholder proposals in recent years, DOL is proposing formal regulatory amendments that expressly state when fiduciaries are prohibited from voting proxies.⁵

The comment period for the Proposal ended 5 October 2020. This shortened comment period continues a trend of shortened notice periods from DOL on recent proposals.⁶ DOL is now reviewing thousands of comment letters,⁷ many of which asked the DOL to withdraw the Proposal. A common theme of the comment letters is that the Proposal would make it more burdensome and costly for ERISA fiduciaries to determine whether or how to vote shares on behalf of the plans over which they have responsibility.⁸

PROPOSAL PROVISIONS

The Proposal would amend 29 C.F.R. § 2550.404a-1, the “investment duties” regulation. A large part of the Proposal appears relatively uncontroversial—that the fiduciary duty to manage plan assets that are shares of stock includes responsibility over voting proxies (and exercising other shareholder rights) appurtenant to those shares and that such a duty is subject to ERISA’s fiduciary standards of prudence and loyalty.

The Proposal would spell out the specific standards fiduciaries must meet when evaluating whether and how to exercise shareholder rights. Specifically, plan fiduciaries would be required to:

1. Act solely in accordance with the economic interest of the plan and its participants and beneficiaries, considering only factors that the fiduciary prudently determines 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;
2. Consider the likely impact on the investment performance of the plan based on factors such as the size of the plan's holdings in the issuer relative to both the total investment assets of the plan as well as to the proportion the plan owns of the issuer, as well as the costs involved;
3. Not subordinate the economic interests of the participants and beneficiaries to any nonpecuniary objective, or sacrifice investment return or take on additional investment risk to promote goals unrelated to those financial interests or the purposes of the plan;
4. Investigate material facts that form the basis for any particular proxy vote or other exercise of shareholder rights. In this connection, before adopting a policy of following recommendations of a proxy advisory firm or other service provider, the fiduciary would need to appropriately investigate and ensure proper supervision of that service provider to determine that the service provider's proxy voting guidelines are consistent with the economic interests of the plan and its participants and beneficiaries;
5. 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
6. Exercise prudence and diligence in the selection and monitoring of any persons 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.

Any investment manager that has been delegated proxy voting authority, or any proxy voting firm or other person performing advisory services in connection with voting proxies, would be subject to a requirement 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 was made solely in the financial interests of participants and beneficiaries.

The Proposal would require fiduciaries to decide whether and how to vote on any proxy, based on whether the matter being voted upon would have an economic impact on the plan after considering the above criteria, and taking into account the costs involved in the research, if necessary, to determine how to vote. More controversially, under the Proposal, fiduciaries would be prohibited from voting on any matter unless the fiduciary determines the matter being voted upon would have an economic impact on the plan.

In a seeming contradiction, the Proposal would both require fiduciaries to investigate material facts that form the basis for any particular proxy vote while also considering the cost of such research as a factor in whether or not to vote. As a possible way to reconcile that contradiction, the Proposal would allow plans to adopt proxy voting policies that establish, in advance, that fiduciaries will only vote proxies under specific parameters reasonably designed to serve the plan's economic interest. Oddly, one of the approved proxy voting policies included in the

Proposal is the policy of voting proxies in accordance with the 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 certain conditions. Such a policy may raise questions regarding where the line would be between an “insignificant” economic impact where the policy would require a fiduciary to vote with management versus “no” economic impact where the fiduciary would be prohibited from voting at all. A policy of voting with management may also raise questions regarding when the interests of management and a plan could diverge and how a fiduciary may be able to protect the plan's interests in such a scenario.

ESG

The Proposal appears to be squarely aimed at limiting the ability of fiduciaries to vote on proposals that deal with environmental, social, or governance (ESG) factors that are not clearly tied to an economic benefit for the issuer (and thus, its investors). In the preamble to the Proposal, DOL states its concern that:

some fiduciaries and proxy advisory firms . . . 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.⁹

Another recent, complementary DOL proposal addresses the issues involved in considering ESG factors when selecting plan investments¹⁰ (ESG Proposal). In the ESG Proposal, DOL acknowledges that at least some ESG factors may have economic impacts. For example, in the preamble to the ESG Proposal, DOL states that:

. . . a company's improper disposal of hazardous waste would likely implicate business risks and opportunities, litigation exposure, and regulatory obligations. These would be appropriate economic considerations that qualified investment professionals would treat as material under generally accepted investment theories. Dysfunctional corporate governance can likewise present pecuniary risk that a qualified investment professional would appropriately consider on a fact-specific basis.¹¹

Presumably, if a proxy vote addresses an ESG factor that will have an economic impact on a plan, the Proposal would require fiduciaries to vote such proxies. However, the Proposal does not provide additional guidance on when ESG factors may be considered when deciding whether and how a fiduciary will vote a proxy.

POTENTIAL IMPLICATIONS FOR INVESTMENT MANAGERS AND OTHER FIDUCIARIES

ERISA fiduciaries should consider the implications for their proxy voting practices if the Proposal is finalized in its current form.

When a named fiduciary of an ERISA plan, such as the plan sponsor, delegates the authority to manage plan assets to an investment manager—such as an investment manager of a collective trust, a separate account, or, in certain circumstances, a private fund¹²—no person other than the investment manager has the authority to vote proxies appurtenant to the plan's assets, except to the extent the named fiduciary reserves to itself or to another named fiduciary authorized by the plan document the right to direct the plan trustee regarding the voting of proxies.¹³ If the plan document or investment management or similar agreement does not expressly preclude an investment manager from voting proxies, the investment manager has the exclusive responsibility for proxy voting.¹⁴

While responsible fiduciaries often hire third-party proxy advisory firms to facilitate voting the plan's proxies or make recommendations as to how to vote, the responsible fiduciary is not relieved of its own fiduciary responsibilities by following directions of another person or by delegating such responsibility to another person. DOL cautioned in the preamble to the Proposal 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” and that fiduciaries “must be aware that conflicts of interest can arise at proxy advisory firms that could affect vote recommendations.” DOL also questioned whether proxy advisory firms' practices are “sufficiently transparent for investors to be able to determine whether their interests are being advanced.”

Recent SEC guidance on the role of proxy advisory firms in the proxy process outlines specific considerations and due diligence practices for investment advisers that engage proxy advisory firms for assistance in fulfilling their proxy voting responsibilities.¹⁵ According to the SEC, investment advisers should consider the capacity and competency of the proxy firm, including staffing, personnel, and technology.¹⁶ While the SEC Guidance is applicable to registered investment advisers under the Investment Advisers Act of 1940 and, therefore, does not apply to ERISA fiduciaries that are outside of the SEC's jurisdiction, such as plan investment committees, the DOL views the SEC Guidance as a “reasonable direction for the diligence” that ERISA fiduciaries perform when reviewing and assessing a proxy advisory firm.

NEXT STEPS

Responsible fiduciaries should review their proxy voting policies and procedures to ensure they are engaging in a prudent process in selecting and monitoring proxy advisory firms. Policies and procedures may need to be refined to ensure they include and consider (a) whether the proxy firm's voting guidelines are consistent with the economic interests of the plan,¹⁷ (b) whether the proxy firm adequately addresses any conflicts of interest, (c) whether the proxy firm documents the rationale for proxy voting decisions or recommendations sufficient to demonstrate that the decision or recommendation was based on the economic interests of the plan, and (d) whether the fiduciary has access to the proxy firm's rationale for proxy voting decisions and recommendations.

Responsible fiduciaries, including plan investment committees, should also consider whether their policies and procedures adequately consider cost. If a proposal has no or negligible implications for the value of a plan's investment, DOL believes it would be better for the plan to refrain from voting than to incur even small costs in making this determination. Further, even if a proposal has substantial implications for the company, the cost of voting may still be higher than the potential benefit to the plan. Fiduciaries may want to consider utilizing the approach outlined in the Proposal for not voting on matters the fiduciary believes will only have marginal impact, or marginal economic benefit, to the plan.

The authors have extensive experience advising ERISA fiduciaries and stand ready to help craft or review proxy voting policies and procedures that adhere to ERISA, SEC, and relevant regulatory and sub-regulatory guidance.

FOOTNOTES

¹ 85 Fed. Reg. 55,219 (Sept. 4, 2020).

² Letter to Helmuth Fandl, Chairman of the Retirement Board, Avon Products, Inc. 1988 WL 897696 (Feb. 23, 1988); Letter to Robert Monks, 1990 WL 1085069 (Jan. 23, 1990).

³ These changes include such things as the increase in the percentage of corporate stock held by plans, the broader diversification of ERISA plan assets, changes in proxy voting trends including the complexity of proxy voting policies, mixed evidence on the effectiveness of shareholder voting in enhancing the value of a plan's investment in a particular security, and recent actions taken by the Securities and Exchange Commission (SEC) related to the proxy voting process.

⁴ See Interpretive Bulletin 2008-02, 73 Fed. Reg. 61,731 (Oct. 17, 2008) (stating that a fiduciary's responsibility for managing proxies includes both deciding to vote or not to vote).

⁵ In 2019, President Trump issued an executive order directing DOL to review existing guidance on the fiduciary responsibility for proxy voting to determine whether any 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.”

⁶ DOL's recently proposed “fiduciary rule” exemption also had a 30-day comment period. 85 Fed. Reg. 40,834 (July 7, 2020). While still subject to potential congressional review, final regulations are likely to have greater permanence than existing sub-regulatory guidance in case of any change in administration after the upcoming elections.

⁷ According to regulations.gov, the Proposal received over 7,000 comments. As of this writing, only a few hundred have been made publicly available.

⁸ See, e.g., Comment Letter from SEC Commissioners Allison Herren Lee and Caroline Crenshaw, dated October 5, 2020.

⁹ 85 Fed. Reg. 55,219, 55,222.

¹⁰ Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 39,113 (June 30, 2020). For more information on the ESG Proposal, please see our client alerts, “ESG Investing for ERISA Plans Part 1: History and State of Play” and “ESG Investing for ERISA Plans Part 2: Implications for Plan Sponsors and Investment Managers.”

¹¹ 85 Fed. Reg. 39,113, 39,116 (June 30, 2020).

¹² ERISA and regulations issued by the DOL establish a “look-through rule” that describes the circumstances under which the assets of a plan subject to ERISA that invest in a private investment fund may include both the ERISA plan's interest in the fund and an undivided interest in each of the fund's underlying assets. DOL Regulation Section 2510.3-101(a)(2).

¹³ DOL Interpretive Bulletin 2016-1.

¹⁴ *Id.*

¹⁵ Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, 84 Fed. Reg. 47,420 (Sept. 10, 2019) (SEC Guidance).

¹⁶ The SEC Guidance also provides that “[A]n investment adviser should also consider whether a proxy advisory firm has adequately disclosed to the investment adviser its methodologies in formulating voting recommendations, such that the investment adviser can understand the factors underlying the proxy advisory firm’s voting recommendations. In addition, the investment adviser should consider the nature of any third-party information sources that the proxy advisory firm uses as a basis for its voting recommendations. The investment adviser also should consider what steps it should take to develop a reasonable understanding of when and how the proxy advisory firm would expect to engage with issuers and third parties.” SEC Guidance, 84 Fed. Reg. at 47,424.

¹⁷ For example, if a proxy firm takes ESG factors into consideration that may not be relevant to the plan’s pecuniary interest, the responsible fiduciary may not be entitled to rely on the firm for that decision.

KEY CONTACTS



KRISTINA M. ZANOTTI
PARTNER
WASHINGTON DC
+1.202.778.9171
KRISTINA.ZANOTTI@KLGATES.COM



ROBERT L. SICHEL
PARTNER
NEW YORK
+1.212.536.3913
ROB.SICHEL@KLGATES.COM

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