Voting on Principle – ERISA Proxy Regulation Finalized

Authored by
Andrew L. Oringer, Steven W. Rabitz
and Aryeh Zuber

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Overview

At the end of last week, on December 11, 2020, the Department of Labor (the "DOL") released a Final Rule, Fiduciary Duties Regarding Proxy Voting and Shareholder Rights (the "Final Rule")[1], which addresses the application of the prudence and exclusive purpose duties under the Employee Retirement Income Security Act of 1974 ("ERISA") to the exercise of shareholder rights, including proxy voting, the use of written proxy voting policies and guidelines and the selection and monitoring of proxy advisory firms. The Final Rule comes after the DOL's September 4, 2020 proposal (the "Proposed Rule"),[2] which we previously discussed in an OnPoint.[3]The Final Rule will become effective on January 15, 2021.

The Final Rule was released after the October 30, 2020 release of another final rule under ERISA, Financial Factors in Selecting Plan Investments (the "Pecuniary Rule")[4], which relates to the consideration of non-pecuniary factors by fiduciaries of ERISA accounts ("Plans") and requires Plan fiduciaries to select investments and investment courses of action based solely on financial considerations. We generally discussed economic, social and governance ("ESG") considerations in the ERISA context in a prior OnPoint[5], and we discussed the Pecuniary Rule in two prior OnPoints that were released in June and November.[6]

In response to the Proposed Rule, the DOL received approximately 300 written comments and an additional 6,700 submissions in response to petitions. According to the DOL, the Final Rule reflects "significant modifications to the [Proposed Rule] based on the public record and commenters' feedback."

Indeed, while some may have wondered why this initiative was needed at all, the DOL noted in the preamble to the Final Rule ("Preamble") that it did not believe that it was necessary to "establish specific evidence of fiduciary misunderstandings or injury to Plans or to Plan participants" in order to issue the Final Regulation.

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[1] 85 FR 81658 (available at https://www.govinfo.gov/content/pkg/FR-2020-12-16/pdf/2020-27465.pdf).

[2] 85 FR 55219 (available at: https://www.federalregister.gov/documents/2020/09/04/2020-19472/fiduciary-duties-regarding-proxy-voting-and-shareholder-rights).

[3] A DOL Proxy Vote Against ESG? – New ERISA Proposal May Limit Plans' Exercise of Shareholder Rights (September 14, 2020) (available at: https://www.dechert.com/knowledge/onpoint/2020/9/a-dol-proxy-vote-against-esg----new-erisa-proposal-may-limit-pla.html).

[4] 85 FR 72846 (available at: https://www.federalregister.gov/documents/2020/11/13/2020-24515/financial-factors-in-selecting-plan-investments).

[5] ERISA's Social Goals? ESG Considerations Under ERISA (May 15, 2020) (available at: https://www.dechert.com/knowledge/onpoint/2020/5/erisa-s-social-goals--esg-considerations-under-erisa.html).

[6] An ESGciting Development - Proposed Regulation on ESG Considerations Under ERISA (June 30, 2020) (available at https://www.dechert.com/knowledge/onpoint/2020/6/an-esgciting-development---proposed-regulation-on-esg-considerat.html) and An ESGplanation of ERISA's New Regulation on Social Investing (November 12, 2020) (available at: https://www.dechert.com/knowledge/onpoint/2020/11/an-esgplanation-of-erisa-s-new-regulation-on-social-investing.html).

The Final Rule will become effective on January 15, 2021. The Final Rule will thus be effective prior to the presidential inauguration that will take place on January 20, 2021 (and therefore presumably not subject to any freeze on as-yet not effective regulations that may be affected by an incoming administration). Of note, the Regulatory Impact Analysis to the Final Rule (the "Regulatory Impact Analysis") states that it is the DOL's belief that "many fiduciaries already are compliant with the Final Rule," because they are currently "meeting the requirements of the Department's sub-regulatory guidance and prudently conducting their business operations to satisfy their fiduciary obligations as required by ERISA."[7]

SUMMARY

According to the DOL, the Final Rule seeks to address a purported misconception that Plan fiduciaries are required always to vote proxies in order to fulfill their obligations under ERISA. The Final Rule clarifies that one's fiduciary duty under ERISA does not require the voting of every proxy, rather a fiduciary must simply act prudently and solely in the interest of Plan participants and beneficiaries when deciding whether to vote and when voting. And it includes a safe harbor provision, modified from the Proposed Rule, pursuant to which Plan fiduciaries may adopt proxy voting policies and parameters prudently designed to serve the Plan's economic interest that provide optional means for satisfying their fiduciary responsibilities with regard to the determination of whether to vote under ERISA.

Although the Final Rule continues to restate the central theme of the Proposed Rule—that, when deciding whether to vote and when voting, fiduciaries, must "carry out their duties prudently and solely in the interests of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and beneficiaries and defraying the reasonable expenses of administering the Plan"—it departs from the Proposed Rule's prescriptive approach in favor of a more principles-based one. The Final Rule focuses instead on whether a fiduciary has a prudent process in place for proxy voting and other exercises of shareholder rights.[8]

The Final Rule's approach includes a list of principles that fiduciaries must comply with when making decisions on exercising shareholder rights, including acting solely in accordance with the economic interest of the Plan and its participants and beneficiaries, considering costs, not subordinating the interests of the participants and beneficiaries in their retirement income or financial benefits under the Plan to any non-pecuniary objective, not promoting non-pecuniary benefits or goals unrelated to the financial interests of the Plan's participants and beneficiaries, and evaluating material facts that form the basis for the proxy vote.

[7] The Regulatory Impact Analysis further notes that the DOL understands that most of the relevant fiduciary duties and activities, including those contemplated under the Final Rule, will "reside with . . . [and be] performed by, third-party asset managers, as is already common practice." The Regulatory Impact Analysis also noted that such asset managers "are often large and provide the relevant fiduciary services for a large number of plans."

[8] Importantly, the Final Rule does not just apply to formal proxy votes but to the exercise of its shareholder rights to monitor or influence management. As the Preamble notes: "The Department believes that the exercise of shareholder rights to monitor or influence management, which may occur in lieu of, or in connection with, formal proxy proposals is just as much an issue of fiduciary management of the investment asset as proxy voting and accordingly should be covered by the final rule." However, it is noted that the Final Rule does not apply to a Plan fiduciary's review of the proxy-related practices of mutual funds in which a Plan may choose to invest: "the Department does not intend that Plan fiduciaries apply the standards of the rule in reviewing, analyzing, or making a judgment on the proxy voting practices of the mutual funds in which the Plan invests."

DISCUSSION

Purpose and Costs/Benefits of the Proxy Initiative

The Preamble explains that the Final Rule is intended, in part, to address "the misunderstanding that exists on the part of some stakeholders that ERISA fiduciaries are required to vote all proxies." The Final Rule, according to the Preamble, is intended to "direct fiduciaries to act in a manner consistent with the economic interests of Plans and Plan participants that does not subordinate their interests to any non-pecuniary objectives or promote goals unrelated to the financial interests of participants and beneficiaries."

The road to the Final Rule was not straightforward. There were strong reactions on both sides of the argument as to whether a rule should be finalized in its current form. Following the Proposed Rule, some commenters agreed with the rule, arguing that the benefits of the proxy voting are "dubious at best" and that the short-term costs are non-trivial and the long-term future benefits are highly speculative. Others took the opposing view, arguing that the research shows positive benefits from proxy voting, that the DOL's impact analysis was "fundamentally flawed," that the DOL's analysis overstated the current costs of proxy voting and understated the new costs that Plans would incur if the rule was finalized, and neglected to account for benefits to proxy voting that the proposal appeared to classify as "non-economic" in nature yet have been linked to better financial performance. Commenters also expressed concern that the rule would discourage voting and that less proxy voting by ERISA investors would increase the influence of non-ERISA investors.

After considering the comments that had been submitted in response to the Proposed Rule – and in particular with respect to the measurement of possible costs, benefits and transfers associated with the Proposed Rule – the DOL agreed generally with commenters that "there is uncertainty regarding the costs and benefits of proxy voting activities of ERISA plans, both currently and under the terms of the proposed regulation," and that the DOL "still lacks critical information that would allow it to [. . .] produce a more accurate measure of the cost of the final rule's requirements." Ultimately, however, the DOL determined that due to "significant revisions" that it had made to the Proposed Rule in response to comments on the proposal, the Final Rule's cost impact was "substantially less than the proposal" due to "significant revisions to the required actions of a Plan fiduciary that were made in the final rule in response to comments on the proposal." The DOL explained that it had determined to go forward with the Final Rule because it believed that:

The Final Rule would benefit ERISA covered plans, as it provides guidance regarding how ERISA's fiduciary duties apply to proxy voting and in particular when fiduciaries should refrain from voting. Plan fiduciaries will be able to conserve plan assets as they refrain from researching and voting on proposals that are unlikely to have a material effect on the investment performance of the Plan's portfolio, and thereby increase the return on plan assets.

It is noted that the Preamble to the Final Rule references the "ongoing proxy reform initiative" of the SEC[9] and states that the DOL relied on the SEC's rulemaking as a "vehicle" to coordinate many of the fiduciary concepts included in the Final Rule.

Skepticism concerning ESG and collateral considerations informed, at least in part, the Proposed Rule. Although the Final Rule doesn't address ESG as directly as did the Proposed Rule, the Preamble still cautions fiduciaries that the use of plan assets to further "policy-related or political issues, including ESG issues," would "violate the prudence and exclusive purpose requirements of ERISA" unless such activities are "undertaken solely in accordance with the economic interests of the Plan and its participants and beneficiaries." The Preamble takes issue with some

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[9] *See e.g., Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers*, 84 FR 47420 (Sept. 10, 2019) and *Exemptions from the Proxy Rules for Proxy Voting Advice*, 85 FR 55082 (Sept. 3, 2020).

commenters who suggested that the Proposed Rule was a "not-so-thinly-veiled, policy-based judgment against the value of ESG shareholder proposals." In response, the DOL noted that it "recognizes rather than ignores the economic literature" that may support the case for considering ESG factors, when done in accordance with "generally accepted investment theories." The DOL cautioned, however, that a fiduciary should not assume that "combining ESG factors into a single rating, index, or score creates an amalgamated factor that is itself pecuniary." The DOL explained that the Final Rule and the Pecuniary Rule sought to make clear that, "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."[10] In particular, the DOL cautioned that Plan fiduciaries should not generally "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, unless the responsible Plan fiduciary concludes that such activities (alone or together with other shareholders) are appropriate after applying the considerations set forth in the Final Rule."[11]

The Final Rule, Generally

The Final Rule amends the DOL's Investment Duties regulation[12] with respect to proxy voting and the exercise of shareholder rights.

The Final Rule requires Plan fiduciaries, when deciding whether to exercise shareholder rights and when exercising such rights, including the voting of proxies, to carry out their duties prudently and solely in the interests of the Plan participants and beneficiaries and for the exclusive purpose of providing benefits to participants and beneficiaries and defraying the reasonable expenses of administering the Plan.

The Final Rule includes a list of principles that fiduciaries must comply with when making decisions on exercising shareholder rights, including proxy voting, in order to meet their prudence and loyalty duties under ERISA, including the duty to act solely in accordance with the economic interest of the Plan and its participants and beneficiaries and not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under

[10] The full quote from the Preamble is as follows:

> A number of commenters asserted that the proposal was a not-so-thinly-veiled, policy-based judgment against the value of ESG shareholder proposals. They argued that this judgment is not the Department's to make; rather, it is the role of Plan fiduciaries to make such judgments, and ESG proposals are material to shareholder decision making and an important part of the due diligence of fiduciaries in constructing long-term, diversified portfolios. The Department disagrees with these commenters. This rulemaking project, similar to the recently published final rule on ERISA fiduciaries' consideration of financial factors in investment decisions, recognizes, rather than ignores, the economic literature and fiduciary investment experience that show a particular ''E,'' ''S,'' or ''G'' consideration may present issues of material business risk or opportunities to a specific company that its officers and directors need to manage as part of the company's business plan and that qualified investment professionals would treat as economic considerations under generally accepted investment theories. However, the Department recognizes that other ''E,'' ''S,'' or ''G'' factors may be nonpecuniary and a fiduciary should not assume that combining ESG factors into a single rating, index, or score creates an amalgamated factor that is itself pecuniary. Rather, this final rule and the financial factors rule sought to make clear that, 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.

[11] The DOL also noted that "it would not be appropriate for Plan fiduciaries, including appointed investment managers, to incur 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." It remains to see how this may be interpreted.

[12] 29 CFR 2550.404a-1.

the Plan to any non-pecuniary objective, or promote non-pecuniary benefits or goals unrelated to the financial interests of the Plan's participants and beneficiaries.

The Final Rule includes specific language to make clear that Plan fiduciaries do not have an obligation to vote all proxies. And finally, it also includes a safe harbor provision, pursuant to which Plan fiduciaries may adopt proxy voting policies and parameters prudently designed to serve the Plan's economic interest that provide optional means for satisfying their fiduciary responsibilities regarding determining whether to vote under ERISA.

Principles-Based Approach

The Proposed Rule had (i) stated that an ERISA fiduciary must vote on matters it determines would have an economic impact; and must not vote on matters it determines would not; (ii) reinforced the DOL's belief that the consideration of non-pecuniary factors, including ESG-related matters, can result in breaches of ERISA's fiduciary duties; (iii) approved permissive categories 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; (iv) required 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 (v) cast skepticism on the use of proxy-advisory services unless their recommendations conform to the standards of the Proposed Rule.

Rather than instituting a more prescriptive process, the Final Rule focuses instead on whether a fiduciary has a prudent process for proxy voting and other exercises of shareholder rights. Thus, the Final Rule removes a number of the prescriptive requirements from the core section of the Proposed Regulation, which listed the requirements of what a Plan fiduciary must do in order to fulfill its fiduciary obligations.

In particular, the Proposed Rule provided that a Plan fiduciary must vote any proxy where the fiduciary prudently determined that the matter being voted upon would have an economic impact on the Plan after considering certain factors enumerated in the rule and taking into account the costs involved, and that a Plan fiduciary must not vote any proxy unless the fiduciary prudently determined that the matter being voted upon would have an economic impact on the Plan after considering those factors and taking into account the costs involved.

Many commenters took issue with this prescriptive approach. The Preamble quotes one commenter who characterized the "must vote/must not vote" requirement as placing the fiduciary in a "high risk compliance dilemma" that could not be resolved without expending funds on analysis and documentation, without knowing in advance whether the expenditure was allowable. Others commenters raised concerns that the rule was unclear as to how to establish whether an economic basis would be strong enough to justify voting and that it could be difficult, if not impossible, to ascertain whether a matter would have a future economic impact. Still others raised practical issues with respect to an obligation to not vote. Some explained that failing to vote could have the effect of a "no" vote or a "yes" vote, depending on the circumstances. One commenter noted that "modern proxy voting processes do not allow a holder of securities subject to the proxy to vote on some but not all proposals," and other commenters raised the concern that such a prescriptive approach could have unintended impacts on quorums.

Commenters also raised questions about the time horizon over which costs and benefits were to be determined. As one commenter noted, "some votes, such as those supporting good corporate governance practices (e.g., election of outside directors) may not have an immediate measurable economic effect, but still be in the interest of plan investors." Another commenter noted that a short-term economic impact will be "easier to prove or disprove in terms of share price or other similarly rudimentary indicators," but questioned whether the Rule should in fact "encourage fiduciaries to think only in terms of short-term economic gains." The Preamble cautions against applying an overly expansive view as to what constitutes an economic interest for purposes of the Final Rule. "Vague or speculative

notions," for example, that a proxy vote "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 a valid economic interest for purposes of the Final Rule. (Emphasis added.)

Regarding the costs that a fiduciary would be required to consider in determining whether to vote a proxy, the DOL noted that the types of relevant costs would "depend on the particular facts and circumstances." The DOL included, as a relevant consideration, whether 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." The DOL further noted that opportunity costs in connection with proxy voting could "also be relevant." Such opportunity costs could include, for example, foregone earnings from recalling securities on loan, or where a plan would be prohibited from selling the underlying shares until after the shareholder meeting as a result of submitted the proxy vote.

These comments suggest a variety of concerns that the DOL appears to have taken to heart. To address them, the Final Rule said that it was removing the prescriptive requirements of the Proposed Rule. The Preamble explains that these changes were made to address concerns regarding potentially increased costs and liability exposure to fiduciaries, as well as the difficulty in some circumstances of determining whether a matter would have an economic impact and the possibility that a fiduciary might prudently determine that there are risks to Plan investments that could result from not voting even when the matter being voted upon itself would not have an economic impact. Thus, instead of mandating that fiduciaries "must not vote unless [. . .]," the Final Rule indicates more simply that Plan fiduciaries are not required to vote all proxies, leaving the judgment to Plan fiduciaries under the newly-adopted principles based approach.

The Final Rule requires that, when deciding whether to exercise shareholder rights and when exercising shareholder rights, a fiduciary must act solely in accordance with the economic interest of the Plan and its participants and beneficiaries. The Proposed Rule had added a further requirement that the fiduciary prudently determine whether the economic value of the Plan's investment will be affected based on a determination of risk and return over an appropriate investment horizon. This additional requirement is not included in the Final Rule due to concerns that the impact of proxy voting may not be readily quantifiable and to reduce potential compliance costs. Although it removed this language, the DOL in the Preamble specifically cautioned fiduciaries 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 [F]inal [R]ule."

The Proposed Rule provided that a fiduciary must not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the Plan to any non-pecuniary objective, or sacrifice investment return or take on additional investment risk to promote goals unrelated to these financial interests of the Plan's participants and beneficiaries or the purposes of the Plan. The Final Rule retains the requirement that a fiduciary must not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the Plan to any non-pecuniary objective. However, it replaces the latter portion of the provision by prohibiting the fiduciary from "promot[ing] non-pecuniary benefits or goals unrelated to these financial interests of the Plan's participants and beneficiaries." The DOL explained in the Preamble that it modified the Final Rule in order to avoid suggesting that a fiduciary may exercise proxy voting and other shareholder rights with the goal of advancing non-pecuniary goals unrelated to the financial interests of the Plan's participants and beneficiaries so long as it does not result in increased costs to the Plan or a decrease in value of the investment. This would appear to be consistent with the DOL's approach under the Pecuniary Rule.

Thresholds

The Proposed Rule highlighted certain factors, such as the size of the Plan's holdings in the issuer relative to the total investment assets of the Plan and the Plan's percentage ownership of the issuer, that Plans should consider when determining the likely impact of proxy voting on the investment performance of the Plan. The DOL removed this language in the Final Rule. While the Final Rule only requires a fiduciary to consider the impact of any costs involved, the Preamble specifically notes that where the Plan's overall aggregate exposure to a single issuer is known, the relative size of an investment within a Plan's overall portfolio and the Plan's percentage ownership of the issuer "may still be relevant considerations in appropriate cases in deciding whether to vote or exercise other shareholder rights."

Proxy Advisory Services

Proxy advisory services have become extremely influential in the market. Proxy advisors and investment managers have often been key in the voting of proxies with respect to ERISA accounts. The Proposed Rule would have required that, where the authority to vote proxies or exercise shareholder rights has been delegated to an investment manager, or a proxy voting firm or other person performs advisory services as to the voting of proxies, a responsible Plan fiduciary must require such investment manager 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, 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 revised the provision in the Final Rule to eliminate the requirement for documentation of the rationale for proxy voting decisions, and instead replaced it with a more general monitoring obligation. The DOL explained in the Preamble that it did not intend to create a higher standard for a fiduciary's monitoring of an investment manager's proxy voting activities than would ordinarily apply under ERISA with respect to the monitoring of any other fiduciary or fiduciary activity. Thus, the Final Rule provides that where the authority to vote proxies or exercise shareholder rights has been delegated to an investment manager, a proxy voting firm or other person who performs advisory services as to the voting of proxies, a responsible Plan fiduciary is required prudently to monitor the proxy voting activities of such investment manager or proxy advisory firm and determine whether such activities are consistent with the requirements of the Final Rule. Importantly, the DOL explained that it was not its "intention to suggest that plans must require investment managers to vote according to custom policies," but instead that the Final Rule "reflected a general concern that responsible fiduciaries might be accepting investment managers' proxy voting policies without sufficient review as to whether those policies comply with ERISA and, if so, whether the investment managers were complying with those policies."

Ultimately, as the Preamble notes, "[t]he provision is essentially a restatement of the general fiduciary obligations that apply to the selection and monitoring of plan service providers, articulated in the context of fiduciary and other service providers that advise or assist with exercises of shareholder rights." In this regard, the DOL noted that "fiduciaries will be expected to assess the qualifications of the provider, the quality of services offered, and the reasonableness of fees charged in light of the services provided" and that "[t]he process also must avoid self-dealing, conflicts of interest or other improper influence." In addition, they will need to monitor advisors so that "[i]f a fiduciary determines that the recommendations and other activities of such person 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."

Proxy Voting Policies; Safe Harbors

The Final Rule focuses on whether a fiduciary has a prudent process in place for proxy voting and other exercises of shareholder rights and includes a safe harbor provision. This change from the Proposed Rule allows Plan fiduciaries to adopt proxy voting policies and parameters they believe are consistent with the principles enshrined in the Final Rule. These, in turn, must be prudently designed to serve the Plan's economic interest and the policies must provide optional means for satisfying their fiduciary responsibilities regarding determining whether to vote under ERISA.

The Proposed Rule expressly acknowledged the appropriateness of ERISA fiduciaries' adoption of proxy voting policies to help them more cost effectively comply with their obligations under the Proposed Rule. The Proposed Rule provided for adoption of general proxy voting policies or procedures and provided three examples of policies that could be utilized by fiduciaries (referred to as "permitted practices"). These permitted practices included conditions intended to require a fiduciary to make prudence-based judgments about the policies.

The Final Rule retains, with modifications, the framework for adoption of proxy voting policies as set forth in the Proposed Rule. However, the Final Rule was modified to more clearly provide safe harbor relief. The safe harbors apply to a fiduciary's duties of loyalty and prudence with respect to decisions on whether to vote, but do not apply to decisions on how to vote. Thus, a fiduciary will not breach its fiduciary responsibilities under ERISA with respect to decisions on whether to vote, provided such policies are developed in accordance with a fiduciary's obligations under ERISA as set forth in the Final Rule. But, of course, the principles of fiduciary responsibility would still apply to the actual decision taken on the vote.

More specifically, the Final Rule provides that in deciding whether to vote a proxy, fiduciaries to Plans may adopt proxy voting policies under which voting authority would be exercised pursuant to specific parameters, where those parameters were prudently designed to serve the Plan's economic interest. The Final Rule further sets forth optional means for satisfying the fiduciary responsibilities under ERISA, provided such policies are developed in accordance with a fiduciary's prudence obligations under ERISA. According to the DOL, these safe harbors are intended to be "applied flexibly rather than in a binary 'all or none' manner and may be used either independently or in conjunction with each other." Helpfully, the Final Rule makes clear that the safe harbors are not intended to set forth an exclusive list of the policies that Plans could adopt that would satisfy their responsibilities under the fiduciary principles.

Safe harbors often are intended to "nudge" the market to conduct that takes advantage of the relative safety of the safe harbor. It remains to be seen how the market will respond to the Final Rule's ones. The first safe harbor describes a policy that voting resources will focus only on particular types of proposals that the fiduciary has prudently determined are substantially related to the issuer's business activities or are expected to have material effect on the value of the investment. The provision is substantively similar to the permitted practice described in the Proposed Rule. However, the Proposed Rule listed types of proposals that a fiduciary might prudently consider focusing voting resources on: proposals relating to corporate events (mergers and acquisitions transactions, dissolutions, conversions, or consolidations), corporate repurchases of shares (buybacks), issuances of additional securities with dilutive effects on shareholders, or contested elections for directors. In the Final Rule, the DOL removed the list of proposals, and explained in the preamble that the list of matters included in the Proposed Rule was not intended as an exhaustive list of particular matters that merit consideration by fiduciaries. Rather the listed issues were examples of matters that the DOL believes generally would be expected to have an economic impact on the value of the investment. Nonetheless, Plan fiduciaries will likely want to consider that list to the extent they hadn't done so already. In clarifying its position, the Final Rule looks approvingly on policies in which voting resources are focused only on particular types of proposals which the fiduciary has prudently determined are substantially related to the issuer's business activities or which are expected to have a material effect on the value of the investment.

Under this rubric, whether or not ESG or other similar considerations can be prudently determined to be substantially related to any given issuer's business activities will likely be case-by-case specific. It thus remains to be seen whether Plan fiduciaries will gravitate to the relative safety of this safe harbor instead of relying on the broader general principles associated with the Final Rule more generally.

The Final Rule also provides for a second safe harbor. The Proposed Rule had provided that a fiduciary could adopt a policy of 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 (or investment performance of assets under management in the case of an investment manager).[13]

The Final Rule's second safe harbor is very similar to the "permitted practice" provided in the Proposed Rule. However, rather than focusing on whether the outcome of the vote is unlikely to have a material impact on the Plan's portfolio, the Final Rule focuses on whether the "matter being voted upon" is expected to have a "material effect" on the Plan's portfolio.

In addition to the other "permitted practices," the Proposed Rule had further described as a "permitted practice" a policy of voting proxies in accordance with the voting recommendations of a corporation's management on proposals or types of proposals that the fiduciary prudently determined would be 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. The DOL did not adopt this permitted practice in the Final Rule's safe harbor provisions, based on concerns expressed by commenters, and on the Department's separate decision to remove the requirement not to vote in certain situations.

The Proposed Rule required Plan fiduciaries to review any proxy voting policies adopted pursuant to the "permitted practices" of the proposal at least once every two years. In the Final Rule, the DOL removed the specific two-year requirement and provided a general requirement for periodic review of policies. The DOL was persuaded that it is unnecessary to set an exact deadline and that doing so could create liability based on a technical temporal violation of the Rule. The DOL further noted that it understands that general industry practice is to review investment policy statements approximately every two years and expects that fiduciaries will review proxy voting policies with roughly the same frequency.

The Proposed Rule had provided that no policies adopted under the "permitted practices" would have precluded, or imposed liability for, submitting a proxy vote when the fiduciary prudently determines that the matter being voted upon would have an economic impact on the Plan after taking into account the costs involved, or for refraining from voting when the fiduciary prudently determines that the matter being voted upon would not have an economic impact on the Plan after taking into account the costs involved. The Final Rule adds similar language with respect to the safe harbors, thus shielding a fiduciary from liability to the extent that the fiduciary deviates from policies adopted pursuant

[13] There was significant comment to this proposal. One commenter worried that if the majority of a Plan's investments in portfolio companies fell within the parameters described in the permitted practice, this could leave the majority of the Plan's portfolio unvoted, which in the aggregate would expose the Plan investor to material risk even if the risks associated with each individual company was small. In addition, some commenters noted that non-voting by small Plan investors could result in concentrating proxy votes in the hands of other investors whose interests might not align with the long-term interests of ERISA Plans and that non-voting by Plans could result in companies with substantial portions of un-voted shares, and could also result in quorum requirements going unmet.

to the safe harbors based on the fiduciary's conclusion that a different approach in a particular case is in the economic interests of the Plan considering the specific facts and circumstances.

There may be reasons why some Plan fiduciaries would gravitate to the safety of one or both of these safe harbors. Nevertheless, some may conclude that they may be able to work within the broader principles-based approach of the Final Rule more generally.

Application of Final Rule to Pass-Through Voting to Participant-Directed Accounts

The Final Rule includes an express provision stating that the Final Rule does not apply to voting, tender, and similar rights with respect to such securities that are passed through pursuant to the terms of an individual account Plan to participants and beneficiaries with accounts holding such securities. Prior DOL guidance recognized that in certain circumstances a trustee may follow the instructions of participants in an eligible individual account Plan that expressly states that a trustee is subject to the direction of Plan participants with respect to certain decisions regarding the management of their account. In such a case, under ERISA, the trustee must follow the direction of participants if those directions are proper, made in accordance with Plan terms, and not contrary to ERISA. Plan trustees and other fiduciaries would continue to have to comply with ERISA's prudence and loyalty provisions with respect to the pass through of votes to Plan participants and beneficiaries.

Application of Final Rule to Pooled ERISA Accounts

The Proposed Rule described obligations of an investment manager of a pooled investment vehicle that holds assets of more than one Plan. It stated that an investment manager of a pooled investment vehicle that holds assets of more than one Plan may be subject to an investment policy statement that conflicts with the policy of another Plan. It also provided that compliance with ERISA's prohibited transaction rules requires the investment manager to reconcile, insofar as possible, the conflicting policies (assuming compliance with each policy would be consistent with those rules).

The Proposed Rule noted that in the case of proxy voting, to the extent permitted by applicable law, the investment manager must vote (or abstain from voting) the relevant proxies to reflect such policies in proportion to each plan's economic interest in the pooled investment vehicle. Under the Proposed Rule, such an investment manager may, however, develop an investment policy statement consistent with Title I of ERISA and the Investment Duties regulation, and require participating plans to accept the investment manager's investment policy, including any proxy voting policy, before they are allowed to invest. In such cases, a fiduciary must assess whether the investment manager's investment policy statement and proxy voting policy are consistent with Title I of ERISA and the Investment Duties regulation before deciding to retain the investment manager.

The DOL did not make any structural changes to the text of this prong of the rule in response to a number of comments that raised concerns about how it could be operationalized, particularly in the context of existing pooled

"plan asset" funds.[14] But it did try to clarify that, as in Interpretative Bulletin ("IB") 2016-01, "the manager may avoid conflicting policies by requiring investors to accept the investment manager's policies before they are allowed to invest." It also tried to bridge any perceived concerns arising out of any difference in language between the Final Rule and IB 2016-01 by citing back to other changes to the Final Rule's text that impose an obligation on investing Plans to assess a fund manager's policy. The extent to which this provision will, in fact, provide challenges for investment managers, and how the Final Rule's provisions may be operationalized by pooled fund managers remains to be seen.

Required Evaluation, Recordkeeping and Other Documentation

The Proposed Rule provided that a fiduciary must investigate material facts that form the basis for any particular proxy vote or other exercise of shareholder rights. The Proposed Rule further stated that the 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 and its participants and beneficiaries. In the Final Rule, this provision was modified by requiring a fiduciary to evaluate, rather than investigate, material facts. This change was intended to remove any implication that Plan fiduciaries would be expected to conduct their own investigation of material facts; instead, the provision is intended to ensure that in making informed proxy voting decisions, fiduciaries should consider information material to a matter that is known or that is available to and reasonably should be known by the fiduciary. In this regard, the DOL noted in the Preamble that if clients of proxy advisory firms become aware of additional information from an issuer which is the subject of a voting recommendation, an ERISA fiduciary should consider the relevance of such additional information if material.

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[14] Many investment managers were concerned that it would be highly burdensome (and practically unwieldy) to reconcile conflicting policies of investing Plans and engage in proportionate voting to reflect conflicting policies. For some funds, ''split voting'' is not permitted. More importantly, there was significant attention paid to the fact that this requirement seemed not to reflect current industry standard practice that investment in a plan asset vehicle is generally conditioned on acceptance of the investment objectives, guidelines, and policies that apply to the vehicle. Concern was also raised about plan-specific evaluations, particularly for existing pooled funds which operated in accordance with established industry practice. In the case of existing pooled funds that otherwise complied with ERISA but would now need to adopt a new set of proxy guidelines to accommodate the Final Rule, there was concern that enormous difficulties would be faced because the new policy "would need to be presented, explained, and accepted by each participating plan, including non-ERISA plans not subject to the rules." In this regard, although the Proposed Rule allowed for a manager to develop a uniform proxy voting policy which would be a condition of investment by Plans in the fund, concerns were raised about differences in language from the DOL's prior guidance in IB 2016-01, which had provided guidance on proxy voting in the pooled funds context.

Specifically, IB 2016–01 states: "An investment manager of a pooled investment vehicle that holds assets of more than one employee benefit plan may be subject to a proxy voting policy of one plan that conflicts with the proxy voting policy of another plan. Compliance with ERISA section 404(a)(1)(D) would require the investment manager to reconcile, insofar as possible, the conflicting policies (assuming compliance with each policy would be consistent with ERISA section 404(a)(1)(D)) and, if necessary and to the extent permitted by applicable law, vote the relevant proxies to reflect such policies in proportion to each plan's interest in the pooled investment vehicle. If, however, the investment manager determines that compliance with conflicting voting policies would violate ERISA section 404(a)(1)(D) in a particular instance, for example, by being imprudent or not solely in the interest of Plan participants, the investment manager would be required to ignore the voting policy that would violate ERISA section 404(a)(1)(D) in that instance. *Such an investment manager may, however, require participating investors to accept the investment manager's own investment policy statement, including any statement of proxy voting policy, before they are allowed to invest. As with investment policies originating from named fiduciaries, a policy initiated by an investment manager and adopted by the participating plans would be regarded as an instrument governing the participating plans, and the investment manager's compliance with such a policy would be governed by ERISA section 404(a)(1)(D)."* (Emphasis supplied.)

The Proposed Rule required a fiduciary to 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. With the Final Rule, the DOL determined that a less prescriptive approach to recordkeeping obligations was appropriate. The Final Rule retains the general recordkeeping requirement but removes the requirement to maintain documents that would be necessary to demonstrate the basis for a vote.

Contemporaneous Revocation of Authority

In connection with its release of the Final Rule, the DOL withdrew Interpretive Bulletin 2016-01 and indicated that the portion of Field Assistance Bulletin ("FAB") 2018-01 that addressed shareholder engagement activities is superseded by the Final Rule (and that therefore the FAB is no longer considered current guidance).

APPLICABILITY DATE

The Final Rule will be effective January 15, 2021. The Final Rule further makes note that the remainder of 25 C.F.R. § 2550.404a-1 (which had previously been revised in connection with the Pecuniary Rule), other than with respect to the Final Rule (and other than with respect to certain matters involving qualified default investment alternatives, which provide until April 30, 2022 for compliance), shall apply in its entirety to all investments made and investment courses of action taken after January 12, 2021.

Fiduciaries (that are not registered investment advisors) have until January 31, 2022, to comply with those provisions of the Final Rule regarding ERISA's prudence and loyalty requirements that require (i) the evaluation of material facts that form the basis for particular proxy votes and (ii) the maintenance of records on proxy voting. All fiduciaries have until January 31, 2022 to comply with the Final Rule with respect to the determination that the proxy advisory firm's guidelines are consistent with the fiduciary's obligations under ERISA. Fiduciaries whose ERISA Plan investments are held by investment managers of pooled investment vehicles have until January 31, 2022 to comply with the Final Rule's requirement that they assess whether the investment manager's investment policy statement and proxy voting policy are consistent with the Final Rule.

CONCLUSION

The DOL's belief that the consideration of non-pecuniary factors, including ESG-related matters, can result in breaches of ERISA's fiduciary duties came to be regarded as animating the Proposed Rule. While the Final Rule (and the Preamble to the Final Rule) are less focused on ESG than the Proposed Rule had been, the Final Rule still maintains the central theme of the Proposed Rule: ERISA fiduciaries are not required to vote all proxies and that they must be judicious in deciding when and how to exercise proxy voting rights in accordance with their general fiduciary duties.

Nevertheless, the Final Rule takes a different tack than that of the Proposed Rule. Instead of the highly prescriptive architecture of the Proposed Rule, the Final Rule adopts a principles-based approach. The safe harbor provisions that provide fiduciaries with optional means for satisfying their fiduciary responsibilities with respect to proxy voting under ERISA—which the Preamble specifically notes should be "applied flexibly rather than in a binary 'all or none' manner"—may be of some use to some fiduciaries. It remains to be seen whether and to what extent the Final Rule will encourage fiduciaries to avoid ESG—and avoid making decisions with respect to collateral matters—in favor of the safe harbors' relative safety.

This update was authored by:

Andrew L. Oringer
Partner
New York, NY
+1 212 698 3571
andrew.oringer@dechert.com

Steven W. Rabitz
Partner
New York, NY
+ 212 649 8785
steven.rabitz@dechert.com

Aryeh Zuber
Associate
New York, NY
+ 212 698 3522
aryeh.zuber@dechert.com

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