September 3, 2020

DOL Proposes Rules Clarifying When ERISA Fiduciaries Need to Vote Proxies

On August 31, 2020, the U.S. Department of Labor (the "DOL") proposed for public comment rules to clarify a misunderstanding that ERISA fiduciaries are required to vote *all* proxies, which it believes has caused plans to expend assets unnecessarily and without economic benefit to plan beneficiaries. The proposed rules provide that "fiduciaries must not vote in circumstances where plan assets would be expended on shareholder engagement … that [does] not have an economic impact on the plan…." The proposed rules are, in this regard, consistent with the SEC guidance issued last August clarifying that investment advisers are not always required to cast votes on behalf of their clients.

Under the proposed rules, in assessing whether or not to exercise the right to vote:

- A plan fiduciary must consider the likely impact of voting on the investment performance of the plan based on such factors as the relative size of the plan's holdings and the costs involved.

- The fiduciary may not subordinate financial interests of the participants and beneficiaries to any "non-pecuniary objective," or "sacrifice investment return or take on additional investment risk to promote goals unrelated to those financial interests of the plan's participants and beneficiaries or the purposes of the plan."

- The fiduciary must "investigate material facts" that form the basis of a proxy vote, and may not simply follow proxy advisory recommendations "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."

- The fiduciary must maintain records regarding proxy voting activities and exercise prudence and diligence in monitoring individuals who are selected to advise or assist in proxy voting.

The proposed rules also would require diligence in assessing whether a proxy advisory firm is competent to analyze proxy voting issues, and call for particular attention for proxy advisory firms that provide both proxy advisory services to investors and consulting services to issuers.

The DOL proposes three non-exclusive "permitted practices," upon which a fiduciary may rely in determining a voting policy: (1) vote in accordance with management's recommendation on proposals that the fiduciary has determined are unlikely to have a significant impact on the value of the plan's investment; (2) focus 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; and (3) refrain from voting on proposals or types of proposals where the plan investment is small.

Citing what it characterizes as "mixed evidence on whether shareholder engagement improves firm value," the DOL expresses concern that some plan fiduciaries have unwittingly sup-

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ported or pursued proxy proposals for environmental, social, or public policy agendas "that have no connection to increasing the value of investments" and may even increase plan expenses.

While the DOL's proposal, if adopted, may have the effect of reducing reliance by plan fiduciaries on one-size-fits-all approaches to corporate governance matters, such as rote application of proxy advisory firm recommendations, it should be considered in the context of the DOL's June 30th proposal to limit the ability of private-sector retirement plan fiduciaries to select investments based on ESG factors and to bar 401(k) plans from offering ESG funds as the default investment alternative. As we noted in our memo on the June 30th proposal, the DOL believes that "ESG investing raises heightened concerns under ERISA," in contrast to the broader investor community's recognition that ESG is about value and performance, and despite growing evidence that the investment returns of ESG funds can outperform those of non-ESG funds.

The DOL's proxy voting proposal is thus a two-edged sword, imposing greater responsibility on plan fiduciaries who may have relied too heavily on proxy advisors' guidance, but continuing the DOL's initiative to prevent plan fiduciaries from taking account of ESG factors. Thus, as to voting, the proposed action could reduce the incidence of investment advisors' use of "robo-voting" and over-reliance on proxy advisors' input, consistent with recent SEC proxy advisory reform discussed previously. The DOL shares the SEC's concern that proxy advisory firms may not give sufficiently rigorous or impartial advice as would be necessary for ERISA fiduciaries to discharge their duties.

On the second front, despite the DOL's objections to investment decisions taking account of ESG considerations, we do not believe that these rules, if enacted, would prevent plan fiduciaries from considering ESG factors in discharging their duties, or would be a blanket prohibition against voting on or in favor of ESG-related proposals. As we have previously discussed in detail, ESG considerations are fundamental to creating long-term value, which is critical for pension funds—the ultimate long-term investors. Exercising shareholder rights in the service of a company's long-term sustainability and profitability is not only a sound investment approach, it is critical to corporate success over the long term. Moreover, we believe that a policy of exercising the vote on ESG-related areas that the applicable fiduciary believes are likely to significantly affect long-term value would be consistent with the second of the DOL's permitted practices.

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It is unclear what effect the proposed rules would have on shareholder voting. Approximately 29,000 defined contribution plans and 5,500 defined benefit plans subject to ERISA hold stock having an aggregate value of approximately $2.1 trillion. If the proposed rules are adopted, ERISA fiduciaries will presumably continue to feel obligated to ensure that the shares under their control are present and counted for quorum purposes, but it is possible that they may abstain more often on certain votes.

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