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DOL Finalizes Rule on Fiduciary Duties Regarding Proxy Voting and Shareholder Rights

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December 15, 2020 TO: ICI Members
Pension Committee
Pension Operations Advisory Committee
Proxy Working Group
SEC Rules Committee SUBJECTS: Pension RE: DOL Finalizes Rule on Fiduciary Duties Regarding Proxy Voting and Shareholder Rights

On December 11, 2020, the Department of Labor (DOL) released its final rule under the Employee Retirement Income Security Act of 1974 (ERISA) to amend its "Investment Duties" regulation[1] to address the application of ERISA's fiduciary duties of prudence and loyalty to the exercise of shareholder rights, including proxy voting, proxy voting polices and guidelines, and the selection and monitoring of proxy advisory firms.[2]

DOL explains that the final rule is intended to protect the interests of participants and beneficiaries by:

- confirming that proxy voting decisions and other exercises of shareholder rights must be solely in the interest of, and for the exclusive purpose of, providing plan benefits to participants and beneficiaries considering the impact of any costs involved;
- ensuring that plan fiduciaries not subordinate the interests of participants and beneficiaries in their retirement income or financial benefits under the plan to any non-pecuniary objective, or promote non-pecuniary benefits or goals; and
- improving fiduciary practices relating to the selection and monitoring of proxy advisory firms.[3]

As described in more detail below, the final rule includes substantial improvements from DOL's proposed rule (the "Proposal"), for which ICI voiced strong opposition.[4] Many of the improvements respond to suggestions made in the ICI Comment Letter.

The final rule also confirms that its adoption removes Interpretive Bulletin (IB) 2016-01 from the Code of Federal Regulations "as it no longer represents the view of the Department."[5]

Overview of Final Rule

Like the Proposal, DOL's final rule amends DOL's existing regulation that describes a fiduciary's investment duties under ERISA.[6] The final rule lays out a list of obligations that fiduciaries must comply with when making decisions on exercising shareholder rights, including proxy voting, in order to meet their duties under ERISA. The stated obligations include that plan fiduciaries must:

- Act solely in accordance with the economic interest of the plan and its participants and beneficiaries;[7]
- Consider any costs involved;[8]
- 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 promote nonpecuniary benefits or goals unrelated to those financial interests of the plan's participants and beneficiaries;
- Evaluate material facts that form the basis for any particular proxy vote or other exercise of shareholder rights;[9]
- Maintain records on proxy voting activities and other 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.

A fiduciary may not adopt a practice of following the recommendations of a proxy advisory firm or other service provider without a determination that such firm or service provider's proxy voting guidelines are consistent with the fiduciary's obligations described above.

Key Changes from Proposal

The final rule adopts the Proposal with a number of significant and mostly helpful modifications in response to comments it received (See attachment below for a blackline showing specific changes). More specifically, the final rule includes the following changes:

Move to a More Principles-Based Approach

In adopting the final rule, DOL states that it is attempting to address concerns with the Proposal by moving to a more principles-based approach and eliminating some of the proposed provisions many commenters identified as likely to result in potentially significant increases in costs to plans and liability exposure for plan fiduciaries if adopted as part of a final rule. DOL also notes that it is not its intention in issuing the final rule "to judge the value of any specific proposal to be voted upon, for example, or to take a position on the merits of any particular topic. Rather, the Department intends only to address the standards according to which plan fiduciaries must make such judgments, a goal that the Department believes is more appropriately advanced in light of revisions made in the final rule."[10]

Significantly, the final rule does not contain two problematic paragraphs from the Proposal—paragraphs (e)(3)(i) and (ii). Paragraph (e)(3)(i) of the Proposal 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

those factors described in paragraph (e)(2)(ii) of the Proposal and taking into account the costs involved (including the cost of research, if necessary, to determine how to vote). Paragraph (e)(3)(ii) of the Proposal provided 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 described in paragraph (e)(2)(ii) of the Proposal and taking into account the costs involved. ICI and others had criticized these provisions of the Proposal as requiring a fiduciary to undertake a costly economic impact analysis in advance of each issue that is the subject of a proxy vote in order to even consider voting thus negating the benefits sought to be achieved from the rulemaking. ICI had also argued that the criteria enumerated in paragraph (e)(2)(ii) of the Proposal for determining the economic impact of a proxy vote were too narrow, which could result in potentially negative consequences to plans because paragraph (e)(3)(ii) of the Proposal could prohibit fiduciaries from engaging in activities that would mitigate risk.[11] Instead of the two problematic paragraphs, the final rule includes specific language that makes clear that plan fiduciaries do not have an obligation to vote all proxies.[12]

Removal of Documentation Requirement for Investment Managers and Proxy Voting or Advisory Firms

The Proposal included a mandate that plan fiduciaries must require that investment managers and proxy voting or advisory firms sufficiently document the rationale for proxy voting decisions or recommendations to demonstrate to the plan fiduciary that the decision or recommendation was based on the expected economic benefit to the plan. In its comment letter, ICI argued that while agreeing that plan fiduciaries retain a duty to monitor service providers, the level of oversight contemplated by the mandate runs counter to the practical reality that plan fiduciaries often outsource such duties and responsibilities because they lack the requisite expertise, as ERISA directs.[13]

DOL significantly simplified this provision in the final rule, requiring only that a responsible plan fiduciary shall prudently 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 regulation.[14] In its explanation of the change to a more general monitoring obligation, DOL confirmed 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.[15]

DOL also included commentary in response to commenters' concerns regarding the statement in the preamble to the Proposal that suggested that uniform proxy policies used by investment managers may sometimes jeopardize plan fiduciaries' satisfaction of their duties under ERISA. DOL noted that it was not its intention to suggest that plans must require investment managers to vote according to custom policies. Instead, this statement was meant to warn that fiduciaries should not accept such proxy voting policies without sufficient review as to whether the policies comply with ERISA.[16]

Conversion of Permitted Practices to Safe Harbors

The Proposal included a new provision that outlined certain "permitted practices" under which plan fiduciaries may adopt proxy voting policies and parameters reasonably designed to serve the plan's economic interest. As pointed out the ICI Comment Letter, use of the Proposal's permitted practices would not have relieved the plan fiduciary from the more prescriptive obligations of the Proposal and would not have eased compliance burdens, as

DOL intended.

In the final rule, DOL modified this provision to more clearly provide safe harbor relief. The rule now includes the following two[17] permitted policies as optional means for satisfying their fiduciary responsibilities regarding determining whether to vote (but not how to vote):

- A policy to limit voting resources to particular types of proposals that the fiduciary has prudently determined are substantially related to the issuer's business activities or are expected to have a material effect on the value of the investment.[18]
- A policy of refraining from voting on proposals or particular types of proposals when the plan's holding in a single issuer relative to the plan's total investment assets is below a quantitative threshold 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 not expected to have a material effect on the investment performance of the plan's portfolio (or investment performance of assets under management in the case of an investment manager).[19]

Plan fiduciaries must *periodically* review these proxy voting policies (rather than the Proposal's requirement to review permitted practices at least once every two years). DOL intends these safe harbors to be applied flexibly rather than in a binary "all or none" manner, and notes that they may be used either independently or in conjunction with each other. DOL also makes clear that adoption of one of these policies will not preclude a fiduciary from voting or refraining from voting a proxy, when the fiduciary has considered whether the matter being voted upon is expected to have a material effect on the value of the investment.[20] DOL explains that the safe harbor provisions are intended to operationalize the fiduciary principles described in the final rule in a cost-efficient manner and provide an alternative to retaining a proxy advisory firm to provide advice on each vote.[21]

Clarification Regarding Pass-Through Voting

The final rule includes a new provision confirming DOL's intention that the rule was not meant to apply to voting with respect to securities that are passed through pursuant to the terms of an individual account plan to participants and beneficiaries with accounts holding such securities.[22] DOL notes, however, that plan fiduciaries would have to comply with ERISA's prudence and loyalty provisions with respect to the pass through of votes to plan participants and beneficiaries, and that they can continue to rely on DOL's prior guidance with respect to such participant directed voting.[23]

Delay of Certain Compliance Dates

The final rule will be effective 30 days after publication in the Federal Register (publication is scheduled for December 16); however, the final rule includes delayed compliance dates to January 31, 2022, for certain recordkeeping and proxy voting policy requirements. The delayed compliance date applies to fiduciaries' (other than investment advisers) compliance with the requirements that plan fiduciaries must:

- Evaluate material facts that form the basis for any particular proxy vote or other exercise of shareholder rights, and
- Maintain records on proxy voting activities and other exercises of shareholder rights.

The delayed compliance date also applies to all fiduciaries' compliance with:

- The prohibition on fiduciaries' adoption of a practice of following the recommendations of a proxy advisory firm or other service provider without a determination that such firm or service provider's proxy voting guidelines are consistent with the fiduciary's obligations described in the rule; and
- The provisions that apply when an investment manager of a pooled investment vehicle that holds assets of more than one employee benefit plan are subject to an investment policy statement that conflicts with the policy of another plan.

As a reminder, the investment selection final rule becomes effective on January 12.

Application of Rule to Mutual Funds

DOL received a number of questions regarding how the rule would apply to mutual funds and includes a discussion of these issues in the preamble to the final rule.

Several commenters, including ICI, requested confirmation that the rule would not apply to a mutual fund's exercise of shareholder rights with respect to the stock it holds. DOL provides this confirmation, clarifying a comment from the Proposal that ERISA does not govern the management of the portfolio internal to an investment fund registered with the SEC, including such fund's exercise of its shareholder rights appurtenant to the portfolio of stocks it holds.[24]

ICI also requested clarification that DOL 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.[25] In the preamble, DOL noted that another commenter suggested that the final rule should require fiduciaries to investigate a mutual fund's objectives in shareholder voting and engagement with portfolio companies and determine that the objectives are consistent with ERISA's loyalty requirement prior to deciding to invest in the fund or considering it as an option for participants. DOL states that this issue is beyond the scope of this rulemaking and that fiduciary responsibilities with respect to investment decisions were addressed in DOL's recently adopted investment duties regulation.[26]

Finally, commenters requested clarification of whether the rule applies to plan fiduciaries in the exercise of shareholder rights with respect to mutual funds when the fund itself seeks a vote of its shareholders on fund matters. ICI's letter explained that SEC-registered funds often face more challenges than operating companies to achieve a quorum and obtain approval of their proxy matters. DOL explained that the changes made to the final rule (including the removal of the "vote/not vote" determination and the addition of the safe harbors) should significantly eliminate any provisions of the proposal that might impede achieving a quorum for shareholder meetings, including those held by funds. In addition, DOL reaffirms its belief that fiduciary proxy voting policies may consider the economic detriment to a plan's investment that might result from direct and indirect costs incurred related to delaying a shareholders' meeting.[27]

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Attachment

endnotes

[1] The Investment Duties regulation is at 29 CFR § 2550.404a-1.

[2] The final regulation is *available at* https://www.dol.gov/sites/dolgov/files/EBSA/temporary-postings/fiduciary-duties-regarding-proxy-voting-and-shareholder-rights-final-rule.pdf, DOL's fact sheet is *available at* https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/fiduciary-duties-regarding-proxy-voting-and-shareholder-rights-final-rule, and DOL's press release is *available at* https://www.dol.gov/newsroom/releases/ebsa/ebsa20201211-1.

[3] DOL press release dated December 11, 2020. DOL also indicates that it initiated the regulatory project to correct a misperception that fiduciaries must always and in every case vote proxies in order to fulfill their obligations under ERISA and to reflect significant changes in the way ERISA plans invest and changes in the investment world more broadly since DOL first issued guidance on these topics in 1988. *See* Preamble at pages 7-8. DOL also notes the recent activity by the SEC in this area as an impetus. Preamble at pages 8-10.

[4] For a summary of the proposed rule, *see* ICI Memorandum No. 32727, dated September 1, 2020, *available at* https://www.ici.org/my_ici/memorandum/memo32727. For a summary of our comment letter, *see* ICI Memorandum No. 32808, dated October 6, 2020, *available at* https://www.ici.org/my_ici/memorandum/memo32808 ("ICI Comment Letter").

[5] Preamble at page 1. For a description of IB 2016-01, *see* ICI Memorandum No. 30522, dated January 13, 2017, *available here* https://www.ici.org/my_ici/memorandum/memo30522.

[6] Note that this regulation is designed to fit within the regulatory framework put forward in DOL's final rule regarding retirement plan investment selection (including ESG investments). This regulation will be inserted into the subsection (e) that was marked as "reserved" in that final rule. *See* 85 Fed. Reg. 72846, at 39128 (November 13, 2020), *available at* https://www.govinfo.gov/content/pkg/FR-2020-11-13/pdf/2020-24515.pdf. *See* ICI Memorandum No. 32888, dated November 3, 2020, *available at* https://www.ici.org/my_ici/memorandum/memo32888.

[7] Note that DOL modified this provision to remove the proposed requirement to 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. However, DOL cautions fiduciaries from applying an overly expansive view as to what constitutes an economic interest for purposes of this provision. Preamble at page 34.

[8] DOL modified this provision to remove the proposed requirement to 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, and the plan's percentage ownership of the issuer. DOL confirms its belief, however, 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. DOL also includes a discussion of the types of costs a fiduciary should consider. Preamble at page 35-36.

[9] DOL modified this provision by requiring a fiduciary to evaluate, rather than investigate,

material facts, to eliminate any implication that plan fiduciaries would be expected to conduct their own investigation of material facts. An ERISA fiduciary would be expected to consider the relevance of any additional material information it becomes aware of. Preamble at pages 38-39.

[10] Preamble at page 11.

[11] *See* ICI Comment Letter at pages 11-14. Further, ICI's letter suggested that DOL could better achieve its goals through a principles-based approach that focuses on whether a fiduciary has a prudent process for proxy voting, including written proxy voting policies and procedures that are reasonably designed to ensure that the fiduciary votes securities in the best interest of the plan. See ICI Comment Letter at pages 14 and 19.

[12] § 2550.404a-1(e)(2)(ii).

[13] *See* pages 16-17 of ICI Comment Letter. The letter further noted that this heightened monitoring requirement seems even more unnecessary in the case of a delegation to an ERISA 3(38) investment manager.

[14] More specifically, the activities must be consistent with (1) the requirement to act 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; (2) the enumeration of fiduciary obligations; and (3) the section regarding permitted voting policies (*i.e.*, paragraphs (e)(2)(i) and (ii) and (e)(3) of this section, respectively).

[15] Preamble at page 47.

[16] Preamble at page 48-50.

[17] These two permitted policies are generally the same as two permitted practices that appeared in the Proposal. A third permitted practice from the Proposal was eliminated (A policy of voting proxies in accordance with the recommendations of management of the issuer on proposals or types of proposals the fiduciary has prudently determined are unlikely to have a significant impact on the value of the plan's investment).

[18] § 2550.404a-1(e)(3)(i).

[19] § 2550.404a-1(e)(3)(ii). In the Proposal, DOL asked for input on whether it should consider a specific quantitative upper limit for the threshold (i.e., a cap) for application of this practice. In the preamble to the final rule, DOL noted that it had not received sufficient information from comments to establish an upper limit in the final rule. Preamble at pages 57-58.

[20] § 2550.404a-1(e)(3)(iii).

[21] Preamble at page 63.

[22] § 2550.404a-1(e)(5).

[23] Preamble at page 69.

[24] Preamble at page 24.

[25] In the preamble to the Proposal, DOL had acknowledged that exercising shareholder rights with respect to securities for which the plan fiduciary is responsible is subject to ERISA and as such there is a question as to whether the standards in the Proposal would influence plan fiduciaries with respect to their exercise of shareholder rights associated with funds registered with the SEC, such as mutual funds. DOL invited comments on the effects of the Proposal on the exercise of shareholder rights for SEC-registered funds and selection of such funds as plan investments. 85 Fed. Reg. 55219, at 55234 (September 4, 2020).

[26] Preamble at pages 25-26.

[27] Preamble at page 26-28.
