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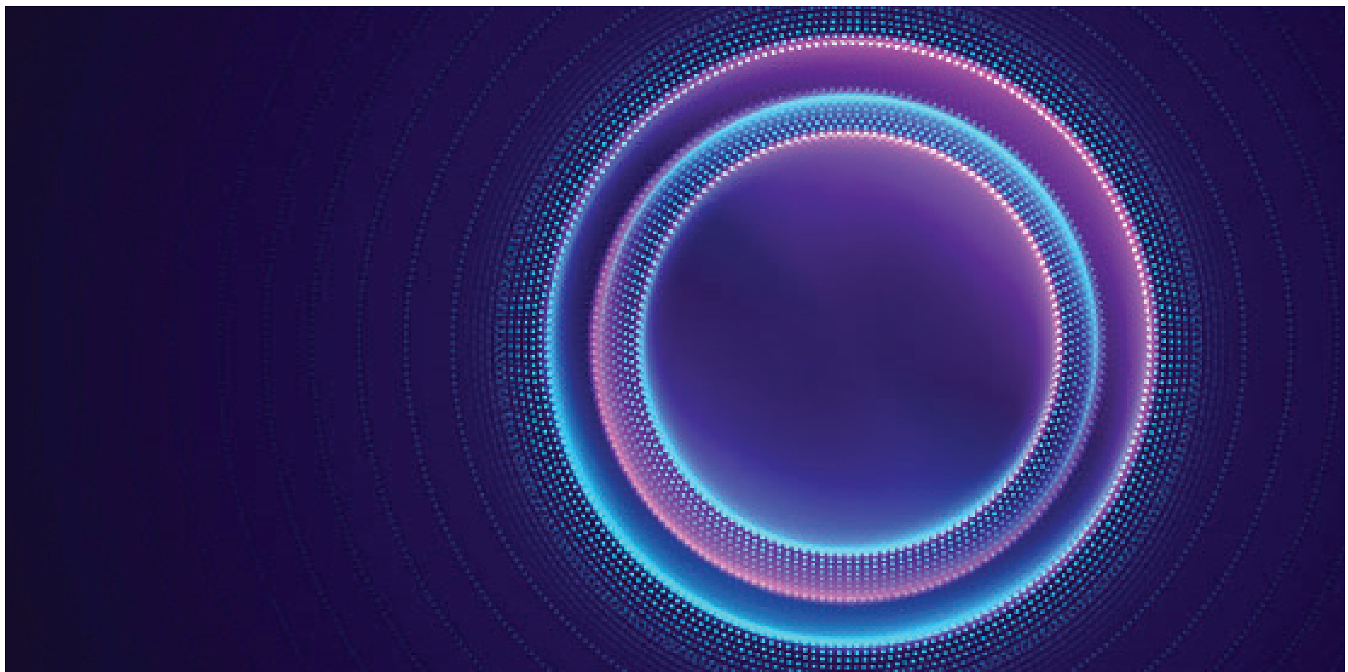
New DOL Rule Proposal Risks Chilling Proxy Voting and Shareholder Engagement



The U.S. Department of Labor (DOL) released its long-awaited proxy voting rule proposal on Aug. 31. If adopted without modification, fiduciaries of plans (e.g., investment managers) subject to the U.S. Employee Retirement Income Security Act of 1974, as amended (ERISA), may shy away from voting proxies and participating in shareholder engagement on matters that do not demonstrably improve the value of the plan's holding in the short-term. Thus, the exercise of shareholder rights on environmental, social and governance (ESG) issues, the benefits of which may be long-term in nature, may indeed be squeezed out of proxy voting policies of ERISA plan fiduciaries. Here are the key takeaways:

- The DOL's longstanding position is that the fiduciary act of managing plan assets includes decisions on the voting of proxies and other exercises of shareholder rights. Over the past few decades, the DOL has issued guidance on a fiduciary's responsibilities regarding proxy voting and shareholder engagement. The DOL's most recent guidance is Interpretive Bulletin (IB) 2016-01, as modified by

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Field Assistance Bulletin 2018-01. The guidance generally permitted fiduciaries to engage in these activities when the responsible fiduciary concluded that there is a reasonable expectation (by the plan alone or together with other shareholders) that such activity is likely to enhance the value of the plan's investment in the issuer, after taking into account the costs involved.

- The DOL has also long held that, while ERISA does not permit fiduciaries to subordinate the economic interests of participants and beneficiaries to unrelated objectives in voting proxies or in exercising other shareholder rights, a "reasonable expectation" that the plan is likely to enhance the value of the plan's investment may be demonstrated where, as is typically the case, the plan's investment is long-term in nature, or where a plan may not be able to easily divest of the particular holding. The DOL noted in IB 2016-01, for example, that the benefits of shareholder engagement may be difficult to quantify in the short-term but nevertheless can be realized in the long-term.

- As with its ESG guidance, the DOL's stance on proxy voting and other forms of shareholder rights have been a political football. Starting with the Clinton Administration in the mid-90s, each administration has taken slightly different approaches. Ultimately, the administrations have gone back and forth as to whether a weighing of the costs and benefits associated with proxy voting is necessary for each such vote or whether such an analysis is reserved for unusually expensive votes or engagements. In 2016, the DOL pointed out that proxy voting rarely entails a significant expenditure of plan assets, and because the value of the vote/engagement may be long-term in nature, there was rarely an issue where the costs outweighed the benefits. Moreover, because many plans' investments track indices, it is often necessary to engage issuer boards rather than to divest the plan's exposure in that company. And so, the DOL reasoned in IB 2016-01, the general rule was that proxy voting and shareholder engagement was permissible in most instances.

- The new proposal provides that the responsible plan fiduciary must vote a proxy where the fiduciary prudently determined that the matter being voted upon would have an economic impact on the plan after taking costs into account. Conversely, the plan fiduciary must not vote any proxy unless the fiduciary determines that the matter being voted upon would have an economic impact on the plan after taking costs into account. This begs the following questions:

    - **How much evidence must the fiduciary marshal to demonstrate that a particular vote would have an economic impact on the plan's investment?** While the proposal allows the fiduciary to determine the "appropriate investment horizon," it raises the prospect that long-term benefits, which may not be readily quantifiable today, could be afforded less weight.

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   - **Does the benefit of engagement by a group of shareholders count?** Prior DOL guidance recognized that benefits from the exercise of shareholder rights might arise from the plan by itself or in combination with other shareholders. Yet, the new proposal seems to ignore this prospect. The proposal instead focuses specifically on the plan's holdings in the issuer relative to the plan's portfolio (as well as the plan's percentage ownership of the issuer) for purposes of calculating whether the plan will stand to economically benefit from the shareholder activity. Because the plan by itself is likely to have a relatively small ownership stake in any particular issuer, and the plan is required under ERISA to be well diversified, this language in the proposal could tilt a fiduciary away from voting.

   - **What are the "costs"?** The DOL has long understood that plans have rarely incurred the cost of proxy voting and shareholder engagement. Yet the DOL, in the preamble to the proposal, suggests that the costs may not be fully understood. Moreover, the proposal suggests that the costs the issuer incurs as a result of the voting and engagement are effectively costs to the plan (the idea being, apparently, that any cost to the company's bottom line necessarily diminishes the value of the plan's investment). Finally, the DOL suggests that opportunity costs are a relevant consideration, though it is unclear how a fiduciary could actually quantify this.

- As noted above, successive administrations have largely fought over how often the ERISA fiduciary must undertake this cost-benefit analysis with respect to proxy voting and other shareholder rights. In 2008, the DOL envisioned the fiduciary undertaking the test rather routinely. Yet, the DOL changed its tune in 2016 to provide that the test would be a rare occurrence because, in most cases, the costs were negligible, and the benefits were assumed. Under the proposal, the DOL takes the position that the fiduciary must evaluate on a vote-by-vote basis whether the plan will receive some economic benefit as a result of the shareholder activity. The DOL, to its credit, recognized that a vote-by-vote analysis would be costly and onerous. Thus, the proposal introduces the concept of "permitted practices," which, while not safe harbors, are examples of voting policies the DOL thinks the fiduciaries can efficiently rely upon to satisfy their compliance requirements under the proposal. The following are specific examples of such voting policies, though the DOL solicited feedback on whether other examples should be provided in a final rulemaking. The DOL stressed that these "permitted practices" are intended to be flexible and that fiduciaries are free to deviate from them if it's prudent under the circumstances or otherwise tailor them to the plan (e.g., provide that the plan will vote in accordance with management's recommendation for uncontested elections of directors, but devote resources when voting on buy-backs, dilutive issuances of securities, etc.). Ultimately, the policies must be "reasonably designed" to serve the plan's economic interest.

   - **Example A:** A policy of voting proxies in accordance with the voting recommendations of management of the issuer on proposals that the fiduciary has prudently determined are 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 may present heightened management conflicts of interest or is likely to have a significant economic impact on the value of the plan's investment.

   - **Example B:** A policy that voting resources will focus only on particular types of proposals that the fiduciary has prudently determined are substantially related to the corporation's business

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activities or likely to have a significant impact on the value of the plan's investment (e.g., mergers, dissolutions, buy-backs, etc.).

  - **Example C:** A policy of refraining from voting on 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 outcome of the vote 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). The DOL floated 5 percent as a potential threshold but specifically requested comments on it. As before, the DOL indicated that such policies would not preclude a fiduciary from voting in any particular case in which a fiduciary subsequently determines that the vote would have an economic impact on the plan.

- The proposal requires that the fiduciary's proxy voting policies be reviewed at least once every two years. Moreover, the responsible fiduciary must maintain records on proxy voting activities and other shareholder rights, including records that demonstrate the basis for particular proxy votes and exercises of shareholder rights.

- The proposal requires that the fiduciary investigate the material facts that form the basis for any particular proxy voting/exercise of shareholder rights. The fiduciary may not adopt a practice of simply 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. A plan fiduciary using a proxy advisory firm is, therefore, responsible for understanding the conflicts of interest that could affect the proxy advisory firm's recommendations.

- The proposal preserves key aspects of prior DOL guidance related to proxy voting, specifically:

  - The fiduciary must be prudent in the selection and monitoring of persons selected to advise or otherwise assist with exercises of shareholder rights, such as research and analysis, recommendations regarding proxy votes, administrative services with voting proxies, and recordkeeping and reporting services. Here, the DOL explains that, as part of the duty to monitor, fiduciaries should require documentation of the rationale for proxy voting decisions so that fiduciaries can periodically monitor proxy voting decisions made by third parties.

  - A plan fiduciary must also assess and monitor an investment manager's use of any proxy advisory firms, including any reviews by the manager of the advisory firm's policies and procedures for identifying and addressing conflicts of interest.

  - Proxy voting decisions may be delegated to third-party investment managers.

  - Investment managers of pooled investment funds may require that, as a condition to subscription in the fund, plan investors adopt the manager's voting policy.

- The proposal has a 30-day comment period, meaning comments are due by early October.

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