

September 11, 2020

U.S. Department of Labor Releases Proposed Regulations Regarding Plan Fiduciary Proxy Voting

SUMMARY

On August 31, 2020, the U.S. Department of Labor released proposed regulations that clarify when fiduciaries under the Employee Retirement Income Security Act of 1974 are required to vote proxies. Under these proposed rules, a plan fiduciary must vote a proxy if the fiduciary prudently determines that the matter being voted upon would have an economic impact on the plan and must not vote a proxy if it determines that the matter being voted would not have an economic impact on the plan. Additionally, the rules provide that the exercise of voting rights must be performed solely for the plan's economic interest, and that this interest may not be subordinated to nonpecuniary goals.

SUMMARY OF PROPOSED REGULATIONS

On August 31, 2020, the U.S. Department of Labor (the "DOL") released proposed regulations ("Proposed Regulations") that clarify when fiduciaries under the Employee Retirement Income Security Act of 1974 ("ERISA") are required to vote proxies. Under these rules, a plan fiduciary must act in accordance with the fiduciary standards of ERISA when determining whether or not to exercise shareholder rights and when exercising those rights (including voting proxies). Moreover, the rules provide that a plan fiduciary must not vote any proxy unless the matter being voted upon would have an economic impact on the plan. Finally, the rules provide that the exercise of voting rights must be performed solely for the plan's economic interest, and that this interest may not be subordinated to nonpecuniary goals.

A. BACKGROUND

Under Section 404(a)(1)(A) and (B) of ERISA, a plan fiduciary must, in addition to other enumerated duties, "discharge his duties with respect to a plan...(A) for the exclusive purpose of: (i) providing benefits to

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participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan” (colloquially known as the exclusive-purpose or loyalty duty), as well as with the “care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims”. As the preamble to the Proposed Regulations notes, courts have interpreted the “exclusive purpose” duty to require fiduciaries to focus solely on the interests of participants and beneficiaries, with the Supreme Court emphasizing that such interests are “financial” rather than “nonpecuniary”.

The DOL believes that prior sub-regulatory guidance has been misunderstood by some to require plan fiduciaries to vote all proxies, leading to increased reliance by plan fiduciaries on proxy advisory firms. The DOL expressed its concern that this misunderstanding of prior guidance has led some plan fiduciaries and proxy advisory firms to unwittingly permit 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 plan investments and that may increase plan expenses. The Proposed Regulations clarify the requirement that fiduciaries manage voting rights prudently and for the exclusive purpose of securing economic benefits for the plan, which may or may not require a proxy vote to be cast (i.e., there is no presumption that abstaining from voting a proxy is a per se fiduciary breach).

The preamble to the Proposed Regulation expressed the DOL’s concern that plan voting costs may exceed the attendant economic benefits to the plan, citing the increase in recent years in the number of environmental and social shareholder proposals and noting that many of these proposals have little bearing on share value or other relation to plan interests. Beyond voting costs, the preamble also expressed concerns about costs incurred by plans to exercise shareholder rights “more vigorously” (e.g., by sponsoring or campaigning for shareholder proposals), even though those activities may deliver little or no economic benefit to the plan.

B. REQUIREMENTS UNDER THE PROPOSED REGULATIONS

Under the Proposed Regulations, a plan fiduciary must vote a proxy if—and only if—the fiduciary prudently determines the matter being voted upon would have an economic impact on the plan, taking into account the costs involved. Additionally, in determining whether to vote a proxy, the Proposed Regulations require that a plan fiduciary must:

- Act solely in accordance with the economic interest of the plan considering only factors that will affect the economic value of the plan’s investment based on a determination of risk and return over an appropriate investment horizon.
- Consider the likely impact on the investment performance of the plan based on factors such as the relative size of the issuer, the plan’s percentage ownership of the issuer, and the costs involved.
- Not subordinate the interests of plan participants and beneficiaries in their retirement income or financial benefits to any nonpecuniary objective, or sacrifice investment return or take on additional risk to promote goals unrelated to those financial interests.

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- Investigate material facts that form the basis for any particular proxy vote, rather than merely 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.
- Maintain records on proxy voting that demonstrate the basis for particular proxy votes.
- Exercise prudence and diligence in the selection and monitoring of any persons selected to advise or assist with proxy voting.

Where the authority to vote proxies or exercise shareholder rights has been delegated to an investment manager or a proxy voting firm performs advisory services with respect to the voting of proxies, the ERISA fiduciary must require the 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.

Acknowledging the potential burden associated with making the evaluations described above for each proxy vote, the Proposed Regulations allow plan fiduciaries to adopt policies (or "permitted practices") intended to reduce this burden. Such permitted practices may include, but are not limited to:

- A policy of voting proxies in accordance with the voting recommendations of management of the issuer on types of issues the fiduciary has prudently determined are unlikely to have a significant impact on the value of the plan's investment.
- A policy that voting resources will focus only on particular types of proposals that are substantially related to the corporation's business activities or likely to have a significant impact on the value of the plan's investment, such as proposals relating to corporate events (e.g., mergers and acquisitions), corporate repurchases of stock, issuances of securities with dilutive effect on shareholders or contested elections for directors.
- 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 prudently determined threshold.

Any such proxy voting policies must be reviewed at least once every two years and the development of these practices is subject to the fiduciary's duties of prudence and loyalty.

Unusually, and perhaps anticipating a challenge in the courts, the Proposed Regulations also include a so-called "blue pencil" clause, which states that if a court holds any provision of the rules invalid, such action will not affect any other provision of the rules. If finalized, the Proposed Regulations would apply 30 days after the publication of the final rule.

C. RELATED TRENDS

The Proposed Regulations stand in contrast to the recent focus on the import of environmental, social and public policy goals, but is generally consistent with another recent proposal from the DOL¹ that provided clarity on circumstances when a plan fiduciary may be prohibited from considering nonpecuniary interests

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in selecting investments, as well as with a similar interpretation from the Securities and Exchange Commission.²

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ENDNOTES

- ¹ See our memorandum to clients "[U.S. Department of Labor Announces Proposal Affecting Plan Fiduciaries and ESG Investments](#)", dated June 26, 2020.
- ² See our memorandum to clients "[The Rise of Standardized ESG Disclosure Frameworks in the United States](#)", dated June 8, 2020.

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