EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION

FINAL REGULATION ON PROXY VOTING AND EXERCISE OF OTHER SHAREHOLDER RIGHTS BY ERISA PLANS

The Department of Labor has released a final regulation regarding fiduciary responsibilities for the exercise of proxy voting rights and other shareholder rights associated with securities held by a benefit plan. The new regulation applies to individual plans and to pooled investment vehicles (such as collective trusts) that are considered to hold "plan assets" and hence are subject to regulation under the Employee Retirement Income Security Act of 1974 ("ERISA"). However, the regulation does not apply to proxy voting rights and other shareholder rights related to securities held by participant-directed defined contribution plans, if those rights are passed through to participants. It also does not apply to the exercise of voting and other rights by managers of investment vehicles that are not themselves subject to ERISA, such as mutual funds.

The final regulation takes effect 30 days from when it is published in the Federal Register, although some specific requirements have delayed effective dates.

In the wake of the strongly negative reaction to the proposed regulation issued earlier this year, the final rule eliminates a number of specific documentation requirements, generalizes language relating to fiduciary standards of conduct, and retreats somewhat from the fairly overt anti-voting stance in the proposal, although the Department continues to emphasize that plans need not necessarily vote every proxy and cautions fiduciaries against pursuing non-economic goals. Overall, the actual text of the final regulation is less controversial than the proposal. In short:

- Proxy votes should be prudently cast and other shareholder rights prudently exercised based on the plan's economic interest, which must not be subordinated to any other goals, and fiduciaries cannot "promote nonpecuniary benefits or goals unrelated to those financial interests of the plan's participants and beneficiaries." The preamble asserts that efforts to further other policy goals would violate ERISA's requirement for plans to be administered prudently and for the exclusive purpose of providing benefits unless undertaken "solely in accordance with the economic interests of the plan and its participants and beneficiaries," and warns fiduciaries against taking too expansive an interpretation of what constitutes an economic issue.
- Decisions about whether to vote should take into account a prudent cost-benefit analysis, although the Department has retreated from the proposed regulation's requirement that fiduciaries should undertake an analysis to cost-justify every decision to vote.
- Investment managers to whom proxy voting decisions have been delegated, proxy advisers whose recommendations are used by the plan, and other relevant vendors should be prudently selected and monitored.
- Appropriate records of proxy voting and the proxy voting oversight process should be kept.

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The above principles are generally consistent with long-standing Department of Labor subregulatory guidance and ERISA's general requirement that fiduciaries act prudently and in the best interests of plan participants and beneficiaries. However, the presence of official regulatory guidance will heighten the necessity for fiduciaries to have (and retain documentation of) a thoughtful, economics-oriented approach to proxies. In particular, the regulation calls for plan fiduciaries to do the following:

- Evaluate costs, the plan's economic interests, and material facts when making decisions about whether and how to exercise shareholder rights.
  - The final regulation allows but does not require fiduciaries to adopt "safe harbor" policies to assist in identifying situations in which a plan typically will not vote, pursuant to which a fiduciary may decide that a plan will limit voting activity "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" and/or that a plan typically will not vote on some or all proposals when the size of the plan's investment in the relevant security is below a prudently determined threshold.[1]
  - These safe harbor policies are *not* the only policies that a plan may adopt.
  - Voting policies may not prohibit voting in the described situations if the fiduciary determines a vote is likely to have an economic impact and is cost-justified, nor may the policies prohibit a decision not to vote if the fiduciary determines that voting is not expected to have a cost-justified material economic impact.
  - Policies must be reviewed periodically. The Department has dropped the requirement that the review take place at least every two years, but noted in the preamble that it believes a two-year timeline is typical in the industry and expects that reviews will occur approximately that often.
- Keep records of proxy voting activity and other shareholder rights decisions.
- If adopting a practice of following the recommendations of a proxy advisory firm or other service provider, make a determination that the vendor's proxy voting guidelines are consistent with the fiduciary's obligations.
- If investing in a pooled investment vehicle, either:
  - Coordinate with the collective investment trust manager to ensure that proxies attributable to the plan's share of the pooled vehicle's portfolio will be voted in a manner consistent with the plan's voting policies, or
  - Approve the use of the pooled vehicle's investment policy statement and associated voting policies, but only after determining that the policies are consistent with the fiduciary's duties under ERISA and the final proxy voting regulation. Fiduciaries taking this latter approach should review the

[1] The Department describes this latter safe harbor as allowing a fiduciary to have a no-voting policy for "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)."

plan's own policies to determine whether those documents accommodate deferring to pooled vehicles' policies, and make any revisions necessary.

In keeping with previous guidance, the regulation provides that a plan's trustee has the authority and responsibility to exercise proxy voting and other shareholder rights unless the trust agreement, investment management agreement or plan document reserves that power to a named fiduciary or an investment manager.

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