

Publications

DOL Finalizes ESG, Proxy Voting Regulation

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Retirement Services

The Department of Labor (the “DOL”) recently finalized a [regulation](#) amending the rules under the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), related to the selection of plan investments and the exercise of shareholder rights (the “Rule”). The Rule – entitled “Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights” – is largely consistent with historic DOL positions, but it endeavors to provide fiduciaries with more latitude when considering environmental, social, and governance (“ESG”) investment factors and voting proxies. In addition to the summary of the Rule below, this alert includes comparisons of the Rule against both the 2020 Trump Administration regulations ([here](#)) and the Biden Administration’s proposed regulation released in 2021 ([here](#)).

Plan fiduciaries may want to consider reviewing their investment and proxy voting policies in light of the regulatory changes. The Rule is scheduled to be published in the Federal Register on December 1, 2022, and it is generally effective 60 days after publication (*i.e.*, January 30, 2023). However, certain provisions related to the reliance on proxy voting advisory firms and pooled fund manager proxy voting requirements will become effective one year after publication (*i.e.*, December 1, 2023).

I. Background

ERISA requires that fiduciaries act prudently, solely in the interest of the plan participants and beneficiaries, and for the exclusive purpose of providing benefits and paying reasonable administrative expenses. Over the past 40 years, DOL has periodically issued guidance addressing the extent to which these duties under ERISA allow for various types of investment considerations. Although the emphasis of guidance has shifted depending on the policy priorities of the administration in power, DOL has been consistent in its position that a fiduciary cannot inappropriately sacrifice returns or take on additional risk when making investment decisions for

ERISA plans, and that the economic risks and returns of an investment must be the plan fiduciary's primary consideration.

In November 2020, DOL issued two regulations related to plan investments. The first (summarized [here](#)) amended DOL's long-standing "investment duties" regulation to, among other things, codify certain principles articulated in prior DOL guidance over the past several decades that emphasized "the primacy of plan participants' economic interests" in investment decision-making. The second regulation (summarized [here](#)) dealt with proxy voting and codified the principle that, when creating and implementing policies surrounding proxy votes, plan fiduciaries must consider any potential economic effects on the plan's investments of the issue being voted on.

On March 10, 2021, DOL announced that the agency was re-examining the 2020 regulations and that the 2020 rules would not be enforced. Seven months later, DOL published a proposed regulation (summarized [here](#)) to make material changes to both of these 2020 rules. At that time, DOL stated that the changes were intended to address stakeholder concerns that the 2020 rules created a "chilling effect" on the consideration of ESG factors and the exercise of shareholder rights.

II. Overview of the Rule

On November 22, 2022, DOL issued the Rule to finalize the regulatory changes proposed in October 2021. The Rule addresses both the financial factors fiduciaries may consider when making investments and the exercise of shareholder rights, including proxy voting. It is largely consistent with historic DOL positions, but there are material differences from the 2020 rules.

A. Investment Factors

The Rule amends DOL's long-standing "investment duties" regulation (29 CFR § 2550.404a-1) to, among other things, modify the changes made in 2020 by the Trump Administration as follows:

- **Consideration of ESG Factors.** The Rule states that fiduciaries may – but are not required to – consider ESG factors when analyzing projected returns on an investment, provided those factors are economically relevant to the investment. Notably, the 2020 Trump rule required that fiduciaries make investment decisions solely based on "pecuniary" factors. The Rule deletes this term from the regulatory text. Additionally, in a departure from the proposed rule, the Rule does not include examples of specific ESG factors that fiduciaries could consider, and DOL did not include the proposal's language that a prudent fiduciary process "may often require" the consideration of ESG factors. In explaining these changes, DOL stated that it did not want to create a mandate for the consideration of these ESG factors.
- **QDIAs No Longer Treated Differently.** The Rule applies the same fiduciary standards to the selection and monitoring of a Qualified Default Investment Alternative ("QDIA") as are applied to other designated investment alternatives, including permitting consideration of ESG factors. This approach removes the restrictions included in the 2020 rule that prohibited plans from designating as a QDIA a fund, product or model portfolio if its objectives or goals or its principal investment strategies include, consider, or indicate the use of one or more non-financial factors.
- **The Tie-Breaker Test.** The Rule reaffirms DOL's long-standing position that fiduciaries are permitted to consider non-economic, collateral benefits as a tie-breaker when choosing among otherwise prudent investments. The Rule does not require investments to be indistinguishable to permit consideration of collateral benefits. However, the plan fiduciary must first determine that competing alternative investments equally serve the financial interests of the plan. With respect to a self-directed plan, the Rule also states that a fiduciary does not breach their duty of loyalty by merely considering participants' preferences in the process of constructing a menu of prudent investment options, provided they do so in a manner that is consistent with their duty of prudence. DOL does not define what constitutes a collateral benefit but does state that collateral factors could include "stimulating union jobs and investing in the geographic region where participants live and work." Presumably, collateral benefits could also include factors related to climate change, governance, and workforce practices. Finally, the 2020 Trump regulation contained a heightened documentation requirement where fiduciaries relied on collateral factors when coming to an investment decision. The Rule discards this requirement "in favor of ERISA's generally applicable statutory duty to prudently document plan affairs."

B. Shareholder Rights & Proxy Voting

The Rule includes the following four major revisions related to the exercise of shareholder rights such as proxy voting:

- **Elimination of “No Vote” Statement.** The Rule reiterates DOL’s 2016 view that proxies should be voted as part of the process of managing a plan’s investments, unless a plan fiduciary determines that voting proxies may not be in the plan’s best interest (*e.g.*, when voting involves significant cost or effort). In this regard, the Rule eliminates the statement in the 2020 rule that “the fiduciary duty to manage shareholder rights appurtenant to shares of stock does not require the voting of every proxy or the exercise of every shareholder right.” As an explanation for this change, DOL states that in its view, this change was necessary to avoid the confusion of plan fiduciaries as to whether to vote shares of stock.
- **Elimination of Specific Monitoring Obligations.** The Rule eliminates the provisions of the 2020 Trump Administration rule that set out specific monitoring obligations with respect to third-parties authorized to vote proxies. Instead, DOL stated that it is more appropriate for a fiduciary’s monitoring obligations to be the same as their duties with respect to the selection and monitoring of other plan service providers.
- **Removal of Safe Harbors.** The Rule eliminates regulatory examples of permissible proxy voting policies, which previously created safe harbors for certain types of policies. DOL stated that it removed the safe harbors because of a concern they could lead fiduciaries to believe it is permissible to broadly abstain from proxy voting.
- **Elimination of Records of Proxy Voting Activities.** The Rule also eliminates a requirement that fiduciaries maintain certain types of records on proxy voting activities and other exercises of shareholder rights. In explaining this change, DOL stated that it does not want to treat proxy voting and other exercises of shareholder rights differently from other fiduciary activities.

III. Conclusion

The Rule represents an evolution in DOL’s guidance on ESG investing and on proxy voting. It is, in many ways, consistent with decades of DOL guidance. The Rule reaffirms that fiduciaries must, first and foremost, consider economic factors when making investment decisions, but it permits fiduciaries to consider collateral benefits as a tie-breaker. However, the Rule makes important changes to the 2020 rule by removing documentation requirements associated with tie-breakers and certain restrictions on QDIAs.

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