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BLOG

DOL Finalizes Latest Iteration of ESG & Proxy Guidance

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After repeated back-and-forth linked to changes in Presidential administrations, the Department of Labor attempts to establish a "principles-based approach" intended to provide "appropriate regulatory neutrality."

The United States Department of Labor (DOL) recently released final regulations (the Final Rule) that would allow retirement plan fiduciaries to consider environmental, social, and governance (ESG) factors when selecting plan investments and exercising shareholder rights, such as proxy voting. The DOL originally issued the proposed regulations in October 2021 in response to its concern that the 2020 final regulations created uncertainty for ERISA fiduciaries around considering climate change and other ESG factors when making investment decisions.

According to the DOL, the Final Rule is intended to clarify the application of ERISA's fiduciary duties of prudence and loyalty when: (1) selecting investments and investment courses of action, and (2) exercising shareholder rights, including the use of written proxy voting policies and guidelines when engaging in proxy voting. The Final Rule essentially restores the investment duty regulations for fiduciaries to its status prior to the adoption of the 2020 regulations, issued during the Trump administration. Importantly, the Final Rule reaffirms two longstanding principles for investment fiduciaries:

- A fiduciary may not: (a) subordinate the interest of the participants and beneficiaries in their retirement benefits under a plan to other objectives, or (b) sacrifice investment return or take on additional investment risk to promote benefits or goals unrelated to interests of the participants and beneficiaries in their retirement benefits.
- The fiduciary duty of managing plan assets that are stock includes the management of shareholder rights related to the shares, including the right to vote proxies.

Highlights of the Final Rule include:

- *Changing the regulatory text to clarify permissible consideration of ESG factors*. The regulatory text clarifies that, when considering projected returns, "a fiduciary's duty of prudence must be based on factors that the fiduciary reasonably determines are relevant to a risk and return analysis and that such factors may include the economic effects of climate change and other ESG considerations on the particular investment or investment course of action."

- *Changing the QDIA Provisions*. The Final Rule removes the special rules for Qualified Default Investment Alternatives (QDIAs) added in the 2020 regulations and replaces them with the same standards that apply to other investments. The DOL notes that a plan fiduciary must not "subordinate the interests of participants and beneficiaries…to objectives unrelated to the provision of benefits under the plan."
- *Changes to Clarify the Application of the Duty of Loyalty*. The Final Rule:
  - Modifies the 2020 rule's "tiebreaker" test, which "required that competing investments be economically indistinguishable before fiduciaries could turn to collateral factors to break a tie." The Final Rule replaces this with a standard requiring the fiduciary to "prudently conclude that competing investments, or competing investment courses of action, equally serve the financial interests of the plan over the appropriate time horizon," which would not prohibit the fiduciary from selecting the investment, or investment course of action, based on collateral benefits other than investment returns. The Final Rule also requires plans to prominently disclose to participants the collateral considerations that were used as tiebreakers.
  - Removes the special documentation requirement in the 2020 regulations and replaces it with ERISA's generally applicable statutory duty to prudently document plan affairs. The DOL noted that the requirement was removed in response to numerous comments and that the requirement created "unnecessary burdens" in tie-breaker situations. The DOL also clarified that the Final Rule "maintains the longstanding principle that the fiduciary may not accept reduced returns or greater risks to secure collateral benefits."
  - Adds a new provision "clarifying that fiduciaries do not violate their duty of loyalty solely because they take participants' non-financial preferences into account when constructing a menu of prudent investment options for participant-directed individual account plans." The DOL noted that this addition was in response to comments that accommodating participant preferences may result in greater participation and higher deferrals in retirement plans.
- *Provisions on Shareholder Rights including Proxy Voting.* The Final Rule:
  - Eliminates the statement in the current regulation 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." The DOL was concerned that this provision could be misread to suggest that plan fiduciaries should be indifferent to the exercise of their rights as shareholders.
  - Eliminates the paragraph of the current regulation that sets out specific monitoring obligations with respect to the use of investment managers or proxy-voting firms. The DOL was concerned that this provision could be read as requiring some special obligations above and beyond the statutory obligations of prudence and loyalty that generally apply to monitoring the work of a plan's service providers.
  - Removes the two "safe harbor" examples for proxy-voting policies in the current regulations. (The first safe harbor allowed a proxy-voting policy to limit voting resources to particular proposals that the fiduciary had "prudently determined" were "substantially related to the issuer's business activities" or were "expected to have a material effect on the value of the investment" and the second safe harbor permitted a proxy-voting policy to refrain from voting on proposals when "the plan's holding in a single issuer relative to the plan's total investment assets was below a quantitative threshold.") The DOL was concerned that the safe harbors did not adequately safeguard the interests of plans and their participants and beneficiaries as they encouraged fiduciaries to abstain from proxy voting.
  - Eliminates from the current regulation a specific requirement on maintaining records on proxy-voting activities and other exercises of shareholder rights. The DOL was concerned that the current regulations resulted in the perception that proxy voting and other exercises of shareholder rights are treated differently from other fiduciary activities, which could create a misperception that proxy voting and other exercises of shareholder rights may carry greater fiduciary obligations than other fiduciary activities.

The Final Rule will be effective 60 days after publication in the Federal Register (with a one-year delay for certain proxy-voting provisions to allow fiduciaries and investment managers additional time to review proxy-voting policies and guidelines to make necessary changes).

- ***Winston Takeaway.*** Although the Final Rule removes some perceived obstacles in considering ESG factors in plan investments, it still requires consideration of how ESG factors relate to the risk-return analysis of a particular investment. The Final Rule essentially returns ERISA fiduciary duties with respect to ESG matters and the voting of proxies to the core principles of the fiduciary duties of prudence and loyalty, a result that many have summarized as “fiduciaries may (but not must) consider ESG factors.”

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