

The DOL Finalizes Yet Another Rule on ESG and Proxy Voting

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On November 22, 2022, the Department of Labor (“*DOL*”) released its final rule (the “*Final Rule*”)¹ clarifying the application of ERISA’s fiduciary duties to the selection of investments and investment courses of action, including with respect to the consideration of environmental, social and governance (“*ESG*”) factors and the exercise of shareholder rights. The Final Rule, which is largely consistent with the DOL’s 2021 proposal, “clarifies that retirement plan fiduciaries can take into account the potential financial benefits of investing in companies committed to positive environmental, social and governance actions as they help plan participants make the most of their retirement benefits.”²

The Final Rule reaffirms a bedrock principle under ERISA’s duties of prudence and loyalty – when selecting investments and/or investment courses of action, plan fiduciaries must focus on the relevant risk-return factors and may not subordinate the interests of participants and beneficiaries to objectives unrelated to the provision of benefits under the plan (e.g., by reducing investment returns and/or increasing investment risks). Through the years, the DOL has issued quite a bit of guidance regarding the consideration of ESG factors and the exercise of shareholder rights. While the foregoing principle has remained constant, the DOL’s guidance has varied as to the degree to which ESG factors may be considered and the responsibilities of fiduciaries in connection with the exercise of shareholder rights.³

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¹ 87 Fed. Reg. 73866 (December 1, 2022).

² DOL news release: “US Department of Labor Announces Final Rule to Remove Barriers to Considering Environmental, Social, Governance Factors in Plan Investments” (November 22, 2022).

³ See Interpretive Bulletin, 94-1, 59 FR 32606 (June 23, 1994); Interpretive Bulletin, 94-2, 59 FR 38860 (July 29, 1994); Interpretive Bulletin 2008-01, 73 FR 61734 (October 17, 2008); Interpretive Bulletin 2008-02, 73 FR 61731 (October 17, 2008); Interpretive Bulletin 2015-01, 80 FR 65135 (October 26, 2015); Interpretive Bulletin 2016-01, 81 FR 95879 (December 29, 2016); Field Assistance Bulletin 2018-01, 85 FR 72846 (November 13, 2020); 85 FR 81658 (December 16, 2020) (the “*2020 Final Rule*”); and Executive Order (E.O.) 13990, “Protecting Public Health and the Environment and Restoring Science to Tackle the Climate Crisis” (January 20, 2021).
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ESG Factors. The DOL intends the Final Rule to “remove the chilling effect created by the prior administration on considering environmental, social and covenants factors in investments.”⁴ Accordingly, even though the DOL has reaffirmed that a plan fiduciary may not sacrifice investment returns or take on additional investment risks to promote benefits or goals unrelated to the interests of plan participants and beneficiaries, the Final Rule may make it easier for such fiduciaries to include investments that consider ESG factors, including with respect to the inclusion of ESG-investments as part of the investment line-up for participant directed (i.e. 401(k)) plans.

The Final Rule:

- acknowledges that, in connection with investment decisions, fiduciaries must reasonably determine which factors are relevant to a risk-return analysis and clearly states that such factors may, but need not, include ESG factors;
- streamlines the “tiebreaker” test (which allows fiduciaries to consider collateral benefits where the fiduciary has prudently concluded that competing investments equally serve financial interests over the appropriate time horizon) by eliminating the need for special documentation or disclosure in connection with investment decisions made thereunder, including with respect to designated investment alternatives offered under participant-directed plans;
- provides that decisions made with respect to “qualified default investment alternatives” are subject to the same standards (i.e., a focus on relevant risk-return factors) as other investments; and
- clarifies that fiduciaries may, without violating their duties of loyalty and prudence, take into consideration participants’ non-financial preferences when constructing a menu of

investment options for participant directed (i.e., 401(k)) plans.

Proxy Voting and Shareholder Rights. The Final Rule reemphasizes that a fiduciary’s duties extend to the management of shareholder rights, including with respect to proxy voting, when an ERISA plan holds shares of stock.

First, the Final Rule eliminates several components of the 2020 Final Rule, including:

- language stating that a fiduciary’s duties do not require the voting of every proxy or the exercise of every shareholder right “because this language may be misread as suggesting that plan fiduciaries should be indifferent to the exercise of their rights as shareholders, even if the cost is minimal;”
- two safe harbors that the DOL believed “encouraged abstention in the ordinary course;” and
- the requirement to retain special records relating to proxy voting activities.

Second, despite urging from commenters on the proposal, the Final Rule retains language requiring investment managers to, “[i]n the case of proxy voting, to the extent permitted by applicable law, ... vote (or abstain from voting) the relevant proxies to reflect such policies in proportion to each plan’s economic interest in the pooled investment vehicle.”⁵

Alternatively, investment managers may “develop an investment policy statement consistent with Title I of ERISA and the regulation, and require participating plans to accept the investment manager’s investment policy statement, including any proxy voting policy, before they are allowed to invest.”⁶ In connection with making an investment or selecting an investment manager, plan fiduciaries will need to “assess whether the investment manager’s investment policy statement and proxy voting policy are consistent with Title I of

⁴ DOL news release: “US Department of Labor Announces Final Rule to Remove Barriers to Considering Environmental, Social, Governance Factors in Plan Investments” (November 22, 2022).

⁵ See the preamble to the Final Rule and paragraph (d)(4)(i) and (ii) of the Final Rule.

⁶ See above.

ERISA and the regulation before deciding to retain the investment manager.”⁷

Third, the Final Rule confirms the ERISA fiduciary duty to prudently select and monitor proxy voting advisory firms (and any other related service providers). A fiduciary may not adopt a practice of rubber stamping decisions made by any such service providers and such fiduciary must independently determine that the proxy voting guidelines utilized by such service providers are consistent with the Final Rule and its fiduciary duties under ERISA.

Take Aways: In connection with investment decisions, ERISA fiduciaries may request information and/or confirmations from investment managers (including with respect to funds/accounts that do not operate subject to ERISA) regarding the role of ESG factors in the relevant investment objectives. ERISA fiduciaries will be seeking these confirmations to memorialize that they engaged in a prudent diligence process in compliance with the Final Rule, especially where a particular investment’s objective includes ESG-factors.

In addition, governmental pension plans, while not subject to ERISA, are subject to similar laws that incorporate ERISA’s duties of prudence and loyalty as well as certain other ERISA-like standards and rules. Certain states have codified laws or adopted policies that require fiduciaries of such plans to *only* consider pecuniary and risk-return factors; these laws or proposals may take the position that the consideration of ESG-factors run in opposition to the applicable fiduciary duties. Certain other governmental plans may require investment managers to contractually agree to be bound by ERISA’s prudent person standard of care. In such circumstances, an investment manager would need to comply with the Final Rule. In each case, investment managers will need to navigate the divergences and similarities applicable to governmental plans with the principles of ERISA and the Final Rule, especially in connection with private funds where both governmental plans and ERISA-governed plans invest.

Lastly, investment managers should require fiduciaries of investing ERISA plans to adopt their proxy voting policies (and investment guidelines). In most cases, reconciling various policies would be difficult and can be avoided by an investment manager requiring adoption of its policies. Investment managers with existing arrangements involving ERISA plans should confirm whether ERISA plans were required to adopt proxy voting policies at the time of investment and, if not, what further action should be taken to confirm adoption of such policies.

Effective Date: The Final Rule generally becomes effective 60 days after publication in the Federal Register with certain sections relating to proxy voting and shareholder rights becoming effective one year after publication.

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⁷ See above.