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Client Alert | Investment Management

Department of Labor Warms to ESG; Fires up on Proxy Voting

On Nov. 22, 2022, the US Department of Labor (DOL) released its Final ESG and Proxy Voting Rules, "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights." The Final ESG and Proxy Voting Rules address the consideration by employee benefit plan fiduciaries (fiduciaries) of environmental, social and governance (ESG) factors in investing plan assets and exercising their rights as shareholders.

In its release of the Final ESG and Proxy Voting Rules, the DOL noted its long history of vacillating on the extent to which fiduciaries could consider ESG factors but highlighted that it has always been clear that fiduciaries must make investment decisions in accordance with fiduciary duties of loyalty and prudence under ERISA.

The final rules come over a year and a half after the DOL issued a non-enforcement policy of the 2020 ESG and proxy voting regulations (2020 Regulation) and over a year after the DOL proposed regulations.

The majority of the final rules will become effective 60 days after publication in the Federal Register. As noted below, certain provisions of the proxy voting-specific rules become effective one year after publication in the Federal Register. The DOL clarified that until then, the 2021 non-enforcement policy remains in effect.

Final ESG Rule

In short, the Final ESG Rule makes clear that a fiduciary's consideration of ESG factors can be consistent with ERISA's duties of loyalty and prudence. In the preamble to the Final ESG and Proxy Voting Rules, the DOL expressed that one of the chief aims of the agency was to remedy any chilling effect that the 2020 Regulation may have had on a fiduciary's ability to take into account ESG factors in making investment decisions. In this regard, among other things, the Final ESG Rule:

- Reiterates that fiduciaries must act prudently and loyally in accordance with ERISA Sections 404(a)(1)(A) and 404(a)(1)(B).
- Maintains the requirement to compare an investment to reasonably available alternatives.
- Like the 2020 Regulation before it, the Final ESG Rule requires a fiduciary to evaluate an investment "compared to the opportunity for gain (or other return) associated with reasonably available alternatives with similar risks."
- Removes both the 2020 Regulation's concept of "pecuniary factors" and the 2021 Proposal's list of factors to consider in making investment decisions.
  - Importantly, the Final ESG Rule provides that a "fiduciary's determination with respect to an investment or investment course of action must be based on factors that the fiduciary reasonably determines are relevant to a risk and return analysis, using appropriate investment horizons consistent with the plan's investment objectives and taking into account the funding policy of the plan established pursuant to section 402(b)(1) of ERISA."

- The Final ESG Rule provides that "Risk and return factors may include the economic effects of climate change and other environmental, social or governance factors on the particular investment or investment course of action. Whether any particular consideration is a risk-return factor depends on the individual facts and circumstances."
- With respect to the weight given to any factor by a fiduciary in its investment determination, the Final ESG Rule provides that the weight "should appropriately reflect a reasonable assessment of the impact of the factor on risk-return."

OBSERVATION:
These provisions are significantly more neutral than the 2020 Regulation and the 2021 Proposal, allowing fiduciaries to determine which factors are relevant to risk and return analyses without mandating consideration of any factors in particular. Fiduciaries would be wise to keep an eye out for ESG disclosure developments from the US Securities and Exchange Commission.

- Retains the tie-breaker test but removes both the 2020 Regulation's documentation requirement in connection with tie-breaker decisions and the 2021 Proposal's participant disclosure requirement.
  - In retaining and reformulating the tie-breaker test, the Final ESG Rule provides that if multiple investment options "equally serve the financial interests of the plan over the appropriate time horizon, the fiduciary is not prohibited from selecting the investment, or investment course of action, based on collateral benefits other than investment returns." It also reaffirms that a fiduciary "may not, however, accept expected reduced returns or greater risks to secure such additional benefits."
  - This should provide more flexibility in determining whether and when collateral benefits may be considered in making investment decisions.
- Removes the prohibition against non-pecuniary factors in Qualified Default Investment Alternatives (QDIAs).
  - In doing so, the DOL stated that it "generally is of the view that QDIAs warrant special treatment because plan participants have not affirmatively directed the investment of their assets into the QDIA but are nevertheless dependent on the investments for long-run financial security."
  - At the same time, the DOL recognized that the rescission of the prohibition does not leave plan participants and beneficiaries without protections, as QDIAs are subject to the same legal standards as all other investments, including the prohibition against subordinating the interests of participants and beneficiaries to other objectives.

OBSERVATION:
This will ease the burden on fiduciaries by removing the burdens of complying with differing standards.

- Clarifies that taking into account participant preference does not violate ERISA's duty of loyalty.
  - The DOL recognized that accommodating participants' preferences could lead to greater participation and higher deferral rates, which, in turn, could lead to greater retirement security. In this regard, the DOL notes that "giving consideration to whether an investment option aligns with participants' preferences can be relevant to furthering the purposes of the plan."

GENERAL OBSERVATIONS:
The Final ESG Rule is principles-based and provides for ESG considerations where appropriate in connection with a risk/return analysis without mandating that fiduciaries consider ESG factors in their analysis.

Final Proxy Voting Rule

In short, the Final Proxy Voting Rule makes clear that the exercise of shareholder rights to monitor or influence management, which may occur in lieu of, or in connection with, formal proxy proposals, is critically important to a fiduciary's duties and obligations. Among other things, the Final Proxy Voting Rule:

- Removes the provision in the 2020 Regulation providing that the fiduciary duty to manage shareholder rights does not require voting of every proxy.
  - The DOL acknowledged that not every proxy must be voted but nevertheless removed the provision "out of a concern that the statement could be misread as suggesting that plan fiduciaries should be indifferent to the exercise of their rights as shareholders, particularly in circumstances where the cost is minimal as is typical of voting proxies," thereby leaving plan investment unprotected.
  - The DOL stated that "abstaining from a vote is not a neutral act that has no bearing on the outcome of a particular matter put to shareholders for vote." Instead, "abstention could determine whether a particular matter or proposal is approved."
- Removes the 2020 Regulation's recordkeeping requirement on proxy voting activities and other exercises of shareholder rights.

OBSERVATION:
The removal of the specific recordkeeping requirements will likely be a welcome relief for ERISA fiduciaries.

- Retains the requirements that in determining whether and when to exercise shareholder rights, fiduciaries must act in accordance with the economic interests of the plan, consider any costs involved, not subordinate the interests of the plan participants and beneficiaries to any other objective, evaluate relevant facts that underlie the exercise of shareholder rights and exercise prudence and diligence in selecting and monitoring service providers to exercise (or assist in exercising) shareholder rights.
  - Prudent fiduciaries should take steps to ensure that the cost and effort associated with voting a proxy or other shareholder engagement activities are commensurate with the significance of an issue to the plan's financial interests. For these purposes, the DOL confirmed that "a fiduciary's analysis may include consideration of the effects of the plan's exercise, either by itself or together with the exercise of rights of other shareholders."
- Retains the requirement that a fiduciary who retains a service provider to exercise shareholder rights must determine that the service provider's proxy voting guidelines are consistent with the fiduciary's obligations under the Final Proxy Voting Rule.[1]

OBSERVATION:
Plan fiduciaries who are responsible for hiring investment managers that will vote proxies on behalf of the plan will want to obtain a copy of the investment manager's shareholder voting policies and determine whether such policies are consistent with the final regulations.

[1] This provision of the rule becomes effective one year after publication in the Federal Register.

- Removes the provision in the 2020 Regulation providing that when proxy voting authority has been delegated, a fiduciary must monitor the proxy voting activities of such delegee.
  - The DOL noted that the standard of monitoring service providers remains and that removing the written requirement to monitor the proxy voting activities of delegees will make clear that there is not a heightened standard in monitoring proxy voting activities of delegees.
  - The DOL confirmed that there is no obligation to second guess or monitor each and every vote (or nonvote) of a delegee.

OBSERVATION:
Fiduciaries that delegate shareholder voting duties to service providers will nevertheless want to monitor whether the service provider is acting in accordance with the applicable shareholder voting policies and ERISA.

- Removes the safe harbors of the 2020 Regulation.
  - The 2020 Regulation provided two safe harbors that permitted fiduciaries to meet their obligations by adopting proxy voting policies, with such policies providing that the authority to vote a proxy is to be exercised pursuant to specific parameters prudently designed to serve the plan's economic interest. The fiduciaries would then be obligated to periodically review these policies for continued compliance.
  - The DOL eliminated these safe harbors because "taken together, they encourage abstention as the normal course."

OBSERVATION:
Given the protections provided by regulatory safe harbors, the rescission of the safe harbors is likely to be an unwelcome change from the 2020 Regulation.

- Retains the requirement that investment managers of pooled investment vehicles vote (or abstain from voting) the relevant proxies to reflect the policies of specific plans (which may differ from plan to plan) in proportion to each plan's economic interest in the pooled investment vehicle.[2]
  - The Final Rule provides that an investment manager may develop a proxy voting policy consistent with Title I of ERISA and the Final Rule and require participating plans to accept such policy before they are allowed to invest.

OBSERVATION:
Investment managers of pooled funds will want to consider developing proxy voting policies consistent with ERISA and the Final Rule and requiring plans participating in such pooled funds to accept and adopt such proxy voting policies prior to investment in the fund. For existing pooled funds, investment managers may want to consider amending applicable agreements to require that participating plans approve and adopt proxy voting policies developed by such investment manager.

To the extent that a plan finds itself on the receiving end of such requirement or amendment, it will want to obtain a copy of the proxy voting policy and determine whether such policy is consistent with ERISA and the Final Rule.

[2] This provision of the rule becomes effective one year after publication in the Federal Register.

GENERAL OBSERVATIONS:

- Fiduciaries should vote proxies unless they can determine it is not in the plan's best interest to vote (such as due to cost considerations or restrictions that may be triggered, as may be the case in voting proxies on foreign securities).
- The reference to the consideration of the revised "risk-return analysis" standard opens the door for a greater level of ESG consideration in proxy voting and perhaps even engagement practices.
- The adoption of the Final ESG and Proxy Voting Rules may not end the controversy – several states have been contemplating anti-ESG rules and laws at the state level, and House Republicans may continue to push bills, such as the Ensuring Sound Governance Act, which would require ERISA fiduciaries to prioritize financial returns over non-pecuniary factors when making investment decisions on behalf of their clients.

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