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DOL Releases Final Rule on ESG Investing and Proxy Voting

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TO: ICI Members
Investment Company Directors
ICI Global Members
ESG Advisory Group
ESG Fund Disclosure Working Group
ESG Public Company Disclosure Working Group
ESG Task Force
Global Retirement Savings Committee
Pension Committee
Pension Operations Advisory Committee
Proxy Working Group
SEC Rules Committee SUBJECTS: ESG
Pension RE: DOL Releases Final Rule on ESG Investing and Proxy Voting

On November 22, 2022, the Department of Labor (DOL) released its final rule on "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights" which addresses the consideration of environmental, social, and governance (ESG) factors in selecting plan investments and exercising shareholder rights.[1] The final rule generally tracks the proposed rule issued in October 2021, which ICI strongly supported, but makes certain clarifications and changes in response to public comments, including ICI's comments.[2]

The final rule will become effective on January 30, 2023 and generally will be applicable on that date. Two proxy voting provisions (both unchanged from the final rule adopted in 2020) have a delayed applicability date of one year after publication to allow fiduciaries and investment managers time to make any necessary changes to proxy voting policies and guidelines.

Background

As a reminder, DOL finalized two rules at the end of the Trump Administration, "Financial Factors in Selecting Plan Investments"[3] and "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights"[4] (together, the "2020 Rulemakings" or individually the "current regulation"). On March 10, 2021, DOL issued an Enforcement Policy Statement announcing that it intended to revisit the 2020 Rulemakings and would not enforce the rules while it considered further guidance.[5] In October 2021, DOL issued a proposed rule that would amend the 2020 Rulemakings. DOL agreed with many stakeholder concerns that the 2020 Rulemakings:

> "have been interpreted as putting a thumb on the scale against the consideration of ESG factors, even when those factors are financially material. The Department is concerned that, as stakeholders warned, uncertainty with respect to the current regulation may deter fiduciaries from taking steps that other marketplace investors would take in enhancing investment value and performance, or improving investment portfolio resilience against the potential financial risks and impacts often associated with climate change and other ESG factors. The Department is concerned that the [2020 Rulemakings have] created a perception that fiduciaries are at risk if they include any ESG factors in the financial evaluation of plan investments, and that they may need to have special justifications for even ordinary exercises of shareholder rights." [6]

The October 2021 proposed rule included changes that would remove perceived barriers for fiduciaries to consider ESG criteria as part of a fiduciary's investment analysis. The proposal responded to ICI concerns about the 2020 Rulemakings, including (1) that preamble language in the rule notice casts doubt on whether ESG factors were really economically material and created the perception that fiduciaries would have increased risk when they considered them; (2) that the special documentation requirement in the rule's tiebreaker test was unneeded and would create a road map for lawsuits; and (3) that it was not clear how the qualified default investment alternative (QDIA) restriction would apply and that it was not needed.

Investment Selection Provisions of Final Rule

As highlighted by DOL, the final rule reiterates two core principles: (1) that the duties of prudence and loyalty require ERISA plan fiduciaries to focus on relevant risk-return factors and not subordinate the interests of participants and beneficiaries (such as by sacrificing investment returns or taking on additional investment risk) to objectives unrelated to the provision of benefits under the plan, and (2) that when a plan's assets include shares of stock, the fiduciary duty to manage plan assets includes the management of shareholder rights related to those shares, such as the right to vote proxies.

The final rule adopts many of the amendments proposed in 2021, including:

- deleting the "pecuniary/non-pecuniary" terminology used in the 2020 Rulemaking, based on concerns that the terminology causes confusion and a chilling effect to financially beneficial choices.
- clarifying 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 and that such factors may include the economic effects of climate change and other ESG factors on the particular investment or investment course of action.[7]
- removing the current regulation's stricter rules for selecting QDIAs, such that, under the final rule, the same standards apply to QDIAs as to selecting investments generally.
- amending the current regulation's "tiebreaker" test, which imposes a requirement that competing investments be indistinguishable based on pecuniary factors alone before

fiduciaries can turn to collateral factors to break a tie and imposes a special documentation requirement on the use of such factors. The final rule replaces those provisions with a standard that instead requires the fiduciary to conclude prudently that competing investments, or competing investment courses of action, equally serve the financial interests of the plan over the appropriate time horizon. The rule explains that, in such cases, the fiduciary is not prohibited from selecting the investment, or investment course of action, based on collateral benefits other than investment returns. The final rule also removes the current regulation's special documentation requirement that would have applied when using the tiebreaker test, in favor of ERISA's generally applicable statutory duty to prudently document plan affairs.

The final rule includes some changes from the proposal:

- As ICI and others requested, the final rule eliminates language in paragraph (b)(2)(ii)(C) of the proposal which specified that consideration of the projected return of the portfolio relative to the funding objectives of the plan "may often require an evaluation of the economic effects of climate change and other environmental, social or governance factors on the particular investment or investment course of action." The final rule is intended to make it clear that climate change and other ESG factors may be relevant in a risk-return analysis of an investment and do not need to be treated differently than other relevant investment factors, without causing a perception that DOL favors such factors in any or all cases. DOL provides the following helpful explanation in the preamble:

  "By declining to carry forward the 'may often require' clause in paragraph (b)(2)(ii)(C) of the proposal, the final rule achieves appropriate regulatory neutrality and ensures that plan fiduciaries do not misinterpret the final rule as a mandate to consider the economic effects of climate change and other ESG factors under all circumstances. Instead, the final rule makes clear that a fiduciary may exercise discretion in determining, in light of the surrounding facts and circumstances, the relevance of any factor to a risk-return analysis of an investment. A fiduciary therefore remains free under the final rule to determine that an ESG-focused investment is not in fact prudent. Finally, nothing about the principles-based approach should be construed as overturning long established ERISA doctrine or displacing relevant common law prudent investor standards." [8]

- The final rule retains language of the proposal in paragraph (b)(4) explaining that a prudent fiduciary may consider any factor in the evaluation of an investment or investment course of action that, depending on the facts and circumstances, is relevant to the risk return analysis, but eliminates the proposal's three examples of ESG factors that may be considered as relevant to risk and return. This elimination responds to comments from ICI and others that the ESG-specific examples unnecessarily differentiate ESG factors from investment factors more generally and could create a presumption of regulatory bias in favor of ESG factors.[9] We note that in this provision, the final rule uses the term "relevant" rather than "material" in the context of determining the factors on which a fiduciary may base its decision, in a risk return analysis.
- The final rule does not include the proposed disclosure requirement within the tiebreaker test (corresponding to paragraph (c)(3) of the proposal and paragraph (c)(2) of the final rule), which provided that, if a plan fiduciary selects an investment, based on collateral benefits other than investment returns, the plan fiduciary must

ensure that the collateral-benefit characteristic of the investment is prominently displayed in disclosure materials provided to participants and beneficiaries. DOL determined not to adopt this new disclosure requirement at this time, in response to various concerns raised by commenters, including that the requirement was ambiguous, unnecessary, potentially confusing, and contrary to the principle of neutrality. DOL noted that the SEC is considering rulemaking relating to fund names and ESG disclosures by funds, and stated that it will monitor those rulemaking projects and potentially revisit the need for a collateral benefit disclosure in the future.[10]
- The final rule adds a new paragraph (c)(3) clarifying that fiduciaries do not violate their duty of loyalty solely because they take participants' preferences into account when constructing a menu of prudent investment options for participant-directed individual account plans. The preamble observes that if accommodating participants' preferences will lead to greater participation and higher deferral rates, as suggested by commenters, then it could lead to greater retirement security and can be relevant to furthering the purposes of the plan.[11]
- The final rule adopts minor amendments to the text in paragraph (b)(2) of the current regulation (describing what is "appropriate consideration") in response to commenters' requests to clarify whether and how it applies in the context of participant-directed individual account plans. The changes clarify that the determination factors in paragraph (b)(2)(i) also apply to menu construction in a participant-directed plan and the factors in (b)(2)(ii) apply only in the context of employee benefit plans other than participant-directed individual account plans.

Shareholder Rights/Proxy Voting Provisions of Final Rule

DOL has made relatively few changes to the portion of the final rule addressing proxy voting and exercise of shareholder rights. Like the 2020 Rulemaking and the 2021 proposed rule, the final rule provides that when deciding whether to exercise shareholder rights and when exercising such rights, fiduciaries must carry out their duties prudently and solely in the interests of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and beneficiaries and defraying the reasonable expenses of administering the plan.[12]

The final rule adopts all four of the significant changes proposed in 2021, including:

- Removal of statement regarding requirement to vote every proxy. Like the proposed rule, 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,"[13] because it may be misread as suggesting that plan fiduciaries should be indifferent to the exercise of their rights as shareholders. DOL's longstanding view is that "proxies should be voted as part of the process of managing the plan's investment in company stock unless a responsible plan fiduciary determines a proxy vote may not be in the plan's best interest; for example, if the costs associated with voting outweigh the expected benefits."[14]
- Modification of requirement to monitor rights delegated to investment manager. The final rule eliminates a provision in the current regulation that sets out specific monitoring obligations where the authority to vote proxies or exercise shareholder rights has been delegated to an investment manager or where a proxy voting firm performs advisory services as to voting proxies.[15] Instead, the final rule includes a more general provision requiring that a fiduciary exercise prudence and diligence in

the selection and monitoring of persons selected to exercise shareholder rights or assist with exercise of shareholder rights.[16] DOL explains this change does not represent a change in its view, but rather addresses DOL's concern that the specific requirements in the current regulation "could be read as creating special monitoring obligations above and beyond the statutory obligations of prudence and loyalty that generally apply to monitoring service providers."[17]

- Removal of "permitted policies" as safe harbors. The final rule removes the two "safe harbors" from the 2020 Rulemaking—permitted policies that are optional means for satisfying a fiduciary's responsibilities regarding determining whether to vote (but not how to vote).[18] DOL explains that it lacked confidence that the safe harbors were helpful in safeguarding the interests of plan participants and beneficiaries and that it was concerned that they "could be construed as regulatory permission for plans to broadly abstain from proxy voting without properly considering their interests as shareholders."[19] Instead of the safe harbors, the final rule includes a provision that fiduciaries may adopt proxy voting policies providing that the authority to vote a proxy shall be exercised pursuant to specific parameters.[20]
- Removal of requirement to maintain records. The final rule eliminates the requirement in the 2020 Rulemaking that, when deciding whether to exercise shareholder rights and when exercising shareholder rights, plan fiduciaries must maintain records on proxy voting activities and other exercises of shareholder rights.[21] DOL's reason for this change is because, in context, including this specific requirement "might create a misperception that proxy voting and other exercises of shareholder rights are disfavored or carry greater fiduciary obligations, and therefore greater potential liability, than other fiduciary activities" and that "[s]uch a misperception could be harmful to plans, as it could potentially chill plan fiduciaries from exercising their right or result in excessive expenditures as fiduciaries over-document their efforts."[22]

In one change from the proposal, DOL removed a clause that provided that when exercising shareholder rights, plan fiduciaries must not "promote benefits or goals unrelated to those financial interests of the plan's participants and beneficiaries." DOL explained its conclusion that this clause "serves no independent function, in terms of adding protections to plan participants, that is not already served by" the requirement to act solely in accordance with the economic interests of the plan and the requirement not to subordinate the interests of participants and beneficiaries to any other objectives.[23] DOL noted commenter concerns with this clause, including a heightened litigation risk and the likelihood that the requirement would be misconstrued to impose additional duties.

In response to requests from commenters (including ICI), the following proxy voting provisions have a delayed applicability date of one year after publication (note that these provisions are identical, other than a cross reference, to provisions in the 2020 Rulemaking, which also included a one-year delayed compliance date).[24]

- Paragraph (d)(2)(iii), regarding the prohibition on fiduciaries' adoption of a practice of following the recommendations of a proxy advisory firm or other service provider without a determination that such firm or service provider's proxy voting guidelines are consistent with the fiduciary's obligations as described in the rule; and
- Paragraph (d)(4)(ii), relating to investment managers of pooled investment vehicles holding assets of more than one employee benefit plan, where such participating plans may have conflicting investment policy statements.

Future of the Rule

Because the role of ESG factors in investing has become even more politicized over the last few years, this final rule is unlikely to be the last we hear on the issue. While we view the final rule as consistent with decades of prior DOL guidance, it is possible that the DOL under a future Republican administration would amend the rule or issue other guidance. In addition, bills have been introduced in Congress to address the issue of ESG investing. For example, the "Ensuring Sound Guidance Act" (H.R. 7151), introduced by Rep. Andy Barr (R-KY), would amend ERISA to specify that only pecuniary factors may be taken into account in meeting the obligation to act solely in the interest of plan participants and beneficiaries.[25] Similarly, Sen. Tom Cotton (R-AR) introduced a Joint Resolution to invalidate the final rule.[26]

Please let us know if you have any questions or comments regarding the final rule.

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Notes

[1] The final rule is published at 87 Fed. Reg. 73822 (December 1, 2022), available at https://www.govinfo.gov/content/pkg/FR-2022-12-01/pdf/2022-25783.pdf. DOL's press release is available at https://www.dol.gov/newsroom/releases/ebsa/ebsa20221122, and a fact sheet is available at https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/final-rule-on-prudence-and-loyalty-in-selecting-plan-investments-and-exercising-shareholder-rights.

[2] For an overview of the proposal, see ICI Memorandum No. 33832, dated October 18, 2021, available at https://www.ici.org/memo33832. For a summary of ICI's comments on the proposal, see ICI Memorandum No. 33954, dated December 14, 2021, available at https://www.ici.org/memo33954.

[3] For a summary, see ICI Memorandum No. 32888, dated November 3, 2020, available at https://www.ici.org/my_ici/memorandum/memo32888.

[4] For a summary, see ICI Memorandum No. 32984, dated December 15, 2020, available at https://www.ici.org/my_ici/memorandum/memo32984.

[5] See ICI Memorandum No. 33176, dated March 10, 2021, available at https://www.ici.org/memo33176.

[6] See preamble to 2021 proposed rule, 86 Fed. Reg. 57272, at 57275-6 (October 14, 2021), available at https://www.govinfo.gov/content/pkg/FR-2021-10-14/pdf/2021-22263.pdf.

[7] See final rule at section (b)(4).

[8] 87 Fed. Reg. at 73831.

[9] The preamble to the final rule includes a discussion of other factors (beyond ESG factors) that may be relevant to a risk/return analysis, explaining that: "Prudent investors

commonly take into account a wide range of financial circumstances and considerations, depending on the particular circumstances, such as a corporation's operating and financial history, capital structure, long-term business plans, debt load, capital expenditures, price-to-earnings ratios, operating margins, projections of future earnings, sales, inventories, accounts receivable, quality of goods and products, customer base, supply chains, barriers to entry, and a myriad of other financial factors, depending on the particular investment. This rule, as amended, does not supplant such considerations, but rather makes clear that there is no inconsistency between the appropriate consideration of ESG factors and ERISA section 404(a)(1)(B)'s standard of prudence . . ." 87 Fed. Reg. at 73832.

[10] 87 Fed. Reg. at 73841.

[11] 87 Fed. Reg. at 73842.

[12] See final rule at section (d)(2)(i).

[13] Section (e)(2)(ii) of the 2020 Rulemaking.

[14] 87 Fed. Reg. at 73871-2.

[15] Section (e)(2)(iii) of the 2020 Rulemaking.

[16] See final rule at section (d)(2)(ii)(E).

[17] 87 Fed. Reg. at 73846.

[18] Section (e)(3)(i) of the 2020 Rulemaking. The two permitted policies are as follows:

1. A policy to limit voting resources 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.
2. A policy of refraining from voting on 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)

[19] 87 Fed. Reg. at 73849.

[20] Final rule at section (d)(3)(i).

[21] Section (e)(2)(ii)(E) of the 2020 Rulemaking.

[22] 87 Fed. Reg. at 73845-6.

[23] 87 Fed. Reg. at 73847.

[24] The current regulation "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights" became applicable on January 15, 2021; however, fiduciaries were given until January 31, 2022 to comply with the requirements of paragraphs (e)(2)(iv) and (e)(4)(ii) of the rule.

[25] The Ensuring Sound Guidance Act (H.R. 7151), introduced on March 18, 2022, is available at https://www.congress.gov/bill/117th-congress/house-bill/7151.

[26] The Joint Resolution, introduced on December 1, 2022, is available at https://www.cotton.senate.gov/imo/media/doc/crapdf.pdf.
