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DOL Proposes Rules Regarding ESG Factors and Proxy Voting

by [R. Sterling Perkinson](#)

One of President Biden's first acts upon taking office was to issue an executive order requiring federal agencies to conduct a review of policies or regulations issued by the prior administration that were inconsistent with its climate change, health and labor policies. Following this review, the Department of Labor (DOL) published proposed rules on October 14, 2021 (the "[Proposed Regulations](#)") that would make major changes to regulations it issued at the end of 2020 that it found could have a "chilling effect" on fiduciaries from making investment decisions or exercising shareholder rights that furthered these policies.

Specifically, the Proposed Regulations, if finalized in their current form, could remove barriers for fiduciaries to make investment decisions that take into account climate change or other environmental, corporate governance or social (ESG) factors.

The Proposed Regulations would also modify 2020 regulations regarding fiduciary considerations in proxy voting for plan investing by modifying aspects of the 2020 regulations that could discourage fiduciaries from voting proxies and engaging in shareholder activism.

Consideration of ESG Factors

Fiduciaries of ERISA plans must make investment decisions that are prudent and based solely on the interests or participants and beneficiaries. As a result, fiduciaries are not permitted to make investment decisions that sacrifice expected investment return for other policy goals of the fiduciary.

Between 2008 and 2018 the DOL issued a series of interpretive bulletins intended to clarify the extent to which ESG factors may be taken into account for plan investments. Generally, these interpretive bulletins were consistent in finding that ESG factors may be taken into account to the extent that a prudent fiduciary finds them relevant to the risk/return analysis of an investment or as a "tie-breaker" among investments that are otherwise distinguishable in terms of risk/return analysis. However, the interpretive bulletins did not provide a consistent framework for the application of these principles. For example, Interpretive Bulletin 2015-1 found that fiduciaries are not precluded from "consideration of collateral benefits, such as those offered by a 'socially responsible' fund" as an investment option. In contrast, Interpretive Bulletin 2018-01 cautioned that fiduciaries should "not too readily treat ESG factors as economically relevant to the particular investment choices at issue when making a decision."

The DOL issued final regulations in November of 2020 that were intended to clarify the principles of these interpretive bulletins, and in particular apply the more skeptical view of Interpretive Bulletin 2018-01. These regulations added heightened documentation requirements when a fiduciary selects an investment by using ESG factors as a tie-breaker and prohibits any fund with investment strategies that included ESG factors from being used as a qualified default investment alternative (QDIA). Earlier this year, the DOL issued a non-enforcement policy for the final regulations while it undertook the review required by the executive order. See: [link](#).

Following this review, the DOL found that its 2020 regulations may have a “chilling effect” on consideration of ESG factors and so are in need of modification. The Proposed Regulations authorize fiduciaries to consider all facts and circumstances that they determine to be material to the risk-return analysis, and specifically reference the following as examples:

Climate change related factors, such as a corporation’s exposure to economic effects from climate change or from governmental regulation addressing climate change;

Corporate governance factors, including board composition, executive compensation and transparency; and

Workforce practices, including diversity and inclusion and labor relations.

The preamble to the Proposed Regulations explains that these examples are intended to be “no different” than any traditional risk/return factors and that they should be taken into account in the evaluation of an investment only when a fiduciary prudently determines that they are material to the risk/return analysis. However, the DOL is welcoming comments on whether fiduciaries should consider climate change as “presumptively material” to an investment’s analysis and the extent to which climate-related financial risk is not already incorporated into market pricing. Accordingly, it is possible that final regulations would go much further by essentially mandating a climate change analysis as part of an investment review.

The Proposed Regulations would also remove the prohibition on using a QDIA that applies ESG factors as part of its investment strategy. However, disclosures to participants would be required whenever an investment option is selected on the basis of “collateral benefits” as a “tie-breaker” among otherwise equivalent investments. These disclosure requirements would not apply when ESG factors are being considered as part of the risk/return analysis for an investment. The Proposed Regulations would still not allow for collateral benefits to be applied that reduce expected return or increase risks of investments.

The DOL has long recognized that fiduciaries have a duty to exercise proxy voting rights prudently in the interest of the plan and to engage in shareholder activities that may enhance the investment after taking into account the costs involved, but as with ESG factors, there has been an inconsistency as to what this means in application.

Regulations issued in 2020 recognized that in many cases the costs of reviewing proxy materials and exercising shareholder rights may exceed the benefit available to the plan. These regulations include an explicit statement that a fiduciary is not required to vote every proxy or to exercise every shareholder right. Further, the 2020 regulations provide safe harbors that would allow fiduciaries to have a policy of limiting resources to types of proposals that it has determined are material to the value of the investment or to refrain from voting on proposals when the plan's holdings for the investment are too insignificant to have a material effect on the investment performance. They also impose a duty to maintain records of proxy voting and other exercises of shareholder rights.

The DOL's review of these regulations found that these provisions may "chill" fiduciaries from exercising shareholder rights to ensure that management is accountable to the shareholders. Accordingly, it struck these provisions in favor of more general duties of prudence and loyalty for proxy voting and exercising shareholder rights.

Conclusion

The Proposed Regulations represent a significant change in the DOL's viewpoint of fiduciary duties that relate to ESG factors and shareholder activism, but they do not fundamentally alter the fiduciary duties to make investment decisions and to vote proxies and exercise shareholder rights to enhance investment returns. They may nevertheless have an impact by removing potential barriers from selecting funds that, for example, take into account climate change impacts or corporate governance practices as part of their investment strategies. It remains to be seen whether the DOL will go a step further in final regulations by mandating consideration of certain ESG factors, or whether they will maintain a more neutral position that they are no different than other traditional investment criteria.