LEGAL UPDATE

DOL Rule Permits Consideration of Climate and ESG Factors and Codifies Proxy Voting Responsibilities [*Continued*]

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[*Editor's Note: This month's Legal Update continues our coverage of the new DOL Investment Duties Regulation. We provided an abbreviated introduction to the topic in the February issue, and in March we discussed the background and the fiduciary duties of prudence and loyalty in context of the new Investment Duties Rule. This month we cover proxy voting and the exercise of shareholder rights as well as some practical effects of the new rule.*]

Proxy Voting and Exercise of Shareholder Rights

The revised Investment Duties Regulation added another new section addressing the exercise of shareholder rights. Like the recent history of regulatory guidance on the duties of prudence and loyalty, a final rule on proxy voting and shareholder rights had gone into effect in January 2021, and was also subject to the nonenforcement policy instituted in March 2021.

ERISA fiduciaries are generally allowed under applicable trust agreements to invest plan assets in shares of stock; a plan thus becomes a shareholder with the same shareholder rights as any other investor. Shares held by an ERISA plan, however, are plan assets held in trust. Thus, as explained in subsection (d) of the final rule, fiduciaries must carry out their duties of prudence and loyalty in deciding whether and when to exercise shareholder rights, including voting proxies, on behalf of a plan in its shareholder capacity.

The final rule echoes and applies the same principles for evaluating and selecting investments to fiduciary decisions on whether to exercise shareholder rights, explaining that fiduciaries must focus on a plan's economic interests, which may not be subordinated to unrelated objectives, and consider the overall facts and circumstances, including any related costs.

The final rule explains that fiduciaries must act prudently in: (i) selecting and monitoring persons to exercise or advise on exercising shareholder rights; (ii) that fiduciaries may not follow the recommendations of a proxy advisory firm without determining that its proxy voting guidelines are consistent with their fiduciary obligations; and (iii) that any plan proxy voting policy must be prudently designed to serve plan interests, be periodically reviewed, and allow fiduciaries to decide whether to vote proxies based on whether the outcome is expected to affect the value of the investment.

The final rule also recognizes that delegating authority to an investment manager to manage plan assets typically includes the authority to exercise shareholder rights. It further explains that compliance with the duty to follow governing documents requires that investment managers of pooled investment vehicles holding assets of more than one employee benefit plan attempt to reconcile differences in the various plans' investment policy statements and also vote proxies of the various plans in accordance with their respective proxy voting policies in proportion to each plan's economic interests in the pooled vehicle. In the alternative, the investment manager may develop an investment policy statement and proxy voting policy for the vehicle and require investing plans to adopt them as a condition of investing. In such cases, the fiduciaries for each plan must assess whether the investment manager's investment policy statement and proxy voting policy for the vehicle are consistent with plan objectives before deciding to invest in such vehicle.

The provisions on proxy advisory firms and pooled investment vehicles take effect on December 1, 2023. The DOL notes that this will allow time for transition, as commenters had requested.

Effects of the Rule

The extended debate over whether and how to revise the Investment Duties Regulation has spotlighted the growing global trend of considering climate change and ESG factors in evaluating investment opportunities. Now that the final rule clarifies that such consideration may be appropriate under relevant circumstances, the focus shifts to how this guidance might affect decision-making going forward. The DOL's Regulatory Impact Analysis provides statistics and information that could be of interest to plan fiduciaries, legal counsel, policy groups, and service providers, including investment managers and proxy advisory services.

♥The DOL recognizes that determining the financial materiality of climate change and ESG factors can be challenging, noting that there is no standardized or generally accepted definition of ESG factors, and drawing no conclusions on the relationship of ESG factors to the investment performance or overall return. For example, the DOL's literature review notes that some studies find that fees for ESG funds are higher than for other funds, though one study found no statistically significant difference when controlling for active management and assets under management.

The DOL's analysis recognizes that financial industry trends are developing and that the industry has not yet reached consensus on standards or measures for evaluating climate change and ESG factors. The fact that it is hard to evaluate these factors, however, does not preclude, require or, for that matter, permit avoidance of the analysis. Going forward, ERISA plan fiduciaries can consider information on climate change and ESG factors as it is available at the time they are evaluating investments, consistent with their fiduciary duty of prudence.

The DOL's Regulatory Impact Analysis also considers the effect of new guidance on the fiduciary duty of loyalty, including the nod to fiduciary consideration of participant investment preferences. Of particular interest, the DOL notes that there may be significant demand for ESG alternatives among participants in self-directed defined contribution plans. For instance, a survey by a financial institution found that 69% of participants aged 45–75 would increase their contribution rate if an ESG option were offered. The DOL recognizes that appealing to investor preference can help promote the policy goal of increasing retirement savings.

The revised tiebreaker rule may also have an impact on fiduciary evaluation of investment opportunities that could provide collateral benefits beyond investment performance. For example, in the regulatory preamble, the DOL confirmed that an investment that "stimulates or maintains employment that, in turn, results in continued or increased contributions to a multiemployer plan" is a permissible example of a collateral benefit that fiduciaries could use in breaking a tie between investments that would equally serve a plan's financial interests. Fiduciaries might also consider climate change and ESG factors in a similar vein, or any other potential collateral benefit, as long as they maintain their primary focus on a plan's financial interests.

Moreover, the DOL estimates that some 63,000 plans that hold stock directly or indirectly, including ESOPs and some welfare plans, may be affected by the proxy voting and shareholder rights provisions, including small plans that do not report their holdings as part of their Form 5500. The DOL estimates that these plans employ more than 17,000 service providers whose services may relate to shareholder rights, including trustees, trust companies, banks, investment advisors, investment managers, and proxy advisory firms. Among the transition and compliance costs, the DOL discusses legal review, updating proxy voting policies, and shifts from non-ESG to ESG investments.

The DOL's economic and statistical analyses should help the agency in defending the rule against legal challenges. Some commenters suggested, for instance, that climate and ESG issues are reserved to Congress under the Supreme Court's "major questions" doctrine. The DOL notes that it has express rulemaking authority under Title I of ERISA to provide guidance for fiduciaries in exercising their responsibilities and that the new final rule was promulgated under that authority.

Final Thoughts for Plan Fiduciaries

- **Principles-Based:** While there is general agreement that the final rule provides helpful clarifications, it embodies a neutral policy that allows for a principles-based approach to ESG investing without being overly prescriptive. Unlike the predecessor rule, the final rule says ESG may be one of many factors that may be considered for investment decision making if it is relevant to the investment decision. Conversely, if ESG is not relevant to an investment decision, it should not be considered. This will enable fiduciaries to take a more facts-and-circumstances approach to the ESG question.
- **Participant Choice:** For the first time, fiduciaries may consider participant choice, and that will not be considered a violation of the duty of loyalty—provided that all the elements of the final rule are satisfied. Honoring participant choice is likely to increase plan participation. However, the rule does not address how to resolve competing or inconsistent participant choices. And what if the participant choice is not a prudent one? In that case, participant choice cannot prevail.
- **Proxy Voting:** The final rule makes clear, in contrast to the predecessor rule, that proxy voting and exercise of shareholder rights and privileges is a fiduciary function, which should be exercised in the absence of a reason not to do so.
- **Tiebreaker:** The final rule allows for collateral benefits to be considered, provided that competing investment otherwise equally serve the interests of the plan. This is more realistic than the predecessor rule, which called for the competing investments to be indistinguishable.

Verification/Confirmation: In connection with investment decisions, ERISA fiduciaries may (and should) request information and/or confirmations from investment managers regarding the role of ESG factors in the relevant investment objectives. This will document that they engaged in a prudent, diligence process in compliance with the final rule.

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