

CLIENT ALERT

# Department of Labor Finalizes Regulation Regarding ESG Investing and Proxy Voting

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On December 1, 2022, the U.S. Department of Labor (the “[DOL](#)”) released a new regulation governing investments by and on behalf of employee benefit plans subject to the U.S. Employee Retirement Income Security Act of 1974 (“[ERISA](#)”). The regulation, “[Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights](#)” (the “[Regulation](#)”), permits ERISA plan fiduciaries to take into account climate change and other environmental, social, and governance (“[ESG](#)”) factors when making investment decisions, when such factors are relevant to ERISA plan fiduciaries’ investment risk and return analysis. The Regulation also requires ERISA plan fiduciaries to engage in proxy voting and other shareholder rights activities when doing so is in the plan’s best interest. ERISA plan sponsors and ERISA plan investment managers are subject to the Regulation.

## **Background**

The DOL issued a [proposed version](#) of the Regulation in October 2021 (the “[Proposal](#)”), following its decision to suspend enforcement of regulations regarding similar topics that were issued at the end of 2020, during the waning days of the prior presidential administration. Prior to 2020, the DOL had expressed its views (and the views of the presidential party in power) regarding ESG investing and shareholder rights activities, including proxy voting, through sub-regulatory guidance. However, in recent years, the DOL has sought to codify its views through notice-and-comment rulemaking in an effort to create regulatory permanency around these topics. The Regulation is the latest development in that effort. However, by making significant changes to the DOL’s 2020 regulations, the Regulation may signal that even formal rulemaking may not create the permanency sought by the DOL on these topics.

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### **ESG Investing**

The Regulation retains many of the principles embodied in the Proposal. Chief among these are the requirements that investment risk and return must be the paramount considerations for ERISA plan fiduciaries when selecting investments on behalf of plans. However, the Regulation permits fiduciaries to consider *any* factor that may be relevant to such risk and return analysis, which may (but does not necessarily) include climate change and other ESG factors. Thus, the Regulation treats ESG factors like any factors that are relevant to an ERISA plan fiduciary's prudent investment analysis.

Importantly, the Regulation omits language included in the Proposal that suggested that ERISA plan fiduciaries may be *required* to include climate change and other ESG factors in their investment risk and return analysis. That original language caused concern among some members of the regulated community that the DOL intended to, or effectively would, create an ESG mandate for ERISA plans. In addition to omitting this language from the text of the Regulation, the DOL confirms in the preamble to the Regulation that there is no mandate to consider ESG factors. Specifically, the DOL notes that "the final rule makes unambiguous that it is not establishing a mandate that ESG factors are relevant under every circumstance, nor is it creating an incentive for a fiduciary to put a thumb on the scale in *favor* of ESG factors." Consistent with this change, the DOL also omits specific ESG examples from the text of the Regulation, which were included in the Proposal and which also created some concern for ERISA plan fiduciaries.

Like the Proposal, the Regulation also permits (but does not require) ERISA plan fiduciaries to use non-economic factors (which may include ESG factors, in some cases) as "tie-breakers" when deciding between competing investments that may equally serve the interests of an ERISA plan. Thus, although ESG factors in some cases may themselves be economic considerations relevant to a fiduciary's risk and return analysis, ESG factors also may be viewed as providing "collateral" or non-economic benefits to ERISA plans. In the latter case, the Regulation permits plan fiduciaries to use ESG factors to decide *between* comparable investment alternatives for plans. Importantly, the DOL's 2020 rules placed significant restrictions on the use of ESG factors as tie-breakers, and some interpreted those restrictions to mean that there would be few, if any, circumstances when such collateral benefits could be considered. These provisions in the Regulation are intended to address those concerns. However, consistent with the DOL's long-standing guidance, ERISA plan fiduciaries may not accept reduced returns or greater risk to secure collateral benefits.

In addition, and consistent with the Proposal, the Regulation permits ERISA plan fiduciaries to select ESG-themed investment products as "qualified default investment alternatives" ("QDIAs") for ERISA participant-directed individual account plans, such as 401(k) plans. However, the use of ESG-themed products as QDIAs must be prudent and must not subordinate the interests of ERISA plan participants in their retirement income to unrelated objectives.

In an important departure from the Proposal, the Regulation expressly allows ERISA plan fiduciaries to consider the investment preferences of plan participants in participant-directed individual account plans when making investments available to such participants. The DOL explains that doing so may stimulate greater plan participation and deferral rates,

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which may in turn lead to greater retirement security. However, the Regulation requires that the inclusion of *any* investment (whether or not driven by participant preferences) be grounded in the ERISA plan fiduciary's prudent risk and return analysis. Notably, the Regulation does not mandate a uniform approach for plan fiduciaries to determine plan participants' preferences. Instead, the DOL has given plan fiduciaries flexibility in making this determination, taking into account the facts and circumstances of each plan and plan population.

### Proxy Voting

Like the ESG components of the Regulation, the DOL has retained key aspects of the Proposal's shareholder rights provisions, with continued emphasis on proxy voting activities on behalf of ERISA plans. Specifically, the Regulation instructs that an ERISA fiduciary's duty to manage "plan assets" includes management of shareholder rights, such as the right to vote proxies. And the Regulation reflects the DOL's long-standing position that proxies *should* be voted *unless* the ERISA plan fiduciary determines that doing so may not be in the plan's best interests.

In this regard, the Regulation requires ERISA plan fiduciaries to act solely in accordance with the *economic* interests of the plans they are responsible for managing and to consider any costs associated with exercising shareholder rights. The DOL notes "... the importance that prudent management of shareholder rights can have in enhancing the value of plan assets or protecting plan assets from risk" and that a fiduciary "may not increase expenses, sacrifice investment returns, or reduce the security of plan benefits in order to promote collateral goals." Thus, the DOL's treatment of plan fiduciaries' proxy voting responsibilities is similar to its treatment of fiduciaries' responsibilities in connection with ESG investing, as noted above.

Fiduciaries must evaluate the relevant facts that form the basis for particular proxy votes or other exercise of ERISA plan shareholder rights. The Regulation, like the Proposal, permits ERISA plan fiduciaries to adopt proxy voting policies that include specific parameters designed to further the plan's interest in providing benefits to plan participants and defraying plan expenses. Plan fiduciaries must periodically review such policies.

ERISA plan fiduciaries also must act prudently and diligently in selecting and monitoring individuals or entities to whom proxy voting responsibility is delegated or from whom proxy voting assistance is sought, consistent with ERISA's requirements regarding selection and monitoring of service providers generally. This obligation includes ensuring that a proxy advisory firm's or other service provider's proxy voting guidelines are consistent with the Regulation's requirements.

The Regulation requires investment managers of pooled investment vehicles to reconcile, insofar as possible, conflicting proxy voting policies of investors and to vote proxies to reflect such policies in proportion to each plan investor's economic interest in the vehicle. However, investment managers may develop their own investment policies and require plan investors to accept such policies as a condition of investing in the vehicle. The DOL notes in the preamble to the Regulation that this is not a new approach but, rather, is consistent with the DOL's past views regarding proxy voting.

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### **Implications**

As noted, the Regulation impacts ERISA plan sponsors and ERISA plan investment managers. The Regulation describes the DOL's current views regarding ESG investing and proxy voting activities, which are largely consistent with past sub-regulatory guidance under ERISA but which depart from the DOL's 2020 rules in certain significant ways. As finalized, the Regulation reflects the DOL's efforts to permit ERISA plan fiduciaries to incorporate ESG considerations into their investing decisions, when appropriate, while avoiding a mandate to do so. It also reflects the importance, in the view of the DOL, of ERISA plan fiduciaries engaging in proxy voting and other shareholder rights activities when doing so furthers the economic interests of ERISA plans. The Regulation thus provides definitive DOL guidance to the ERISA plan sponsor and investment management community, at least during the remainder of the current presidential administration. Both groups should review the Regulation and determine whether changes to their current processes or procedures are indicated.

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