

CLIENT ALERT

# Department of Labor Clarifies Its Position Regarding ESG Investing and Proxy Voting for ERISA Plans

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## **Introduction**

On October 14, 2021, the U.S. Department of Labor (the “DOL”) published a proposed regulation, called “Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights,” 86 Fed. Reg. 57272 (the “Proposed Regulation”), which, once adopted, would clarify and codify the DOL’s views regarding the extent to which fiduciaries of retirement and benefit plans governed by the U.S. Employee Retirement Income Security Act of 1974, as amended (“ERISA”), can or should consider environmental, social, and governance (“ESG”) factors when selecting plan investments. Relatedly, the Proposed Regulation would clarify and codify the DOL’s position regarding the obligations of ERISA plan fiduciaries with respect to proxy voting and other shareholder activities.

The Proposed Regulation amends similar regulations that were issued by the DOL in November and December 2020, during the previous presidential administration (the “Prior Regulation”). In so doing, the Proposed Regulation provides greater leeway to ERISA plan fiduciaries to prudently incorporate ESG considerations into their investment activities and encourages ERISA plan fiduciaries to take seriously the exercise of plan shareholder rights. The DOL has invited the regulated community to submit comments on all facets of the Proposed Regulation. Comments are due no later than

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December 13, 2021.<sup>1</sup> Following is an overview of the Proposed Regulation and its implications for ERISA plan fiduciaries and asset managers.

### **Background**

Over the years, the DOL has issued multiple pronouncements regarding the extent to which ERISA plan fiduciaries may incorporate ESG considerations into their plan-related investment selections. Similarly, the DOL has issued multiple iterations of guidance regarding ERISA plan fiduciaries' engagement in proxy voting and other shareholder rights activities on behalf of such plans. In general, the views of the DOL have been informed by different policy priorities.

The Prior Regulation acknowledged that ESG factors may be appropriate considerations for ERISA plans, but only in very limited circumstances. The Prior Regulation also acknowledged the DOL's longstanding view that the fiduciary duty to manage ERISA plan assets includes the duty to manage ERISA plan shareholder rights, including proxy voting, but only when justified on the basis of the plan's economic interests. However, the preamble discussions in the Prior Regulation indicated that the DOL was concerned that ERISA plan fiduciaries were relying too heavily on ESG considerations and devoting too much time and expense to exercising shareholder rights. Therefore, the Prior Regulation imposed constraints on ERISA plan fiduciaries in connection with these activities.

Earlier this year, as part of the presidential administration's efforts to combat climate change, the current DOL announced that it would not enforce the Prior Regulation. The DOL also announced that it intended to review and possibly revise the Prior Regulation to better reflect its current views regarding ESG investing and shareholder rights activities, particularly as they relate to efforts to mitigate climate change. The Proposed Regulation is the result of that undertaking.

### **The DOL's Intent**

The preamble to the Proposed Regulation broadly reflects the DOL's concern with the Prior Regulation. The DOL believes that the Prior Regulation has already had a "chilling effect" on ERISA plan fiduciaries' consideration of ESG factors in their plan-related investment decisions.<sup>2</sup> Similarly, the DOL believes that the Prior Regulation has discouraged ERISA plan fiduciaries from vigorously engaging in proxy voting and other shareholder rights activities, to the detriment of plans.<sup>3</sup> The DOL is concerned that ERISA plan investment portfolios may suffer as a result. Accordingly, the Proposed Regulation clarifies that (i) ERISA plan fiduciaries may – and in some cases must – consider ESG factors as part of their investment risk-return analysis and (ii) ERISA plan fiduciaries are duty-bound to engage in proxy voting and other shareholder rights activities when doing so serves the economic interests of ERISA plan participants and beneficiaries.

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<sup>1</sup> 86 Fed. Reg. 57284.

<sup>2</sup> Id. at 57275.

<sup>3</sup> Id. at 57281.

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### Investment Selection and ESG Factors

This component of the Proposed Regulation largely codifies certain views of the DOL under previous administrations, as articulated in various guidance issued by the DOL over time. However, the Proposed Regulation also contains notable updates. We summarize the key provisions of this component of the Proposed Regulation below.

First, the Proposed Regulation reflects the DOL's longstanding view that financial risk and return must be ERISA plan fiduciaries' paramount concerns when selecting investments for ERISA plans. Accordingly, ERISA does not allow plan fiduciaries to subordinate these considerations to other unrelated goals and objectives.<sup>4</sup> This feature of the Proposed Regulation is consistent with the Prior Regulation and years of DOL guidance.

Next, the Proposed Regulation clarifies that ESG factors – including the impact of climate change and regulatory efforts to combat climate change – *can and often may* be material considerations in an ERISA plan fiduciary's evaluation of an investment or investment course of action. In this regard, the DOL notes that, “[i]f a fiduciary prudently concludes that a climate change or other ESG factor is material to an investment or an investment course of action under consideration, the fiduciary can and should consider it and act accordingly, as would be the case with respect to any material risk-return factor.”<sup>5</sup> The Proposed Regulation provides specific examples of ESG-themed considerations that ERISA plan fiduciaries can or should incorporate into their investment evaluation process, in order to provide clarity that ERISA plan fiduciaries may consider ESG factors in their investment decisions. These examples include (i) climate change-related factors, (ii) governance factors, and (iii) workforce practices. Importantly, the DOL notes in the preamble to the Proposed Regulation that these are merely clarifying *examples*, not conditions of the Proposed Regulation.<sup>6</sup> This feature of the Proposed Regulation is a significant change from the Prior Regulation, which took a much more discouraging approach to ESG considerations in ERISA plan investments.

In addition, the Proposed Regulation codifies the DOL's long-held position that ESG factors can be “tie-breaking” determinants when multiple competing investment alternatives “equally serve the financial interests” of an ERISA plan. This feature of the Proposed Regulation is a shift from the Prior Regulation, which effectively prohibited the use of ESG factors as “tie-breakers” except in very limited circumstances where competing investments were effectively indistinguishable, a test that was viewed as particularly narrow and challenging to document. The Proposed Regulation departs from the Prior Regulation by (i) allowing ERISA plan fiduciaries to rely on ESG factors as “tie-breaker” elements when considering investments that serve a plan's financial interests equally well and (ii) omitting any special documentation requirement on the part of ERISA plan fiduciaries when they rely on such elements.<sup>7</sup> However, the

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<sup>4</sup> Id. at 57278.

<sup>5</sup> Id. at 57277.

<sup>6</sup> Id.

<sup>7</sup> Id. at 57278-79.

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Proposed Regulation requires ERISA plan fiduciaries to prominently display in investment disclosure materials for ERISA individual account plans (e.g., 401(k)-type plans) the ESG factors used to break a “tie” so that participants in such plans are adequately apprised of such factors.<sup>8</sup>

Finally, the Proposed Regulation deviates from the Prior Regulation by clarifying that ESG-themed investment products are *not* per se prohibited from serving as “qualified default investment alternatives” (“QDIAs”) for ERISA individual account plans, assuming that such products are otherwise appropriate for such plans.<sup>9</sup> As most ERISA plan fiduciaries know, QDIAs are investment options into which 401(k) plan and other individual account plan participants may be defaulted in the absence of affirmative investment directions to plan sponsors. However, if an ESG-themed investment product is selected as a QDIA in a “tie-breaker” situation, the ERISA plan fiduciary must ensure that the investment disclosures provided to plan participants include the ESG features of the investment product, in the interest of providing greater transparency to plan participants.<sup>10</sup>

### **Proxy Voting and Other Shareholder Rights**

Like the investment selection and ESG factors component of the Proposed Regulation, the shareholder rights component of the Proposed Regulation largely codifies certain views of the DOL under previous administrations. However, like the ESG component, this component of the Proposed Regulation contains some noteworthy changes. We summarize the key provisions of this component of the Proposed Regulation below.

First (and much like the ESG component of the Proposed Regulation), this component of the Proposed Regulation restates the DOL’s long-held position that ERISA plan fiduciaries must, in exercising shareholder rights, act solely in the economic interests of plan participants and beneficiaries and must not subordinate those interests to unrelated goals and objectives.<sup>11</sup>

Second, ERISA plan fiduciaries may adopt specific parameters for exercising shareholder rights, including voting proxies. However, such policies must not prohibit exercising shareholder rights, or require exercising such rights, when the plan fiduciary determines that doing otherwise is in the economic interest of the plan.<sup>12</sup> Relatedly, the Proposed Regulation omits a provision in the Prior Regulation that expressly permitted ERISA plan fiduciaries to not vote every proxy or exercise every shareholder right.<sup>13</sup> The Proposed Regulation also omits “safe harbor” provisions contained in the Prior

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<sup>8</sup> Id. at 57279.

<sup>9</sup> Id. at 57279-80.

<sup>10</sup> Id. at 57280.

<sup>11</sup> Id. at 57282.

<sup>12</sup> Id. at 57282-83.

<sup>13</sup> Id. at 57281.

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Regulation that in some cases permitted ERISA plan fiduciaries to refrain from exercising such rights.<sup>14</sup> In making these changes, the DOL explains that it is concerned that these provisions in the Prior Regulation may have been viewed as giving “regulatory permission” to ERISA plan fiduciaries to avoid their shareholder responsibilities.<sup>15</sup> However, the DOL confirms that these changes do not mean that ERISA plan fiduciaries must *always* vote proxies or engage in shareholder activism: fiduciaries must consider an ERISA plan’s best interests and ensure that proxy voting expenses and efforts are commensurate with the significance of an issue to a plan’s financial interests.<sup>16</sup>

Next, the Proposed Regulation omits a condition in the Prior Regulation that imposed special monitoring obligations on ERISA plan fiduciaries with respect to plan investment managers and proxy voting firms when the exercise of shareholder rights was specifically delegated to these entities. Instead, the Proposed Regulation highlights the obligation of plan fiduciaries to monitor ERISA plan service providers more broadly, consistent with what ERISA already requires.<sup>17</sup> The Proposed Regulation also eliminates a special documentation provision contained in the Prior Regulation that applied to ERISA plan fiduciaries’ exercise of shareholder rights. In the view of the current DOL, such a provision could discourage ERISA plan fiduciaries from exercising their shareholder rights or result in excessive expenditures and over-documentation.<sup>18</sup>

Finally, like the Prior Regulation, the Proposed Regulation requires investment managers for pooled funds to reconcile, insofar as possible, conflicting proxy voting policies of ERISA plan investors and to vote proxies in proportion to each plan’s economic interest.<sup>19</sup> However, as in the Prior Regulation, the Proposed Regulation allows pooled fund investment managers to adopt proxy voting policies that apply to such funds as a whole and to require ERISA investors to adopt such policies as a condition of their investment in such funds. In that scenario, an ERISA plan fiduciary must determine that the investment manager’s policies are consistent with Title I of ERISA (ERISA’s fiduciary responsibility provisions) prior to investing in the pooled fund.<sup>20</sup>

### **Implications**

The Proposed Regulation signals a more permissive and encouraging environment for ESG-themed investment decisions by ERISA plan fiduciaries. If finalized, the Proposed Regulation should provide greater flexibility to plan fiduciaries and investment managers to select ESG-related investments and products when they can justify doing so on the basis of the

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<sup>14</sup> Id.

<sup>15</sup> Id. at 57282.

<sup>16</sup> Id.

<sup>17</sup> Id. at 57281.

<sup>18</sup> Id. at 57281-82.

<sup>19</sup> Id. at 57283.

<sup>20</sup> Id.

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risk-return profile of such investments and products, or when they can satisfy the “tie-breaker” standard described in the Proposed Regulation. Importantly, the Proposed Regulation may, and in some cases would, require ERISA plan fiduciaries and investment managers to consider the impact of ESG factors as part of their evaluation of proposed plan investments. Consequently, the Proposed Regulation may spur greater interest by ERISA plan fiduciaries in ESG-themed investments and may create opportunities for ERISA plan investment managers as a result.

The Proposed Regulation also should encourage ERISA plan fiduciaries and investment managers to take seriously their proxy voting activities and other shareholder rights, while eliminating some of the administrative burden imposed by the Prior Regulation in connection with these activities.

We note that the Proposed Regulation is subject to change, and that some of these elements of the Proposed Regulation may be modified in the final version of the DOL’s rule. We are following developments in this area.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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