The Long and Winding Road: The DOL's Proposed Rule on ESG Factors and the Exercise of Shareholder Rights | Fiduciary Focus Series

Oct 27, 2021

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Authors:

Sarah N. Lowe

On October 13, 2021, the Department of Labor (DOL) released its proposed "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholders Rights" rule (the "Proposed Rule"). They published the rule on October 14. If finalized, the Proposed Rule would amend the "Investment Duties" regulation under Title I of ERISA, which was previously amended by two final rules issued by the DOL in 2020 during the final months of the Trump Administration (the "Current Rule").

The Proposed Rule reconfigures how ERISA[1]'s core fiduciary duties of prudence and loyalty apply to the use of environmental, social, and corporate governance (ESG) factors in connection with investment decision-making and the exercise of shareholder rights appurtenant to investments in shares of stock held by ERISA plans. The changes are intended to address what DOL viewed as the "chilling" effects of the 2020 changes in the Current Rule.

How did we get here? (The Winding Road)

The Proposed Rule represents the DOL's latest turn on these topics. For several decades, the DOL guidance "clarifying" the role ESG factors should play in fiduciary investment decision-making and the standards applicable to an ERISA fiduciary's exercise of shareholder rights, including proxy voting, has been issued by successive administrations of different political parties.[2]

These successive "clarifications" have invariably shifted the direction of the guidance, while adhering to certain core tenants. Such core tenants include, for example, that ERISA does not permit fiduciaries to subordinate the economic interests of plan participants and beneficiaries to unrelated objectives and would never justify accepting reduced returns or greater risks to promote

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extraneous goals. Nevertheless, such guidance has consistently provided that under certain circumstances, it was permissible for a fiduciary to consider ESG factors in its investment decision-making and that the fiduciary act of managing plan assets includes the management of those shareholder rights, including proxy voting rights, connected to shares of stock.

Prior to 2020, the DOL guidance on these issues was sub-regulatory (informal, non-binding guidance). In 2020, however, this changed. On November 13, the DOL published a final rule titled "Financial Factors in Selecting Plan Investments," which amended the "Investment Duties" regulation to require plan fiduciaries to choose investments and investment courses of action solely based upon "pecuniary factors." The rule also prohibited defined contribution plan fiduciaries from having a qualified default investment alternative (QDIA) that includes non-pecuniary objectives as a part of its investment objectives of principal strategies.

On December 16, 2020 the DOL published a final rule titled "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights." This final rule further amended the "Investment Duties" regulation to provide regulatory standards applicable to plan fiduciaries when exercising shareholder rights, including proxy voting rights, in connection with shares of stock held as a plan investment.

On January 20, 2021, President Joe Biden signed Executive Order 13990, which empowered agencies, including the DOL, to suspend, revise, or rescind existing rules and regulations promulgated, issued, or adopted between January 20, 2018, and January 20, 2021.

On March 10, 2021, the DOL announced a non-enforcement policy with respect to the Current Rule, noting that its reexamination of the rule had begun.

Finally, on May 20, 2021, President Biden signed Executive Order 14030, titled "Executive Order on Climate Related Financial Risk" which, in relevant part, directed DOL to publish a proposed rule to suspend, revise or rescind the Current Rule.

E-S-G, as Easy as 1-2-3

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The Proposed Rule would amend the "Investment Duties" regulation in three principal ways that the DOL believes will provide plan fiduciaries a framework allowing them to more broadly use ESG factors in making investment decisions consistent with the duties of prudence and loyalty.

1. A plan fiduciary acts prudently when it considers ESG factors in making investment decisions

The Proposed Rule clarifies that a prudent fiduciary can (and often should) consider ESG factors when determining that an investment or investment course of action (for simplicity, referred to as an "investment") is reasonably designed to promote the purposes of the plan. Specifically, the Proposed Rule states that estimating the projected return of a portfolio relative to its funding status "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 Proposed Rule further clarifies that a plan fiduciary can consider any factor material to the risk-return analysis when evaluating investments. It also provides three examples that, depending on facts and circumstances, may be material to a plan fiduciaries' risk-return analysis in the evaluation of an investment:

- Climate change-related factors, such as a corporation's exposure to the real and potential economic effects of climate change including exposure to the physical and transitional risks of climate change and the positive or negative effect of government regulations and policies to mitigate climate change
- Governance factors, such as those involving board composition, executive compensation, and transparency and accountability in corporate decision-making, as well as a corporation's avoidance of criminal liability and compliance with labor, employment, environmental, tax, and other applicable laws and regulations
- Workplace practices, including the corporation's progress on workforce diversity, inclusion, and other drivers of employee

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hiring, promotion, and retention; its investment in training to develop its workforce skill; equal employment opportunity; and labor relations

The DOL notes that these examples are not intended to provide new conditions under the prudence safe harbor, but rather are meant to provide clarification through examples. These examples are not exhaustive. The DOL seeks comments on whether other or fewer examples would be helpful.

The Proposed Rule specifically provides that a fiduciary's evaluation of an investment must be based upon "risk and return factors that the fiduciary prudently determines are material to investment value" and may include the factors listed in the examples above.

2. Changes to the Tie-Breaker Rule

Both the Current Rule and the Proposed Rule address the duty of loyalty in connection with investments and articulate the "tie-breaker" standard in connection with ESG investments. The tie-breaker standard had long been a staple of the DOL's sub-regulatory guidance. Still, the Current Rule had significantly curtailed its availability by requiring two investments to be indistinguishable based upon pecuniary factors before non-pecuniary factors could tip the scale, and by requiring special documentation whenever the scales were tipped.

The Proposed Rule provides that if a fiduciary determines that competing investments equally address the plan's financial interest, the fiduciary may make its selection based upon collateral benefits other than investment returns. The fiduciary will not be subject to any special documentation requirements in connection with this selection.

If, however, an investment option is selected for a participant-directed individual account plan based upon collateral benefits under the tie-breaker rule, the Proposed Rule requires that the collateral-benefit characteristic of such option must be prominently displayed in the disclosure materials provided to participants and beneficiaries.

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3. Plans can now offer QDIAs with non-pecuniary objectives like ESG

The Proposed Rule also removes the prohibition on the inclusion of QDIAs with non-pecuniary objectives like ESG for participant-directed individual account plans.

Exercising Shareholder Rights

As discussed, ERISA's duty of prudence and loyalty provide standards for plan fiduciaries when exercising shareholder rights in connection with plan investments, including voting proxies. The Proposed Rule makes four noteworthy changes to the exercise of shareholder rights, as follows:

1. Eliminating the "No Vote" Rule

The first major change eliminates a portion of the Current Rule that provides that fiduciary compliance in connection with the management of shareholder rights "does not require the voting of every proxy or the exercise of every shareholder right." The DOL expressly states that plan fiduciaries should not be indifferent to the exercise of their rights as shareholders, especially when the cost of voting the proxies is minimal. However, the DOL clarifies in the preamble that the change does not require all proxies to be voted. Rather, fiduciaries should weigh the cost and effort associated with voting a proxy to make sure it is commensurate to the plan's financial interest.

2. Eliminating the Special Monitoring Requirements

The second major change eliminates a special fiduciary monitoring obligation set forth in the Current Regulation that applies where an investment manager has been delegated discretion over the exercise of shareholder rights, or a proxy voting firm has been appointed to vote proxies. The DOL notes that monitoring these delegations is already required by ERISA and requiring additional monitoring duties could be read as requiring special obligations in connection with shareholder rights.

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Eliminating the Proxy Voting Policy Safe Harbors

The Current Rule permits plan fiduciaries to maintain proxy voting policies which set forth specific parameters prudently designed to address the economic interest of the plan and provides two "safe harbor" examples of policies that satisfy a fiduciary's duties of prudence and loyalty with respect to decisions to vote proxies. The first safe harbor allows voting resources to be limited to proposals that the fiduciary has determined are expected to materially impact the value of the investment. The second safe harbor permits a proxy voting policy of refraining from voting on proposals where, among other factors, the plan's investment is below a threshold amount.

The Proposed Rule retains the permissive framework for proxy voting policies with specific parameters tailored to the plan's economic interest. But, it eliminates both safe harbors due to the DOL's concern that they may encourage plan fiduciaries to adopt a broad abstention policy from voting proxies. By removing these safe harbors and removing the no vote rule, discussed before, the DOL is seeking to encourage plan fiduciaries to vote their proxies where appropriate.

3. Eliminating the proxy voting records requirement

The final major change eliminates the requirement in the Current Rule that plan fiduciaries must maintain records on exercises of shareholder rights, including proxy voting activities. Again, the DOL believes that the general fiduciary duties imposed by ERISA inherently provide for these requirements already, so such language only creates a misperception of a greater fiduciary obligation for the exercise of shareholder rights and proxy voting.

Next Steps

The Proposed Rule does not burden fiduciaries with complex new duties or requirements; rather, it eliminates requirements that, in the DOL's view, "chilled" plan fiduciaries' ability to utilize ESG factors in investment decisions and encouraged plan fiduciaries to be indifferent to exercise of shareholder rights. Once the Proposed

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Rule is finalized, fiduciaries will be back to taking into account all relevant factors in making decisions on investments or shareholders' rights. This, no doubt, will be a welcome change to many within the retirement market. While it seems that the door is opening on ESG, waiting for the issuance of the final rule before making any plan investment changes in reliance on the new rules is the safest option.

Comments to the Proposed Rule are due on December 13, 2021. If your organization is interested in providing a formal comment to the DOL or you have any questions related to the effect of the Proposed Rule, please contact Sarah Lowe , Edward Rivin, or any other attorney with Frost Brown Todd's Employee Benefits & ERISA practice group.

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[1] The Employee Retirement Income Security Act of 1974, amended.
[2] Interpretive Bulletins ("IB) 94-1, IB 2008-01, IB 2015-01, IB 2016-01 and Field Assistance Bulletin 2018-01.

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