Proskauer

DOL's Final ESG Rules Reflect Warmer Attitude Toward ESG, But Maintain Bedrock Principle that Risk and Return Cannot Be Sacrificed

Employee Benefits & Executive Compensation Blog on **December 5, 2022**

On November 22, 2022, the U.S. Department of Labor's Employee Benefits Security Administration (the "DOL") released final regulations (the "Final Rules") that are intended to be more supportive of ERISA fiduciaries considering environmental, social, and governance factors ("ESG") in investment decisions as compared to the Trump administration's 2020 regulations (the "2020 Regulations"). The Final Rules are largely consistent with the DOL's proposed ESG regulations issued in October 2021 (the "Proposed Rules"), with a few important differences noted below. Although the Final Rules are warmer to ESG considerations than the 2020 Regulations, the Final Rules retain ERISA's bedrock principle that an ERISA fiduciary cannot sacrifice investment returns or assume greater investment risk to promote collateral objectives. The Final Rules also retain the core principle that a fiduciary's responsibility with respect to investment management includes the management of appurtenant shareholder rights, such as voting proxies.

The Final Rules will generally become effective on January 30, 2023, except that certain of the proxy voting-related rules described below will not take effect until December 1, 2023.

Key Takeaways

- The Final Rules provide some comfort that ESG considerations are not off limits, but the underlying principle that risk and return cannot be sacrificed has not changed.
- The Final Rules do not include a "safe harbor" for a fiduciary to treat ESG-themed funds as a separate asset class. Accordingly, ESG-themed funds must be evaluated relative to other alternatives in the particular asset class, and fiduciaries could be exposed to potential claims if an ESG-themed investment option underperforms its benchmark. To mitigate risk, fiduciaries should carefully document the reasons for their investment decisions—including the relevance of ESG considerations to risk

and return objectives.

- The Final Rules say that fiduciaries of participant-directed plans (such as a typical 401(k) or 403(b) plan) may consider participant preferences when constructing a plan's investment lineup, but there is no softening of the rule that fiduciaries may not sacrifice return or expose participants to additional risk to accommodate those preferences. Consequently, ESG factors will generally be relevant only insofar as they relate to the fiduciary's evaluation of risk and return.
- While U.S. state "governmental plans" are not subject to ERISA, certain governmental plans are subject to rules that are similar to ERISA and that are generally interpreted consistently with ERISA. It remains to be seen how state laws that restrict consideration of ESG factors will be interpreted or applied.
- Investment managers of separate accounts, private investment funds and other pooled investment vehicles that have contractually agreed to operate as if the fund, account or other vehicle were subject to ERISA or in accordance with the ERISA standard of care should consider whether these changes to the ERISA investment duties regulation should affect the operations or investments of the account, fund or vehicle.
- The Final Rules retain the core principle that a fiduciary's responsibility with respect to investment management includes the management of appurtenant shareholder rights, such as voting proxies. Driven by a concern that the 2020 Regulations could discourage proxy voting activity by plan fiduciaries, the Final Rules eliminate burdensome recordkeeping requirements and underscore that proxy voting is a key tool in managing investments in issuers that should be taken seriously by ERISA fiduciaries. The Final Rules also retain the core requirements relating to the prudent selection and monitoring of service providers to advise and assist with the exercise of shareholder rights.
- The Final Rules allow plan fiduciaries to establish investment policies that cover proxy voting, and they require managers of pooled "plan asset" funds to reconcile conflicting policies of participating plans to the extent possible. This could require that the fund manager exercise shareholder rights of the fund (i.e., voting or abstaining) in proportion to each plan's economic interest in the fund. Alternatively, the fund manager may develop its own investment policy statement that is consistent with Title I of ERISA and require participating plans to accept that investment policy statement, including any proxy voting policy, before they are allowed to invest (or in order to remain invested in the fund).

Background

The 2020 Regulations consisted of two separate, but related, rulemakings– one specific to selecting ERISA plan investments[1], the other related to proxy voting and the exercise of other shareholder rights.[2] Although the 2020 Regulations did not specifically refer to "ESG" considerations, they distinguished between "pecuniary" and "non-pecuniary" factors, creating a perception that any consideration of ESG factors (even factors considered to be financially material) could expose ERISA fiduciaries to liability.

As part of a directive by President Biden to review regulations that were inconsistent with the promotion and protection of public health and the environment, the DOL announced on March 10, 2021 that it would not enforce the 2020 Regulations. In October 2021, the DOL issued the Proposed Rules (discussed here), and the Final Rules are the culmination of that review.

Final Rules

The Final Rules make a number of ESG-related changes to ERISA's "investment duties" regulation set forth at 29 C.F.R. 2550.404a-1, including the following:

Investment-Related Changes

- *Acknowledges that Consideration of ESG Factors May be Permitted as Part of Satisfying Duty of Prudence.* Like the 2020 Regulations, the Final Rules preserve the long-standing requirement that a fiduciary give "appropriate consideration" to the facts and circumstances that the fiduciary knows or should know are relevant. "Appropriate consideration" includes consideration of the projected return of the portfolio relative to the funding objectives of the plan; and the Final Rules state that risk and return factors "*may include*" the economic effects of climate change and other ESG factors on the particular investment. The Final Rules also state that the weight given to any factor should reflect an assessment of its risk/return impact. Unlike the Proposed Rules, the Final Rules do not say that prudent analysis "*may often require*" consideration of ESG factors, and they do not include a list of examples of ESG factors that may be appropriate for an ERISA fiduciary to consider; but the Preamble to the Final Rules discusses examples.
- *Eliminates the Bifurcation Between "Pecuniary" and "Non-pecuniary" Factors*. As noted above, the Final Rules eliminate the distinction between "pecuniary" and "non-pecuniary" factors. Instead, they provide that a fiduciary "may" consider *any* factor material to the risk/return analysis, including climate change and other ESG factors.

- *Simplifies the "Tie-Breaker" Concept.* The Final Rules make it easier to use ESG or other "collateral benefits" as a "tie-breaker" between competing investments.
    - First, the Final Rules change the definition of a "tie." Instead of limiting a tie to a case where the applicable investments could not be distinguished based on "pecuniary factors" alone, the Final Rules define a tie as competing investments that "equally serve the financial interests of the plan over the appropriate time horizon".
    - Second, the Final Rules eliminate the special documentation and disclosure requirements for a tiebreaker. Instead, the Final Rules contemplate application of the same documentation and disclosure principles as for other investment decisions.

Changes Affecting Participant-Directed Plans

- *Removes the Prohibition on Funds and Products Supporting "Non-Pecuniary" Goals as Qualified Default Investment Alternatives ("QDIAs")*. The 2020 Regulations prohibited a fund, product, or model portfolio that expressly considered ESG factors to be used as a QDIA. The Final Rules do not include such a prohibition, or any other special ESG-related rules with respect to QDIAs: QDIAs are treated like other investment options.
- *Clarifies that Fiduciaries May Take Into Account Participant Preferences When Constructing 401(k) or 403(b) Plan Investment Lineups*. The Final Rules include a new clarification that a fiduciary of a participant-directed plan (such as a typical 401(k) or 403(b) plan) does not violate the duty of *loyalty* solely because the fiduciary takes into account participants' preferences when setting the plan's investment lineup. The DOL noted in the Preamble that if aligning an investment option with participants' preferences would lead to greater participation and higher deferral rates, then it could lead to greater retirement security and thus further the purposes of the plan. Nonetheless, the clarification does not change the duty of *prudence*. The duty of prudence still turns on analysis of risk and return characteristics (without regard to what participants might want). The Preamble specifically notes that the Final Rules do not mandate that fiduciaries factor participants' preferences into their decision making and they do not prescribe a methodology to account for such preferences.

Proxy Voting-Related Changes

- *Removes Statement that Voting of Every Proxy is Not Required*. The 2020 Regulations stated that a fiduciary's duties to manage shareholder rights "*does not require the voting of every proxy or the exercise of every shareholder right*". The

DOL deleted this language out of a concern that it could imply that plan fiduciaries should be indifferent to the exercise of their rights as shareholders, even if the cost is minimal. The Preamble to the Final Rules does, however, acknowledge that a fiduciary may determine on a case-by-case basis that voting of a proxy is not in the plan's best interests (for example, because the cost exceeds the potential benefit).

- *Removes Proxy Voting Policy "Safe Harbors."* The 2020 Regulations permitted a fiduciary to discharge its duties with respect to proxy voting by establishing (i) a policy to limit voting resources to particular types of proposals that the fiduciary had prudently determined were substantially related to the relevant issuer's business or expected to have a material effect on the value of the investment, and/or (ii) a policy of refraining from voting on proposals or particular types of proposals when the plan's holdings in the relevant issuer were sufficiently small. The DOL did not include these "safe harbors" in the Final Rules out of a fear that they could encourage abstention as the normal course, rather than emphasize the importance that prudent management of shareholder rights can have in enhancing the value of the plan's investment.
    - Consistent with the 2020 Regulations, the Final Rules continue to allow a fiduciary to adopt and follow prudently designed proxy voting policies, provided that the policies do not (i) prohibit voting on matters that the fiduciary prudently determines are expected to have a "*significant*" (the 2020 Regulations used "*material*") effect on the value of the investment or investment performance after taking into account the costs involved, or (ii) require the fiduciary to vote when the fiduciary prudently determines that the matter being voted upon is not expected to have such an effect after taking into account the costs involved.
    - As under the 2020 Regulations, the Final Rules require that an investment manager of a pooled "plan asset" fund must reconcile, insofar as possible, conflicting investment policies of participating plans. In general, this could mean that the investment manager must take action (vote or abstain) in proportion to each plan's economic interest in the fund. Alternatively, the investment manager may develop its own investment policy statement that is consistent with Title I of ERISA and require participating plans to accept that investment policy statement, including any proxy voting policy, before they are allowed to invest. In such cases, ERISA plan fiduciaries would need to assess the prudence of the investment manager's investment policy statement and proxy voting policy before deciding to invest with the manager. Although the Final Rules generally become effective on January 30, 2023, these rules related to proxy voting will not take effect until December 1, 2023.

- *Removes Special Monitoring Obligations for Delegated Proxy Voting Rights and Advisory Services*. The 2020 Regulations provided specific monitoring obligations on plan fiduciaries who delegated proxy voting rights or utilized advisory services of proxy voting firms. The Final Rules remove the special monitoring obligations but still require "prudence and diligence" in the selection and monitoring of delegates and advisers.
- *Eliminates Special Recordkeeping Requirement Regarding Proxy Voting Activities*. The 2020 Regulations required fiduciaries to maintain records on proxy voting activities and other exercises of shareholder rights. The Final Rules remove this special recordkeeping requirement; but fiduciaries should still document their oversight of investment managers.

Changes Specific to "Plan Asset" Funds and Investment Managers

- As noted above, the Final Rules require that a pooled "plan asset" fund manager must reconcile conflicting investment policies of participating plans to the extent possible, which could mean exercising shareholder rights of the fund (i.e., voting or abstaining) in proportion to each plan's economic interest in the fund. Alternatively, the fund manager may develop its own ERISA-compliant investment and proxy voting policies and require participating plans to accept that them in order to invest (or remain invested in the fund). This portion of the Final Rules will not take effect until December 1, 2023.
- Investment managers that have contractually agreed to operate a fund, account or other vehicle as if it was subject to ERISA or in accordance with the ERISA standard of care should consider whether any changes to the operations or investments of the account, fund or vehicle are necessary in light of the Final Rules.

Although the Final Rules are generally supportive of considering ESG factors under certain circumstances, the bedrock principles of ERISA's fiduciary duties of prudence and loyalty generally remain unchanged. In particular, ERISA plan fiduciaries still must base their investment decisions and exercise shareholder rights on the risk-adjusted value to plan participants and beneficiaries, without subordinating their economic interests to other goals or objectives.

As always, Proskauer is here to help plan fiduciaries apply the Final Rules.

[1] For more on the plan investments portion of the 2020 Regulations, see here and here.

[2] For more on the proxy rule portion of the 2020 Regulations, see here.

View original.

Related Professionals

- **Ira G. Bogner**
  Managing Partner
- **Seth J. Safra**
  Partner
- **Adam W. Scoll**
  Partner