The DOL Issues its Final Word on ESG and Proxy Voting (For Now)

November 29, 2022

On November 22, 2022, the U.S. Department of Labor (the "DOL") made available final regulations revising and rescinding portions of the Trump-era rules addressing a fiduciary's duties under Section 404 of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), that placed a chilling effect on the ability to consider environmental, social and governance (ESG) factors in the management and investment of ERISA plan assets.[1] The final regulations restate the long-standing policy that an ERISA fiduciary "may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives, and may not sacrifice investment return or take on additional investment risk to promote benefits or goals unrelated to interests of the participants and beneficiaries." However, the regulations also adopt new principles that permit ERISA fiduciaries to embrace ESG-driven investing by empowering ERISA fiduciaries to decide for themselves which risk and return factors have economic effect and what weight to assign to such factors.

The proposed regulations were promulgated in October 2021 (see our Debevoise Debrief on the proposal here), and were intended to unwind a late Trump-era regulation which:

- provided that an ERISA fiduciary must focus solely on the plan's "pecuniary factors" (i.e., financial returns and the interests of plan participants and beneficiaries in their plan benefits) in its investment decision-making process, and
- prohibited the addition or retention of a qualified default investment alternative ("QDIA") that reflected any non-pecuniary objectives in its investment objectives or principal investment strategies, even if the selection of the investment alternative was otherwise made in compliance with ERISA's fiduciary duties.

While the Trump-era rule on its face appeared to be a more-or-less plain vanilla restatement of decades-old DOL policy with respect to retirement assets and did not expressly mention ESG, the preamble to that rule discussed ESG at length in a manner

[1] "*Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights*," *available at* https://www.dol.gov/sites/dolgov/files/ebsa/temporary-postings/prudence-and-loyalty-in-selecting-plan-investments-and-exercising-shareholder-rights-final-rule.pdf.

that caused many market participants to view the rule as a clear signal from the DOL that it would generally disfavor the consideration of ESG factors by ERISA fiduciaries and would presume them to be non-pecuniary, except in extraordinary circumstances.

The final regulation dials back the Trump-era rule by expressly acknowledging that the consideration of ESG factors may be taken into account in a manner that comports with ERISA's fiduciary duties of prudence and loyalty. It also eliminates the restriction on selecting QDIAs that reflect any non-pecuniary factors. Like the proposal, the final rule does not expressly embrace ESG-focused investing by ERISA plans, but empowers fiduciaries to take ESG into account as long as the ESG factors given consideration are evaluated as risk/return factors that prudent and loyal investment professionals use in their decision-making process. While the changes to the proposal were generally modest, they do appear to show a DOL that is leaning further in favor of taking ESG into account by deferring to plan fiduciaries' determinations of appropriate factors to consider in their investment decision making process—that consideration of ESG as part of a fiduciary's evaluation would no longer be treated as a presumptive violation the fiduciary's duty.

The regulations will be applicable sixty days after publication in the Federal Register, except for the provisions related to proxy voting, which will not take effect until one year after publication.

Below is a summary of key takeaways from the final regulation and notable changes from the proposal.

A New and Potentially Confusing Set of Principles Regarding the Duty of Prudence. Unlike the Trump-era rule that it was reacting to, the proposal made several specific and targeted references to ESG considerations as they relate to the fiduciary duty of prudence. The proposed rule even went so far as to state that the evaluation of the projected return to a plan's portfolio "may often require" an evaluation of ESG considerations, and attempted to define what those ESG considerations may look like.

Perhaps recognizing a core tenet of ERISA—that ERISA provides only for a fiduciary standard of care and does not purport to embrace specific investments or investment courses of action—the DOL significantly softened the regulatory text on ESG without removing references to ESG altogether. It eliminated the "may often require" statement as well as the attempt to define certain ESG factors in favor of three principles outlining what it considers to be relevant to a fiduciary's duty of prudence:

- First, a fiduciary's determination with respect to an investment or investment course of action must be based on factors that the fiduciary reasonably determines are relevant to a risk and return analysis, using appropriate investment horizons

consistent with the plan's investment objectives and taking into account the funding policy of the plan established pursuant to section 402(b)(1) of ERISA.

- Second, risk and return factors may include the economic effects of climate change and other environmental, social, or governance factors on the particular investment or investment course of action. Whether any particular consideration is a risk/return factor depends on the individual facts and circumstances.

- Third, the weight given to any factor by a fiduciary should appropriately reflect an assessment of its impact on risk and return.

These new principles appear to offer significant deference to a fiduciary's own determinations of what is important to an investment decision, free from the objective measurement of prudence that is required by the statute and determined by reference to a hypothetical prudent person. All that a fiduciary needs to do in order to adhere to these principles is to act "reasonably," as opposed to acting in accordance with a standard of care that courts have famously found is the "highest known to the law."

It's not clear how this reasonableness standard can be squared with the language in the statute or with the earlier text of the regulation which requires a fiduciary to give appropriate consideration to those facts and circumstances that the fiduciary "knows **or should know**" (our emphasis) are relevant to the action involved. Rather than try to reconcile the apparent inconsistency, one might view these principles as the DOL's effort to reflect the views of the current administration (and undo those of the prior administration), while simultaneously embracing the core tenets of the statue with the goal of avoiding having their efforts again being judicially overturned.

A Modified Approach to the Duty of Loyalty. In what appears to be a subtle acknowledgment that taking ESG into account when making investment decisions is more problematic from a loyalty perspective than a prudence perspective, specific references to ESG in the portion of the regulation addressing the duty of loyalty have been removed altogether. The final regulation retains language that makes clear that fiduciaries may not sacrifice investment return or take on additional investment risk to promote benefits unrelated to the interests of participants and beneficiaries in their retirement income or financial benefits. In other words, an ERISA fiduciary cannot take ESG into account solely for its own sake. However, the final rule also expressly provides that a fiduciary of a participant-directed individual account plan does not violate this fiduciary duty of loyalty solely because it takes participant preferences into account when designing a menu of investment options.

The DOL stated in the preamble to the final rule that this new provision does not represent a change in its existing position, though this strikes us as a noteworthy

inclusion. The DOL's basis for adding this new language is that taking into account participant preferences would lead to greater participation and higher deferral rates, which in turn would lead to greater retirement security. In this manner, accommodation of participant preferences would have the effect of furthering the "purposes of the plan" as is required as part of a determination of prudence under the final rule. Thus, a plan sponsor of a customary 401(k) plan could determine that including investment alternatives that take ESG into account would encourage more employee participation and, as long as such investment alternatives have otherwise been prudently selected, not violate the duty of loyalty.

Reliance on this provision by a plan sponsor choosing investments that take ESG into account would strike us as fraught with danger. How will a plan sponsor know what its participants' preferences are? Does it need to periodically survey all employees to gather this data? Is a plan sponsor exposed to challenges that it took into account only some participants' preferences in selecting investment options? And how does one reconcile this action with the recent Supreme Court decision in *Hughes v. Northwestern University*, which concluded that that affording participants a choice of prudent investments does not relieve a fiduciary from liability for offering other choices that may not be prudent? The DOL acknowledged some of these issues in the preamble, noting that it declined to mandate that participant preferences be taken into account when designing investment menu options because of the difficulties such a mandate would present.

The final noteworthy change to the provisions relating to the duty of loyalty relates to the longstanding "tie-breaker" rule, which permits a fiduciary to look to collateral benefits when choosing between investment alternatives that equally serve the financial interests of the plan. The DOL had proposed that if a fiduciary relied on the tie-breaker rule in selecting a designated investment alternative for a participant directed plan, it needed to provide disclosure to plan participants related to the collateral benefits it relied on in breaking the tie. This requirement has been removed from the final rule.

Several Key Provisions Remain Unchanged from the Proposed Rule. Except for the changes noted above and some modest changes to language to provide for greater consistency and clarity around the application of the rules to participant directed plans, the final rule is largely the same as the proposal. Specifically:

- There is no reference to "pecuniary" factors anywhere in the rule. Fiduciaries are charged with determining whether ESG factors need to be considered in evaluating the risk and return profile of their investment decisions as part of prudent investment decision making. However, by indicating that a fiduciary may determine that ESG factors affect an investment's risk and return profile, the DOL is essentially stating that such factors can be considered in a fiduciary's decision making when the fiduciary determines they are in fact pecuniary in nature.

- The final rule does not include any restrictions on adding or retaining a QDIA solely because they reflect ESG objectives.

- The modest changes to the proxy voting provisions in the proposal have all been adopted with one notable change, described below.

The notable change to the proxy voting rules was the deletion of a prohibition against voting proxies in a manner that would "promote benefits or goals unrelated to [the] financial interests of the plan's participants and beneficiaries." Commenters had expressed a concern that a violation of this provision would occur "merely because stakeholders other than the plan would potentially benefit along with the plan." The DOL acknowledged that other provisions of the proxy voting rules were sufficiently protective of plans' financial interests and adhered to the DOL's position that plan fiduciaries not expend plan assets to promote public policy preferences, and agreed to remove the language in question.

As we noted in our 2021 Debrief, the proxy voting amendments (a) remove two "safe harbor" examples for proxy voting policies and (b) eliminate the requirement that plan fiduciaries must maintain records on their proxy voting activities and other exercises of shareholder rights. Fiduciaries who have historically relied on one of the two safe harbors should update their proxy voting policies. As noted above, fiduciaries will have an extended period of time in which to comply the portions of the rules relating to proxy voting.

The final rule otherwise continues retain many of the existing provisions from the current regulations on proxy voting policies, including (i) the requirement that a plan fiduciary may not adopt a practice of following the recommendations of a proxy advisory firm or other service provider without determining that such firm or service provider's proxy voting guidelines are consistent with the fiduciary's obligations set forth in the regulations; and (ii) a requirement that plan fiduciaries periodically review any adopted proxy voting policies.

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