

Takeaways From DOL's Final ESG Rule For ERISA Fiduciaries

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The U.S. Department of Labor released the final regulation on Nov. 22, titled "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights."^[1]

This final rule clarifies that fiduciaries regulated by the Employee Retirement Income Security Act may take into account environmental, social and governance, or ESG, factors that are relevant to an investment's expected risk return and similar financial metrics.

While the final rule does give a thumbs up to ESG investing in certain circumstances, it actually deemphasizes the focus on ESG in particular and provides a broader gloss on appropriate fiduciary decision making processes in general. Notably, it does not specifically require ERISA fiduciaries to consider ESG factors in investment decision making.

The key ERISA issue presented by ESG investing is the extent to which consideration of ESG factors can be consistent with ERISA's stringent fiduciary duties of loyalty and prudence. ERISA's duty of loyalty requires fiduciaries to act solely in the interest of the plan participants and beneficiaries. ERISA's duty of prudence requires a fiduciary to act "with the care, skill, prudence, and diligence" that a prudent person would use.

The DOL has grappled with this issue in various forms over the last several decades, in a manner often resembling a Ping-Pong match as positions bounced back and forth with changing presidential administrations. The guidance over the years, however, has uniformly required that any consideration of ESG or similar factors in investment decision making must satisfy the duties of loyalty and prudence.

The most recent volley prior to the final rule was adopted at the end of the previous administration in 2020 and titled "Financial Factors in Selecting Plan Investments."^[2] The 2020 rule interpreted ERISA's fiduciary duties in a manner that was skeptical that consideration of ESG factors could be consistent with ERISA's stringent fiduciaries duties of loyalty and prudence. The 2020 rule also overhauled long-standing DOL guidance on proxy voting and the exercise of other shareholder rights.

Key Takeaways



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The final rule takes a more neutral, middle-of-the-road approach to ESG factors, clarifying that taking into account ESG factors is permissible but not prescribed.

The final rule clarifies that ESG factors may be among the financially relevant factors considered as part of ERISA fiduciary investment decision making in a manner that can be consistent with ERISA's fiduciary duties of loyalty and prudence.

While the regulation in its proposed form suggested that there may be circumstances where consideration of certain ESG factors may be required, the final rule includes no such language. Instead, under the final rule ESG factors can take their place among the myriad factors that ERISA fiduciary investment decision makers may consider. The standard does not require ESG to receive special treatment, nor does it require special documentation for ESG.

The final rule broadens applicability and eases application of the tie-breaker test.

Prior DOL guidance has included the notion of permitting nonfinancial factors to be used to break a tie between investments under consideration.

The exact contours of the tie-breaker rule have evolved over the years, but the final rule can be viewed as making it easier for fiduciaries to consider collateral factors — i.e., unrelated to retirement savings — because the final rule does not require the investments to be indistinguishable from a financial standpoint to allow for consideration of such collateral benefits.

Rather, it allows for consideration of collateral benefits where "competing investments ... equally serve the financial interests of the plan."

The final rule allows fiduciaries of participant-directed plans to consider participant preference in certain circumstances.

The final rule adds a new provision stating that fiduciaries of participant-directed individual account plans do not violate the duty of loyalty solely by considering participant preferences in selecting investment options as long as the other requirements under the final rule are met. The DOL states that this provision is not intended to be novel or a change in position.

It is, however, the first time that the DOL has explicitly addressed the role of participant preference in a regulation. It is important to note that this provision only addresses the duty of loyalty, not the duty of prudence. Thus, a fiduciary may not honor participant preference for investment options unless the fiduciary believes that they are also prudent.

We suspect that this provision may have been driven by the research cited in the preamble supporting the notion that accommodating participant preferences, such as a preference for an ESG-themed investment option, drives higher plan participation and investment.

The final rule reaffirms the fiduciary duty to vote proxies and exercise shareholder rights.

The final rule reemphasizes a long-standing DOL principle that a fiduciary's duty to manage plan assets includes the exercise of shareholder rights related to those shares, including the right to vote proxies.

The final rule removes provisions included in the 2020 rule that some read as increasing the regulatory burden for a fiduciary to vote proxies or otherwise could have been viewed as discouraging proxy voting. The final rule should provide clarity on these points and, in many ways, returns to long-standing ERISA guidance that fiduciaries generally should vote proxies unless they have a good reason not to.

Conclusion

While this rule is final, it is not yet effective. Most provisions — other than certain proxy voting provisions — will be effective 60 days after publication in the Federal Register, which will likely be soon.

This rule presents important considerations for ERISA fiduciaries, including for plans and investment service providers that already consider ESG factors or utilize an ESG fund or mandate. Fiduciaries navigating the final rule and ESG in ERISA plan investing should consider these issues in light of the upcoming changes.

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[1] <https://www.dol.gov/sites/dolgov/files/ebsa/temporary-postings/prudence-and-loyalty-in-selecting-plan-investments-and-exercising-shareholder-rights-final-rule.pdf>.

[2] <https://www.govinfo.gov/content/pkg/FR-2020-11-13/pdf/2020-24515.pdf>.