

ERISA and ESG: Less Confusion?

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Last year the Department of Labor (“DOL”) proposed changes to ERISA regulations that govern the consideration of environmental, social, and governance (“ESG”) factors in retirement plans, as well as fiduciary considerations relating to the exercise of shareholder rights (such as voting proxies) with respect to plan holdings. Recently, on November 22, 2022, the DOL released its final amendment to the ESG/Proxy Voting rules, “Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights” (the “2022 Final Rule”). The 2022 Final Rule provides greater flexibility for plan fiduciaries to consider climate change and other environmental, social, and governance factors when they select retirement investments and provides a renewed emphasis on exercising shareholder rights, such as proxy voting.

Context and Overview

ERISA requires that fiduciaries must act “solely in the interest of participants and beneficiaries.” While this principle remains the heart of fiduciary behavior, questions have arisen regarding whether and to what extent fiduciaries can or should consider ESG factors in investment decisions. For decades, this issue has resulted in a constant tug-of-war of subregulatory guidance (i.e., informal, nonbinding guidance such as Field Assistance Bulletins) between Republican and Democratic administrations.

In 2020, the DOL finalized amendments to its ERISA investment duties and proxy voting rules, “tightening” in some respects the rules with respect to ESG investing and to some extent “downplaying” fiduciaries’ obligations to exercise shareholder rights. The general view of the asset management industry and retirement plan community was that these 2020 amendments (the “2020 Regulations”) created uncertainty around whether ESG factors can be considered pecuniary and, as a result, whether a fiduciary may consider ESG and other factors in making investment and proxy voting decisions. In early 2021, the DOL issued a non-enforcement policy regarding the 2020 Regulations. Later in 2021, the DOL issued a new set of proposed regulations (the “2021 Proposal”) seeking to change key aspects of the 2020 Regulations and remove perceived barriers to consideration of ESG factors.

The 2022 Final Rule released last month largely mirrors the 2021 Proposal, with some clarifications, and significantly relaxes restrictions on ESG investing. The Final Rule is effective 60 days after publication in the Federal Register, except that the proxy voting changes are effective one year after publication. Specific changes in the 2022 Final Rule and the key take-away from the rule are discussed below.

Elimination of the 2020 “Pecuniary/Non-pecuniary” Terminology

The 2022 Final Rule eliminates the “pecuniary/non-pecuniary” terminology in the 2020 Regulations which distinguished between decisions that would be permitted if based on “pecuniary factors” or not permitted if based on “non-pecuniary factors.” This language was confusing to many and had a chilling effect on financially beneficial choices. Instead, the 2022 Final Rule adopts a “risk-return” terminology: “[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.”

Consideration of ESG Factors

The 2022 Final Rule adds regulatory text clarifying that a fiduciary’s determination with respect to an investment or investment action must be based on factors that the fiduciary reasonably determines are relevant to a risk and return analysis and such factors “may include the economic effects of climate change and other environmental, social, or governance factors.”

Significantly, the 2022 Final Rule deviated from the 2021 Proposal by removing proposed language stating that a fiduciary’s consideration of an investment “may often require” an evaluation of the effects of climate change and other ESG factors on the investment. By rejecting this proposed “may often require” language, the DOL confirms that although ESG factors may be part of a prudent evaluation of risk and return, a consideration of ESG factors is not a mandate.

Qualified Default Investment Alternative (“QDIA”) Changes

The 2022 Final Rule eliminates the 2020 Regulations’ prohibition of qualified default investment alternatives (“QDIAs”), such as a 401(k) plan’s default target date fund, that “include, consider, or indicate the use of one or more non-pecuniary factors.” In other words, the 2022 Final Rule removes the special rules for QDIAs that applied under the 2020 Regulations such that “the same standards apply to QDIAs as to investments generally.”

Amendments to the Tie-Breaker Test

Another important change to the 2022 Final Rule is its formulation of the “tiebreaker” standard, which permits fiduciaries to consider collateral benefits as tiebreakers in some circumstances. Previously, the 2020 Regulations only allowed consideration of non-pecuniary factors as a “tie-breaker” where “the plan fiduciary is unable to distinguish [between alternative investments] on the basis of pecuniary factors alone.” In contrast, the 2022 Final Rule provides a more flexible tie-breaker rule, “requir[ing] the fiduciary to conclude prudently that competing investments ... equally serve the financial interests of the plan over the appropriate time horizon.” In such cases, the fiduciary is not prohibited from selecting the investment based on collateral benefits, or non-pecuniary factors, other than investment returns. The 2022 Final Rule also eliminates the 2020 Regulations’ more elaborate documentation requirement for these tie-breaker decisions.

Participant Preferences

Further, the DOL added a provision stating that fiduciaries do not violate their duty of loyalty by participants' preferences when constructing a menu of prudent investment options for participant-directed individual account plans. The DOL explained that if accommodating participants' preferences will lead to greater participation and higher deferral rates, then it could also lead to greater retirement security. Therefore, considering whether an investment option aligns with participants' preferences can be relevant to furthering the purposes of the plan. However, the duty of prudence would still apply, and an "imprudent" investment could not be included in the plan fund menu even if participants wanted it. This clarification could have broad implication for investment selection beyond the ESG space.

Changes to Proxy Voting Rules

The 2022 Final Rule eliminates the statement in the 2020 Regulations that "the fiduciary duty to manage shareholder rights ... does not require the voting of every proxy or the exercise of every shareholder right." The DOL believed that this language could be "misread as suggesting that plan fiduciaries should be indifferent to the exercise of their rights as shareholders, even if the cost is minimal." In contrast, the 2022 Final Rule appears to indicate that in some situations at least, fiduciaries may be required to exercise shareholder rights when that is necessary to protect participants' interests.

The 2022 Final Rule also eliminates the two "proxy non-voting" safe harbors which allows sponsors to adopt a non-voting position where (1) a proposal is not "substantially related to the issuer's business activities or ... expected to have a material effect on the value of the investment" or (2) "the plan's holding in a single issuer relative to the plan's total investment assets is below a quantitative threshold."

Key Takeaway

The 2020 Regulations initially had a chilling effect on some ERISA fiduciaries' willingness to invest in private funds that integrated consideration of ESG into their investment decision-making. The 2022 Final Rule should provide increased comfort to ERISA fiduciaries who may wish to invest in such funds by empowering those retirement plan fiduciaries to consider climate change and other ESG factors when making investment decisions and exercising shareholder rights, such as proxy voting. However, despite the posturing around these regulations, the slight changes in terminology, and the shifts in a few key nuances, the 2022 Final Rule ultimately shares far more similarities with the 2020 Regulations (and previous guidance) than differences.

Despite loosening the prior regulations, the 2022 Final Rule reaffirms two long-standing principles for investment fiduciaries: *First*, the duties of prudence and loyalty require ERISA plan fiduciaries to focus on relevant risk-return factors and not subordinate the interests of participants and beneficiaries (such as by sacrificing investment returns or taking on additional investment risk) to objectives unrelated to the provision of benefits under the plan. *Second*, when a plan's assets include shares of stock, the fiduciary duty to manage plan assets includes the management of shareholder rights related to those shares, such as the right to vote proxies.

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