Something to Get ESGcited About?

DOL Finalizes ESG- and Proxy-Related Rules

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The U.S. Department of Labor (the "DOL") on December 1, 2022, released a new final regulation (the "Final Regulation") generally relating to certain aspects of the prudence and loyalty duties under the fiduciary rules of the Employee Retirement Income Security Act of 1974 ("ERISA") and to the voting of proxies under ERISA. The Final Regulation, which follows a proposed regulation released on October 13, 2021 (the "Proposed Regulation"), is the latest attempt to address the appropriateness of the consideration of environmental, social and governance ("ESG") factors in connection with investment-related decisions by fiduciaries of employee benefit plans that are subject to ERISA ("Plans"). The Final Regulation also follows a Trump Administration set of final regulations on prudence (the "Trump Administration Prudence Regulation") and another set addressing proxy voting (the "Trump Administration Proxy Regulation," and, together with the Trump Administration Prudence Regulation, the "Trump Administration Regulations").[1] The release of the Final Regulation, focused as it is on ESG, is a major development, and by transcending ERISA-centric concerns, has received broad coverage and significant attention from the mainstream press, politicians and others inside and outside of the United States who are not ERISA practitioners.

SUMMARY OF IMPACT

At its core, the Final Regulation will:

(1) Allow Plan fiduciaries to decide how and when to use ESG factors in evaluating investment options and investment courses of action so long as they do so prudently and solely in the Plan's financial interest;

(2) Continue to prohibit Plan fiduciaries from subordinating the interests of participants and beneficiaries under the Plan to other (non-Plan) objectives;

(3) Permit Plan fiduciaries to consider non-financial factors as tiebreakers when competing investment options or courses of action "equally serve the financial interests of the plan over the appropriate time horizon"; and

(4) Allow Plan fiduciaries to consider the preferences of participants in selecting investment options in defined contribution Plans, particularly where honoring such preferences may enhance participation so long as prudent.

[1] Our May 2020 OnPoint, ERISA's Social Goals? ESG Considerations Under ERISA, traces the development of the DOL's ESG-related authority over the years and contains other general background regarding ESG considerations under ERISA. The Trump Administration Regulations are discussed in our November 2020 OnPoint, An ESGplanation of ERISA's New Regulation on Social Investing, and in our December 2020 OnPoint, Voting on Principle – ERISA Proxy Regulation Finalized. Our November 2021 OnPoint, More ESGcitement From the DOL – New Proposed Investment/Proxy ERISA Regulations, discussed the Proposed Regulation. These OnPoints contain a great deal of additional background information, beyond what is presented below.

Additionally, the Final Regulation:

(1) Makes clear that the foregoing analysis applies across defined benefit plans and defined contribution plans, with no special requirements for qualified default investment alternatives ("QDIAs");

(2) Preserves flexibility in proxy voting by Plan fiduciaries (and removes two safe harbors thought to unnecessarily encourage abstention); and

(3) Addresses certain concerns that have been expressed in the market by making clear that the DOL in the Proposed Regulation was not suggesting that a fiduciary is always required to consider ESG factors, by eliminating a number of documentation and record-keeping requirements and by eliminating previous proxy-related provisions that may have had the effect of being overly prescriptive or limiting regarding proxy voting.

SUMMARY OF FINAL REGULATION

Features of the Final Regulation: ESG

- **Makes Clear that Prudence Is Paramount, but that ESG Factors May Be Considered Where Doing So Is Prudent**. An ERISA fiduciary always has a duty to act as a prudent expert in making investment decisions. The Final Regulation retains the core principle that ERISA Plan fiduciaries must focus on relevant risk-return factors and can never subordinate the interests of participants and beneficiaries under the Plan. However, the Final Regulation addresses the concern that the Trump Administration Prudence Regulation created uncertainty as to whether ESG factors may be considered and, as indicated in the preamble to the Proposed Regulation (the "Proposed Regulation Preamble"), "is having the undesirable effect of discouraging ERISA fiduciaries' consideration of climate change and other ESG factors in investment decisions, even in cases where it is in the financial interest of plans to take such considerations into account." Accordingly, the Final Regulation makes clear that ESG factors may be considered in connection with a fiduciary's investment analysis of relevant risk-return factors.

  Specifically:

  - **No Subordination of Economic Interests**. A fiduciary "may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives;"
  - **No Sacrifice of Investment Return or Acceptance of Additional Investment Risk**. A fiduciary "may not sacrifice investment return or take on additional investment risk to promote benefits or goals unrelated to interests of the participants and beneficiaries in their retirement income or financial benefits under the plan"; and
  - **No Acceptance of Expected Reduced Returns of Greater Risks**. A fiduciary may not "accept expected reduced returns or greater risks to secure [collateral] benefits."

  But:

  - **ESG Factors May Be Considered Where Fiduciary Reasonably Determines Them to Be Relevant to a Risk and Return Analysis.** A fiduciary's investment related decision "**must**

be based on factors that the fiduciary reasonably determines are relevant to a risk and return analysis and that such 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." [emphasis added].

- **ESG Weighting Should Reflect Reasonable Assessment on Impact to Risk-Return Analysis**. "The weight given to any factor by a fiduciary should appropriately reflect a reasonable assessment of its impact on risk-return."
- **There Is no Affirmative Obligation to Consider ESG Factors Where Doing So Is Not Prudent**. The Department intends to make clear that ESG factors may be relevant to risk-return analysis but do not need to be treated differently than other relevant factors.

- **Permits Tiebreakers**. A tiebreaker may be utilized where the ERISA fiduciary prudently determines that competing investment options or courses of action "equally serve the financial interests of the plan over the appropriate time horizon." In determining whether a fiduciary may select an investment based on collateral considerations, the Final Regulation moves away from the "economically indistinguishable" standard included in the proposed Trump Administration Prudence Regulation to decide among competing investment options. The DOL in the preamble to the Trump Administration Prudence Regulation (the "Trump Administration Prudence Regulation Preamble") skeptically indicated its perspective that a tiebreaker scenario was not anything more than a theoretical possibility. The Biden administration's DOL conversely signaled that it believes the tiebreaker scenario may more broadly arise in practice and is palpably more open to the view that competing investments or investment courses of action might serve a Plan's interests equally such that there may legitimately be a consideration of ancillary factors in determining which investment(s) to choose.

- **Removes Proposed Regulation's New Documentation Requirements on Tiebreakers**. The Proposed Regulation added a new disclosure requirement that has now been removed in the Final Regulation. The Proposed Regulation had indicated that where a tiebreaker analysis is used in selecting a "designated investment alternative" (including a QDIA) in a participant directed defined contribution plan like a 401(k) plan, the Proposed Regulation indicated that the "collateral-benefit characteristic of the fund, product, or model portfolio" would have to be disclosed to Plan participants so that they have "sufficient information to be aware of the collateral factor or factors that tipped the scale in favor of adding the investment option to the plan menu, as opposed to its economically equivalent peers that were not." In reaching the decision to remove these requirements, the DOL noted that it "is aware that the SEC is conducting rulemaking on investment company names, addressing, among other things, 'certain broad categories of investment company names that are likely to mislead investors about an investment company's investments and risks.'"

- **Permits Fiduciaries to Consider Participant Desires Where Doing So Is Prudent —Especially Where Doing So May Lead to Higher Participation**. The preamble to the Final Regulation (the "Final Preamble") provides that "fiduciaries do not violate their duty of loyalty solely because they take participants' preferences into account when constructing a menu of prudent investment options for participant-directed individual account plans." In addition, "[i]f accommodating participants' preferences will lead to greater participation and higher deferral rates, as suggested by commenters, then it could lead to greater retirement security. Thus, in this way, giving consideration to whether an investment option aligns with participants' preferences

can be relevant to furthering the purposes of the plan." However, the DOL stated that "plan fiduciaries may not add imprudent investment options to menus just because participants request or would prefer them."

- **Clarifies that Fiduciaries Have No Affirmative Obligation to Consider ESG Factors Where Doing So Is Not Prudent**. An ERISA fiduciary does not have an affirmative obligation to consider ESG factors where not prudent to do so. The Proposed Regulation contained language that some commenters regarded as obligating fiduciaries "to consider climate change and other ESG factors for every investment." The Final Preamble notes that "[t]he modified version of the proposed language is intended to make it clear that climate change and other ESG factors may be relevant in a risk-return analysis of an investment and do not need to be treated differently than other relevant investment factors, without causing a perception that the Department favors such factors in any or all cases."

- **Removes Proposed Regulation's Examples Seen by Some as Limiting**. The Proposed Regulation included three non-exclusive sets of examples of ESG factors that may be material to a fiduciary's risk/return analysis relating to (i) climate change, (ii) corporate governance, including board composition, executive compensation, transparency and accountability in corporate decision-making and good corporate behavior, such as avoiding criminal liability and compliance with labor, employment, environmental, tax and other laws and (iii) workforce practices, including workforce diversity and inclusion, investment in training, equal employment opportunity and labor relations. In response to commenters' concerns that these factors could be regarded as limiting, the Final Regulation removes them.

- **Eliminates the Express Restriction on ESG-themed QDIAs.** The Final Regulation eliminates the Trump Administration Prudence Regulation's prohibition on using ESG factors or investments as components for QDIAs. The Proposed Regulation Preamble stated that, if an investment alternative expressly considers climate change or other ESG factors, is financially prudent, and meets the protective standards set out in the DOL's QDIA regulation, "there appears to be no apparent reason to foreclose plan fiduciaries from considering [such investment alternative] as a QDIA," and the Final Regulation remains consistent with this proposition.

Features of the Final Regulation: Proxy Voting

As to proxy-related matters (and exercises of other ownership rights), the Final Regulation:

- **Makes Changes Intended to Avoid Interpretive Confusion and to Avoid Disincentives to the Exercise of Ownership Rights.** Like the Proposed Regulation, the Final Regulation eliminates the Trump Administration Prudence Regulation's express language that ERISA "does not require the voting of every proxy or the exercise of every shareholder right." The DOL indicated the rule changes were made because, based on stakeholder feedback, they were concerned the Trump Administration Regulations caused confusion and likely would chill fiduciaries' exercise of Plan ownership rights.

- **Reverts to Prudence, Eliminates Special Call Outs on Monitoring and Documentation Requirements**. Like the Proposed Regulation, the Final Regulation removes the Trump Administration Proxy Regulation's monitoring and documentation requirements out of concern that they could be regarded as imposing greater fiduciary obligations than would otherwise apply with respect to other fiduciary decisions.

- **Eliminates Proposed Safe Harbors**. The Final Regulation removes the two "safe harbor" examples for proxy voting policies permissible under the Trump Administration Regulations. One of these safe harbors permitted a policy to limit voting resources to types of proposals that the fiduciary has prudently determined are substantially related to the issuer's business activities or are expected to have a material effect on the value of the investment. The other safe harbor permitted a policy of refraining from voting on proposals or types of proposals when the Plan's holding in a single issuer relative to the Plan's total investment assets is below a quantitative threshold. Taken together, the Department believes that "the safe harbors encouraged abstention as the normal course and the Department does not support that position because it fails to recognize the importance that prudent management of shareholder rights can have in enhancing the value of plan assets or protecting plan assets from risk. Because of this failure, the Department believes these safe harbors do not adequately safeguard the interests of plans and their participants and beneficiaries."

- **Provides for Pooled Voting Rules.** The Final Regulation contains rules on how fiduciaries of "plan asset" pooled investment vehicles are expected to vote proxies. The Final Regulation follows the Proposed Regulation by adding an alternative pursuant to which a pooled fund manager may describe its policies in advance of a Plan investment (which policies would be deemed to be accepted by the Plan when it invests in the fund).

The Appendix hereto contains for your information, convenience and reference a chart that compares certain provisions of the Trump Administration Regulations, the Proposed Regulation and the Final Regulation.

ADDITIONAL DISCUSSION AND ANALYSIS

I. Historical Development

During the last 30 years, the DOL has issued guidance regarding ERISA's fiduciary duties in respect of Plan investments that promote objectives such as furthering environmental, social or public policy goals. The DOL has consistently indicated that ERISA does not necessarily prohibit fiduciaries from making investment decisions that reflect ESG considerations. Still the DOL has cautioned fiduciaries that they could not subordinate the interests of Plans to further ESG goals. In this regard, the operative language of the Proposed Regulation was quite clear that a "fiduciary may not . . . accept reduced returns or greater risks to secure [collateral benefits]." The DOL also has been clear that the exercise of voting rights as well as other shareholder rights connected to shares of stock are fiduciary acts subject to ERISA's fiduciary requirements.

Over the years, the debate has focused to a significant extent on (i) the extent to which ESG (and similar collateral) factors may be used to support a position that a given investment is in the best economic interests of the Plan and (ii) the circumstances in which a Plan fiduciary may choose an investment that utilizes ESG factors as a "tiebreaker" when comparing otherwise substantially identical investment propositions. Differences in the tone and tenor of the DOL's guidance in different administrations has created confusion about these investment issues and could well be described as giving rise to an unhelpful "regulatory game of ping pong."

To continue the metaphor, the Trump Administration Prudence Regulation, however, arguably converted the decades'-long game of table-tennis into one of full-fledged lawn tennis: the move to abandon sub-regulatory guidance in favor of actual regulatory language effectively moved the game to a larger playing surface. In particular, a final regulation by its very nature has greater legal significance and permanence. Unlike sub-regulatory guidance, final

regulations require formal notice and comment. Whether or not any Biden administration's effort to amend the Trump Administration Prudence Regulation will be the final say on the matter remains to be seen.

While the Trump Administration Regulations generally reflect the previous administration's overall skepticism regarding the proper role of ESG factors in fiduciary decision-making, the Final Regulation, in turn, reframes certain aspects of the ERISA regulations to bring them more in line with the current administration's approach to ESG.[2]

II. General Background

Under ERISA, a Plan fiduciary has a duty to act prudently and solely in the best interests of Plan participants and beneficiaries. The duty of prudence requires fiduciaries to act with "the care, skill, prudence and diligence of a prudent person acting in a like capacity and familiar with such matters." The duty of prudence also requires diversifying investments to minimize the risk of large losses and acting in accordance with the proper Plan documents. The duty of loyalty requires Plan fiduciaries to act "for the exclusive purpose of providing benefits to participants and beneficiaries." The Trump Administration Prudence Regulation expressed concerns that ESG considerations arguably could raise issues under the duty of loyalty that other pecuniary considerations might not raise.

The DOL's interpretations over the course of various administrations have been consistent on the fundamental point that a fiduciary may not subrogate a Plan's investment returns to accommodate ESG (or other) benefits, and ESG factors may not overtake financial considerations or be utilized at the expense of other cost indicators, such as rate of return. However, successive administrations have disagreed as to the extent to which ESG (and similar collateral) factors may be used to support a Plan fiduciary's decision to invest Plan assets.

A concept that emerged early is generally that it may be possible to use ESG-type factors as a kind of "tiebreaker," so to speak, so that collateral factors may indeed be considered when all other factors between two or more investment choices are effectively equivalent. Thus, in Interpretive Bulletin 94-1, the DOL permitted the consideration of collateral benefits in tiebreaker scenarios, such as where other financial factors were not dispositive. In 2008, DOL guidance under a Republican administration more firmly restricted investment decisions based on factors "other than the economic interest in the plan" and emphasized that tiebreakers only exist when alternatives are "truly equal" from both a quantitative and qualitative perspective. In 2015, the pendulum swung again, as DOL guidance under a Democratic administration emphasized that ESG considerations are "proper components of the fiduciary's primary analysis."

III. The Trump Administration's Regulations

The DOL under the Trump administration seemed frustrated with the vagaries surrounding ESG in the ERISA context. In the Trump Administration Prudence Regulation Preamble, the DOL said:

> As ESG investing has increased, it has engendered important and substantial questions with numerous observers identifying a lack of precision and consistency in the marketplace with respect to defining ESG investments and strategies, as well as shortcomings in the rigor of the prudence and loyalty analysis by some participating in the ESG investment marketplace. There is no consensus about what constitutes a

[2] The Final Regulation's policy objective also squares with President Biden's two earlier Executive Orders regarding climate change, released in January 2021 and May 2021.

> genuine "ESG" investment, and ESG rating systems are often vague and inconsistent, despite featuring prominently in marketing efforts . . . . In part, the confusion stems from the fact that, from its beginning, the ESG investing movement has had multiple goals, both pecuniary and non-pecuniary. Moreover, ESG funds often come with higher fees, because additional investigation and monitoring are necessary to assess an investment from an ESG perspective.

It may not be surprising then, that the DOL in the Trump Administration Prudence Regulation Preamble exhibited significant skepticism of ESG's place in an ERISA fiduciary's investment considerations, stating, for example, that:

> The purpose of this action is [to] separate the legitimate use of risk-return factors from inappropriate investments that sacrifice investment return, increase costs, or assume additional investment risk to promote non-pecuniary benefits or objectives . . . . The Department . . . cautions fiduciaries against too hastily concluding that ESG-themed funds may be selected based on pecuniary factors or are not distinguishable based on pecuniary factors . . . .

In the course of finalizing the Trump Administration Regulations, the DOL softened its proposed approach to ESG from the initial proposal, even ultimately deleting all express references to ESG. Nevertheless, the Trump Administration Regulations still effectively significantly limit the ability for ESG factors to be utilized. For example, the DOL expressed concerns in the Trump Administration Prudence Regulation Preamble that ESG investing could result in "lack of precision and consistency in the marketplace with respect to defining ESG investments and strategies, as well as shortcomings in the rigor of the prudence and loyalty analysis by some participating in the ESG investment marketplace." Similarly, regarding proxy voting, the DOL expressed in the Final Preamble that there was a "general concern that responsible fiduciaries might be accepting investment managers' proxy voting policies without sufficient review as to whether those policies comply with ERISA and, if so, whether the investment managers were complying with those policies."

IV. The Biden Administration's Response to the Trump Administration Regulations

Overview

The Proposed Regulation Preamble expressed concerns regarding the Trump Administration Regulations, stating that "the current regulation has created a perception that fiduciaries are at risk if they include any ESG factors in the financial evaluation of plan investments," and that, unlike the Trump Administration Regulations, the Proposed Regulation would make clear that "climate change and other ESG factors are often material and that in many instances fiduciaries should consider climate change and other ESG factors in the assessment and investment risks and returns."[3]

Indeed, the Proposed Regulation Preamble also expresses concern that the uncertainty surrounding the Trump Administration Regulations act as a deterring factor that would cause a fiduciary to act more ESG-adverse than other marketplace investors by creating a perception that fiduciaries are "at risk if they include any ESG factors in the financial evaluation of plan investments." The Proposed Regulation Preamble further provides that failure to consider ESG factors may "hamper fiduciaries as they attempt to discharge their responsibilities prudently and solely in the interest of plan participants and beneficiaries."

[3] Id.

The Final Regulation continues to follow this viewpoint by indicating that "rather than provide clarity, some aspects of the [Trump Administration Regulation] . . . may have created further uncertainty about whether a fiduciary under ERISA may consider ESG and other factors in making investment and proxy voting decisions that the fiduciary reasonably believes will benefit the plan and its participants and beneficiaries. Many stakeholders questioned whether the Department rushed the current regulation unnecessarily and failed to adequately consider and address substantial evidence submitted by public commenters suggesting that the use of climate change and other ESG factors can improve investment value and long-term investment returns for retirement investors." Additionally, the Final Preamble indicates that the Trump Administration Regulations "appeared to express [an unnecessary] skepticism about fiduciaries' reliance on ESG considerations," especially because those regulations "cautioned fiduciaries against 'too hastily' concluding that ESG-themed funds may be selected based on pecuniary factors."

General Scope

In keeping with Biden administration priorities, the Final Preamble expressly contemplates that fiduciaries could consider "[c]limate 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."

The Proposed Regulation Preamble and the Final Preamble also make clear that: "governance factors, such as those involving board composition, executive compensation, transparency and accountability in corporation decision-making," and a corporation's "avoidance of criminal liability and compliance with labor, employment, environmental, tax and other applicable laws and regulations" may be considered by a fiduciary; and "workforce practices, including the corporation's progress on workforce diversity, inclusion, and other drivers of employee hiring, promotion, and retention; its investment in training to develop its workforce's skill; equal employment opportunity; and labor relations" may also be considered by a fiduciary.

The Proposed Regulation Preamble notes that "[t]he list of examples . . . is not exclusive" and the Final Regulation indicates that "[t]he foregoing examples are merely illustrative, and not intended to limit a fiduciary's discretion to identify factors that are relevant with respect to its risk/return analysis of any particular investment or investment course of action. A fiduciary may reasonably determine that a factor that seems to fall within a general category described above (e.g., climate-related factors), but is not specifically identified above, nonetheless is relevant to the analysis (e.g., drought)." The Final Preamble also states that "relevant factors may include impact on communities in which companies operate, due diligence and practices regarding supply chain management, including environmental impact, human rights violations records, and lack of transparency or failure to meet other compliance standards," as well as "labor-relations factors, such as reduced turnover and increased productivity associated with collective bargaining, also may be relevant to a risk and return analysis."

The Final Preamble notes that ultimately "a fiduciary's determination of relevant factors is not limited to the general categories described above. Prudent investors commonly take into account a wide range of financial circumstances and considerations, depending on the particular circumstances, such as a corporation's operating and financial history, capital structure, long-term business plans, debt load, capital expenditures, price-to-earnings ratios, operating margins, projections of future earnings, sales, inventories, accounts receivable, quality of goods and products, customer base, supply chains, barriers to entry, and a myriad of other financial factors, depending on the particular investment." Acknowledging general principles, the DOL stated that the Final Regulation is not intended to "supplant

such considerations, but rather makes clear that there is no inconsistency between the appropriate consideration of ESG factors" and the duty of prudence under ERISA, which requires that the fiduciary act with "care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

Financial Analysis

The Proposed Regulation allowed ESG factors to be considered in connection with a fiduciary's investment analysis. The Proposed Regulation Preamble notes that "consideration of the projected return of the portfolio relative to the funding objectives of the Plan may often require an evaluation of the economic effects of climate change and other ESG factors" and that a fiduciary's calculus "may often require an evaluation of the effect of climate change and/or government policy changes to address climate change on investments' risks and returns" and that "climate-related financial risk[s] . . . are, in appropriate cases, risk-return factors that fiduciaries should take into account when selecting and monitoring plan investments and investment courses of action." The Final Regulation follows this approach.

The Final Regulation provides expressly that consideration of ESG factors may be consistent with the fiduciary duty of prudence and that a fiduciary would be permitted to consider any factor relevant to the risk-return analysis, including ESG factors. Particularly, ESG factors would be able to be part of a risk-return analysis and they would be treated no differently from other "traditional" risk-return factors. Under the Final Regulation, a fiduciary's determination with respect to an investment decision or a course of investment action should be "relevant to a risk and return analysis."

The Final Preamble states that it is "particularly concerned that the [Trump Administration Prudence R]egulation created a perception that fiduciaries are at risk if they consider any ESG factors in the financial evaluation of plan investments and that they may need to have special justifications for even ordinary exercises of shareholder rights." The Final Preamble emphasizes that the consideration of ESG related factors, like other metrics, may be relevant to the risk-reward analysis. Thus, a basic purpose of the Final Regulation is "to make it clear that 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 and that such 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."

Elimination of the Proposed Regulation's "May Often Require" Language

The Proposed Regulation included regulatory text that stated that, when considering projected returns, a fiduciary's duty of prudence may often require an evaluation of the economic effects of climate change and other ESG factors on the particular investment or investment course of action.

The DOL eliminated this language in the Final Regulation, noting in the Final Preamble that it "was not intended to create an effective or de facto regulatory mandate. Nor was the language intended to create an overarching regulatory bias in favor of ESG strategies." The DOL clarified that the Final Regulation's operative text "is intended to make it clear that climate change and other ESG factors may be relevant in a risk-return analysis of an investment and do not need to be treated differently than other relevant investment factors, without causing a perception that the Department favors such factors in any or all cases." The DOL noted that, "[b]y declining to carry forward the 'may often require' clause . . . the final rule achieves appropriate regulatory neutrality and ensures that plan fiduciaries do

not misinterpret the final rule as a mandate to consider the economic effects of climate change and other ESG factors under all circumstances." Instead, the Final Preamble states that the Final Regulation "makes clear that a fiduciary may exercise discretion in determining, in light of the surrounding facts and circumstances, the relevance of any factor to a risk-return analysis of an investment. A fiduciary therefore remains free under the final rule to determine that an ESG-focused investment is **not** in fact prudent. [emphasis in original]" Thus, the Final Regulation opts for a "principles-based" test under which:

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

Elimination of the Proposed Regulation's ESG Examples

The Proposed Regulation contained a list of three examples of ESG related factors that might be considered by Plan fiduciaries. These included climate change related factors, governance factors and workforce practices. The Final Preamble states: "The list of examples was never intended to be exclusive; nor was it intended to define 'ESG' or introduce any new conditions under the prudence safe harbor . . . . The list of examples was merely intended to reaffirm that fiduciaries may consider ESG factors that are relevant to a risk-return analysis of the investment." In light of the DOL's concerns regarding how the examples might be perceived, the Final Regulation does not include the examples.

Tiebreakers Permitted

The Final Regulation adopts the Biden administration's more favorable approach to the tiebreaker rationales, rather than the approach of the DOL of the Trump administration, which was less favorable to the tiebreaker rationale. Specifically, the Final Regulation states that:

> If a fiduciary prudently concludes that competing investments, or competing investment courses of action, equally serve the financial interests of the plan over the appropriate time horizon, the fiduciary is not prohibited from selecting the investment, or investment course of action, based on collateral benefits other than investment returns. A fiduciary may not, however, accept expected reduced returns or greater risks to secure such additional benefits.

The Proposed Regulation Preamble states that where "a fiduciary prudently concludes that competing investments or competing investment courses of action equally serve the financial interests of the plan over the relevant time horizon, the fiduciary is not prohibited from selecting the investment, or investment course of action, based on collateral benefits other than investment returns." The Final Regulation stays this course. The Final Preamble states that the "imposition of a standard that effectively requires investments to be precisely identical therefore is both impractical

and unworkable." Thus, the Final Preamble states: "[Because i]nvestments can and do differ in a wide range of attributes, but when considered in their totality, may serve the financial interests of the plan equally well[,] the 'equally serve' standard comports with the realities of fiduciary decision-making and firmly protects participant retirement benefits, since it strictly forbids the subordination of plans' and participants' financial interests to any other objective."

Rejecting calls for the removal of any tiebreaker, the Final Preamble states that "there has been some mostly semantic variation in what constituted ties under the Department's prior non-regulatory guidance, some version of the tiebreaker test has appeared in the [ERISA regulations] since 1994." The DOL continued that "the tiebreaker test thus aligns the final rule with the settled expectations of fiduciaries and others involved in the investment of assets of employee benefits plans under ERISA." The DOL's specifically confirmed that its approach applies "especially in the multiemployer plan context."

The DOL also indicated that in many cases, a tiebreaker may not be necessary, and that it "is choosing to leave [the decision whether or not a tiebreaker is even appropriate] in the hands of fiduciaries, who are charged with choosing among investment alternatives that equally serve the financial interests of the plan." As an example of where tiebreakers may not be needed, the DOL stated: "Fiduciaries without a need to break a tie while selecting investments need not use the provision. This may be the case, for example, with respect to participant-directed individual account plans where adding additional investment options is not necessarily a zero-sum game, such that the fiduciary may choose only one option." In addition, the DOL stated that, "when there is a need to break a tie, there is nothing in the regulation that requires fiduciaries to look to climate change or other ESG factors to break the tie."

As was the case under the Trump Administration Prudence Regulation, investment alternatives must be reviewed based on risk and return factors in order for the door to be open to using ESG factors as tiebreakers. However, a tiebreaker would be permissible as long as both alternatives "equally serve the financial interests of the plan over the appropriate time horizon."[4] Indeed, confirming that prudence is paramount, however, the DOL expressly reminded fiduciaries that the "tiebreaker provision remain[s] subject to ERISA's prudence requirements . . . [and] subject to the explicit prohibition against accepting expected reduced returns or greater risks to secure such additional benefits."

No Special Tiebreaker Disclosure

The Proposed Regulation contained a disclosure requirement within the tiebreaker test limited to participant-directed individual account plans. Specifically, the Proposed Regulation would have provided that, if a Plan fiduciary selected an investment, or investment course of action, based on collateral benefits other than investment returns, "the plan fiduciary must ensure that the collateral-benefit characteristic of the fund, product, or model portfolio is prominently displayed in disclosure materials provided to participants and beneficiaries." This requirement was not adopted in the Final Regulation. In this regard, the DOL acknowledged that it "is aware that the SEC is conducting rulemaking on investment company names, addressing, among other things, 'certain broad categories of investment company names that are likely to mislead investors about an investment company's investments and risks.'"

Participant Input as a Positive Factor

[4] But cf., e.g., Burgess, "$41 Billion Pension Fund Settles Australian Climate Change Lawsuit" (Bloomberg Green, Nov. 1, 2020 (updated Nov. 2, 2020)) (reporting on the settlement of a claim brought in the case of *McVeigh v. Retail Employees Superannuation Trust* against an Australian pension fund to the general effect that the fund was not sufficiently protecting retirement savings against the impact of rising world temperatures).

The DOL specifically stated in the Final Preamble that a "plan fiduciary of a participant-directed individual account plan does not violate the duty of loyalty . . . solely because the fiduciary takes into account participants' preferences consistent with requirements [of the Final Regulation]." The DOL went on to say: "If accommodating participants' preferences will lead to greater participation and higher deferral rates, then it could lead to greater retirement security." Thus, it continues, "in this way, giving consideration to whether an investment option aligns with participants' preferences can be relevant to furthering the purposes of the plan." While consideration of ESG factors may be viewed as a potential positive insofar as it may achieve greater participation, the DOL cautioned: "At the same time, however, plan fiduciaries may not add imprudent investment options to menus just because participants request or would prefer them."[5]

QDIAs

The Trump Administration Prudence Regulation prohibits the use of ESG factors or investments as components for QDIAs. The Final Preamble describes this provision as "unnecessary" and goes on to state that maintaining the provision "will only serve to harm participants. It would . . . effectively preclude fiduciaries from considering QDIAs that include ESG strategies, even where they were otherwise prudent or economically superior to competing options." The DOL concluded by stating it "sees no reason to deprive participants of such options." The elimination of this prohibition could well be enormously significant as a practical matter given the growth of QDIA investment options and their use by Plan participants.

V. Final Regulation: Proxy Voting

In General

The promulgation of the Trump Administration Proxy Regulation was arguably an effort by the Trump administration to curtail what it believed was pervasive activist voting by Plans on collateral considerations. The Final Regulation departs from this premise and is more concerned that the Trump Administration Proxy Regulation could have been "misread as suggesting that plan fiduciaries should be indifferent to the exercise of their rights as shareholders, even if the cost is minimal."

As with its more general ESG-related portions, the Final Regulation conforms to basic standards of prudence consistent with the general fiduciary rules under ERISA. While indicating that shareholder rights are fundamental to Plans, the Final Preamble makes note of the fact that voting proxies in every situation may not be cost effective or appropriate. The DOL seems here to be taking a flexible approach that may be less prescriptive than it had under the Trump administration.

Removal of "Does Not Mean Fiduciaries Must Always Vote Proxies or Engage in Shareholder Activism"

The Final Regulation deletes express language in the Trump Administration Proxy Regulation that stated that the regulation "does not mean that fiduciaries must always vote proxies or engage in shareholder activism." The Final Preamble clarifies, however, that "[prudent fiduciaries] should take steps to ensure that the cost and effort associated with voting a proxy is commensurate with the significance of an issue to the plan's financial interests. The solution to

[5] Indeed, the Final Preamble quotes the following passage from the Trump Administration Prudence Regulation for support: "Nothing in the final rule precludes a fiduciary from looking into certain types of investment alternatives in light of participant demand for those types of investments. But in deciding whether to include such investment options on a 401(k)-style menu, the fiduciary must weigh only pecuniary . . . factors."

proxy-voting costs is not abstention, but is, instead, for the fiduciary to be prudent in incurring expenses to make proxy decisions and, wherever possible, to rely on efficient structures (e.g., proxy voting guidelines, proxy advisors/managers that act on behalf of large aggregates of investors, etc.)." The Final Preamble also urges fiduciaries to use prudence in selecting and monitoring proxy advisory firms. In a nod to other regulatory initiatives, the Final Preamble states that, "in 2020, the U.S. Securities and Exchange Commission adopted final rules that were intended to help ensure that investors who use proxy voting advice receive more transparent, accurate, and complete information on which to make their voting decisions. Information required to be provided pursuant to those final rules also may be useful to responsible plan fiduciaries relying on recommendations from proxy advisory firms."

Removal of Record Retention Requirement

In the Proposed Regulation, the DOL proposed to eliminate the requirement contained in the Trump Administration Proxy Rule that, when deciding whether to exercise shareholder rights and when exercising shareholder rights, Plan fiduciaries must specifically maintain records on proxy voting activities and other exercises of shareholder rights. There, the DOL "was concerned that the provision appeared to treat proxy voting and other exercises of shareholder rights differently from other fiduciary activities and might create a misperception that proxy voting and other exercises of shareholder rights are disfavored or carry greater fiduciary obligations, and therefore greater potential liability, than other fiduciary activities. Such a misperception could be harmful to plans, as it could potentially chill plan fiduciaries from exercising their right or result in excessive expenditures as fiduciaries over-document their efforts."

While the DOL retained this deletion in the Final Regulation, it also noted that it "does not disagree with the need for proper documentation of fiduciary activity." Thus, under general principles, "the fiduciary must be able to review periodically not only the voting procedure pursuant to which the investment manager votes the proxies appurtenant to plan-owned stock, but also the actions taken in individual situations so that a determination can be made whether the investment manager is fulfilling their fiduciary obligations in a manner which justifies the continuation of the management appointment." Concluding that no specific provision is required in the Final Regulation, the DOL indicated that maintaining the condition that had been contained in the Trump Administration Regulation "could be viewed by some as treating proxy voting and other exercises of shareholder rights differently from other fiduciary activities and may create a misperception that proxy voting and other exercises of shareholder rights are disfavored or carry greater fiduciary obligations, and therefore greater potential liability, than other fiduciary activities."

Removal of Specific Monitoring Requirement

The Final Regulation also deletes the Trump Administration Proxy Regulation provision that set out specific monitoring obligations with respect to use of investment managers or proxy voting firms. The Final Regulation instead addresses such monitoring obligations in another provision of the regulation that more generally covers selection and monitoring obligations. The Final Preamble worries that these Trump Administration provisions "could be read as requiring special obligations above and beyond the statutory obligations of prudence and loyalty that generally apply to monitoring the work of service providers" and that it would "create a higher standard in monitoring proxy voting activities of parties delegated such responsibilities."

Pooled Plan Asset Funds

The Final Regulation requires that a "plan asset" pooled investment vehicle with more than Plan investor must vote in proportion to each Plan's economic interest in the pooled investment vehicle. The Proposed Regulation indicated that

an investment manager may, however, develop an investment policy statement consistent with Title I of ERISA, and require participating Plans to accept the investment manager's investment policy statement, including any proxy voting policy, before they are allowed to invest. The DOL rejected calls in the Final Regulation for eliminating this provision. But it did recognize commenters' practical observation that most "plan asset" pooled funds would adopt the alternative. The DOL declined "to reorder the provisions . . . solely to put more emphasis on the exception to the proportional voting provision."

Removal of Two Safe Harbors

The Final Regulation eliminates two safe harbors contained in the Trump Administration Proxy Regulation. One was applicable where the fiduciary had prudently determined the proposal subject to a proxy vote was substantially related to the issuer's business activities or was expected to have a material effect on the value of the investment. The other permitted a policy of refraining from voting on proposals when the Plan's holding in a single issuer relative to the plan's total investment assets was below a quantitative threshold. The DOL was concerned that the safe harbors do not adequately safeguard the interests of Plans and their participants and beneficiaries. "Taken together, the Department believes the safe harbors encouraged abstention as the normal course and the Department does not support that position because it fails to recognize the importance that prudent management of shareholder rights can have in enhancing the value of plan assets or protecting plan assets from risk. Because of this failure, the Department believes these safe harbors do not adequately safeguard the interests of plans and their participants and beneficiaries." In this regard, the Final Preamble notes that the DOL "has never taken the position that ERISA requires fiduciaries to cast a proxy vote on every ballot item. Thus, it follows that abstention or not voting on a matter or matters may be appropriate and not a violation of ERISA, from the Department's perspective. Voting rights, however, are a type of plan asset and, in the Department's view, an important tool to protect the plan's investment."

EFFECTIVE DATE

The Final Regulation generally becomes effective on January 29, 2023, however two provisions concerning proxy voting have immediate effect as of December 1, 2022: (i) a fiduciary may not adopt a practice of following the recommendations of a proxy advisory firm or other service provider without a determination that such firm or service provider's proxy voting guidelines are consistent with the fiduciary's obligations, and (ii) the provisions relating to pooled investment vehicles (including the alternative methodology of permitting pooled fund sponsors to disclose their proxy voting policies for consideration by investing Plan fiduciaries).

CONCLUSION

Given the focus of climate-change policy generally in the Biden Administration, it was not surprising that the release of the Final Regulation was accompanied with some fanfare from the White House. The DOL News Release announcing the Final Regulation trumpets: "Climate change and other environmental, social and governance factors can be useful for plan investors as they make decisions about how to best grow and protect the retirement savings of America's workers." Media outlet after media outlet has reported how the Final Regulation frees Plan fiduciaries up to consider ESG factors in their decision-making. In this regard, the Final Regulation has been pitched as greatly easing impediments in the Trump Administration Regulations to the consideration of ESG factors by fiduciaries in their decision-making processes.

But there is more than mere perception at work here. The Final Regulation does eliminate specific requirements as to process-related documentation and how fiduciaries need to consider specific substantive considerations. In addition, the express skepticism that a true tiebreaker scenario may arise as a practical matter, which was palpable in some of the pronouncements of the Trump Administration, is now clearly gone. And there are other areas in which the rules have been loosened, as discussed above.

However, the Final Regulations necessarily exist in the context of statutory rules promulgated by Congress under which prudence and loyalty regarding the decision-making is not only paramount but also central. Indeed, on close examination, the basic tenor of the Final Regulation does not depart from this fundamental principle. Thus, the Secretary of Labor has stated, "Today's rule clarifies that retirement plan fiduciaries can take into account the potential financial **benefits** of investing in companies committed to positive [ESG] actions as they help plan participants make the **most** of their retirement benefits. [emphasis added]" And, even where laying out the feasibility of using ESG factors as a tiebreaker, the DOL specifically emphasized that "the final rule maintains the longstanding principle that fiduciaries may not accept lower expected returns or take on greater risks to secure collateral benefits."

Historically, regulatory tonal shifts over the years regarding ESG have been perceived by some as having an impact on fiduciary behavior (and, by extension, investment managers generally). Over the years, as fiduciaries have felt that the government is less (or more) hostile to the taking into account by fiduciaries of ESG considerations, they arguably have felt less (or more) constrained to focus on ESG factors if inclined to do so. In addition, here, there are a number of specific substantive changes, which we have addressed above, that will be relevant to the inquiry. It will be interesting to see if and how the Biden administration's approach to climate change and other matters relating to ESG, together with the substantive changes that have been made over the course of finalizing the guidance, will impact fiduciaries (and other investment managers) as a practical matter.

So where does that presently leave the ESG-related inquiry under ERISA? On the one hand, fiduciaries may well find themselves more easily able to consider ESG factors as they make their fiduciary decisions, particular with a DOL under an administration that is not generally hostile to the consideration of ESG factors. It may be argued that the Final Regulation is more balanced in their approach to relaxing restrictions on considering ESG than as compared with objections to the consideration of ESG factors that were expressed by the Trump Administration. On the other hand, it is arguably the case that an enduring high-level effect of the Trump Administration Regulations, even after its replacement with the Final Regulation, will be an increase in the focus of Plan fiduciaries and managers on affirmatively identifying the positive economic impact of ESG benefit or ESG-type thinking, as opposed to proceeding on the basis that considering ESG may not be harmful to economic returns.

Regardless of where we are currently, there may be those in a future administration who see the opportunity for what they consider to be additional improvements. But, unlike earlier pronouncements, the Final Regulation could be seen as an attempt to move the starting point more to the middle of the range of outcomes, with the hope that pendulum swings, if any, would be more measured than dramatic. If physics is an appropriate guidepost perhaps any equal and opposite reaction to the Final Rule could be incremental. But the laws of physics break down not only in black holes but in politics as well. In other words, stay tuned.

APPENDIX
COMPARISON CHARTS

ESG-RELATED PROVISIONS

Rule Feature	Trump Administration Regulations (2020)	Proposed Regulation (2021)	Final Regulation (2022)
Appropriate consideration of . . .	"Appropriate consideration" includes: • Determination that investment is reasonably designed to further plan purpose taking into account risk of loss and opportunity for gain compared to reasonably available alternatives • Consideration of: 1) diversification, 2) liquidity, and 3) projected return relative to funding objectives	Retains same provisions as Trump Administration Regulations (2020) but includes "may often require an evaluation of climate change" and other ESG factors in the consideration of funding objectives.	Provides for same provisions as Proposed Rule (2021) but: • Clarifies that consideration of diversification, liquidity and funding objectives is not applicable to participate-directed individual account plans • Removes "may often require an evaluation of climate change" and other ESG factors from funding objectives considerations
Standard for factors to be evaluated in investment decision	Only pecuniary factors	Any factor material to risk-return analysis	Relevant risk and return factors
ESG-specific reference for factors to be evaluated	No reference to ESG in the text	Material risk-return factors might include: 1) Climate change; 2) Governance; and 3) Workforce practices	• Risk-reward factors may include economic effects of climate change and other ESG factors • Whether factor is risk-return factor depends on facts and circumstances • No other specific ESG language
"Tiebreaker" Test	• When unable to distinguish investment alternatives on basis of pecuniary factors alone may use non-pecuniary factors as deciding factor • Specific documentation required	• If competing investments equally serve financial interests of the plan based on risk and return factors, not prohibited from selecting investment based on collateral benefits other than investment returns • Specific disclosures required only if selected as designated alternative for individual account plan	Same provision as Proposed Regulation but no specific disclosures required.
Participant Directed Plan Investment Options Generally	Specifically notes duties of prudence and loyalty apply to investment option selection and QDIAs not permitted to use any non-pecuniary factors	No specific participant directed plan rules except for "Tiebreaker" Test specific disclosures	• General prudence requirement applies to selection of menu of investment options • Fiduciary of participant directed plan does violate duty of loyalty solely because participant preference taken into account so long as it meets prudence requirement
QDIAs	QDIAs not permitted to include any non-pecuniary factors	No specific QDIA provisions (other than those applicable generally to individual account plan designated alternatives under "Tiebreaker" Test)	No specific QDIA provisions

PROXY-RELATED PROVISIONS.

Rule Feature	Trump Administration Final Regulations (2020)	Proposed Regulation (2021)	Final Regulation (2022)
Proxy Voting	• Provides fiduciary duty includes management of shareholder rights such as right to vote proxies • Exercising shareholder rights subject to duties of prudence and loyalty • States ERISA does not require voting of every proxy or exercise of every shareholder right • Specific monitoring obligations for Plans' investment managers and proxy voting firms • Two safe harbors permit refraining from exercising proxy votes where certain parameters are met • Specific documentation requirement on proxy voting activities	• Retains provisions that fiduciary duty includes management of shareholder rights such as right to vote proxies and exercising shareholder rights subject to duties of prudence and loyalty • Removes statement providing ERISA does not require voting of every proxy or exercise of every shareholder right • Removes specific monitoring obligations • Removes safe harbors • Removes specific documentation requirement on proxy voting activities	Generally retains same provisions as Proposed Regulation

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