

# Retirement Spotlight

Illuminating current industry news and events

December 21, 2022

## DOL's Final ESG Rule Clarifies Duties

Retirement plan assets should be invested prudently to obtain the best possible financial returns, of course. But what if your plan invests in a company that conducts business in a way that violates your ethical values? For example, is it okay for a plan administrator to buy stock in a company with a record of environmental violations and polluting with impunity? Should that behavior affect whether a company qualifies as a suitable retirement plan investment? Is it possible, or even likely, that a company that responsibly produces a similar product may actually be a better choice, measured both by investment returns and by other factors?

The Department of Labor (DOL) has released a [final rule](#) intended to help answer this question. For decades, the DOL has addressed the tension between the investment duties of plan administrators and the concerns about the environmental, social, and governance (ESG) actions of the companies that plans invest in. In this latest guidance, the DOL amends the “Investment Duties” regulation, and this final rule will generally become effective on January 30, 2023, with the provisions related to proxy voting effective December 1, 2023.

### Background

The Employee Retirement Income Security Act (ERISA) requires that plan fiduciaries act as prudent experts in providing participants and beneficiaries with benefits. When investing plan assets—or in choosing a menu of investments for participant-directed plans—such fiduciaries must weigh the risks of each investment against the likelihood of appropriate returns. This fundamental rule remains the cornerstone for fiduciaries’ investment decisions.

But each federal administration seems to want to leave its mark on how investment decisions must be made. In keeping with this longstanding practice, the previous administration, in the last two months of 2020, released two final rules (the “2020 rule(s)”) that became effective in January 2021. One rule sought to clarify how fiduciaries should properly exercise a plan’s proxy-voting responsibilities when a plan owns shares of stock. The second rule—among other things—stated that a plan fiduciary’s investment decisions must be based solely on “pecuniary factors” (that is, financial criteria), without considering other factors such as long-term climate impact.

On his first day in office, President Biden signed an executive order that directed federal agencies to review any regulations from the previous four years that were inconsistent with improving public health, protecting the environment, and adapting to climate change. Shortly after that, the DOL announced that it was reviewing the 2020 rules and that it would take no enforcement action against any plan fiduciary failing to comply with those rules. In October 2021, the DOL released proposed rules amending the 2020 rules. These new rules were intended to address the uncertainty created by the 2020 rules. In fact, the DOL clearly acknowledges that “the tone and tenor of guidelines across Administrations during approximately 40 years have contributed to confusion among stakeholders about these investment issues.” And demonstrating the significant interest that “stakeholders” have in this matter, the DOL received some 900 written comments, both supporting and opposing the new rules.

## What's changed from the proposed rule?

The final rule leaves intact two longstanding principles. First, the final rule retains the core principle that the duties of prudence and loyalty require ERISA plan fiduciaries to focus on relevant risk-return factors. They must not subordinate the interests of plan participants and beneficiaries to objectives unrelated to the provision of benefits under the plan. But importantly, ESG factors may be considered in evaluating investments' risks and returns. Second, when plan assets include shares of stock, fiduciaries must responsibly manage any shareholder rights relative to those shares, including the right to vote proxies.

The new final rule contains several important changes that clarify the duties that ERISA imposes on plan fiduciaries.

- **ESG factors may be part of risk-return analysis.** The final rule specifically includes ESG factors “that the fiduciary determines are relevant to a risk and return analysis, using appropriate investment horizons consistent with the plan’s investment objectives . . . .” Such an analysis might include, for example, giving weight to the likelihood that investing in an alternative energy company will be a prudent long-term plan investment. The final rule also removes the 2020 rule text that prohibits fiduciaries from considering any non-pecuniary factors in selecting investments.
- **Qualified default investment alternatives (QDIAs) play by the same rules.** QDIAs are investments that employers use when those in a participant-directed plan have not selected how to invest their account assets. Among other things, these default funds are supposed to achieve reasonable growth while protecting principal. The 2020 rules contained a provision that prohibited a fiduciary from considering any non-pecuniary factor in choosing a QDIA. The final rule deletes this provision and clarifies that prudently selecting a QDIA generally involves the same analysis as selecting other plan investment options.
- **The new rules clarify ERISA’s duty of loyalty.**
  - *The “tiebreaker test” revised* – The 2020 rules required investment options to be “economically indistinguishable” before using any non-pecuniary factors, such as ESG considerations. Now, the final rule states that the fiduciary must prudently conclude that investments “equally serve” the plan’s financial interests over the appropriate time horizon. This new standard seems to provide a more practical approach to investment selection, recognizing that “collateral benefits” may be considered when comparing investments with similar risk-return characteristics.
  - *Participant-directed plans have more latitude* – Most 401(k) plans permit participants to select their own account investments from a menu of options that the employer chooses. The final rule clarifies that fiduciaries will not violate their duty of loyalty merely because they consider participants’ non-financial preferences when choosing a plan’s investment menu. This allows employers to tailor the menu to include investments that take into account the unique investment objectives of their employees. By accommodating participants’ preferences, more employees may choose to participate in the plan—with higher deferral rates.
- **The final rules contain three changes to shareholder rights, including proxy voting.** Fiduciaries of plans that contain shares of stock can typically vote on corporate matters, just as other shareholders do. Sometimes stockholders will delegate their voting rights to others (proxies). Because shareholder votes can directly affect a company’s course of business, it is a responsibility that must be taken seriously.
  - Text in the 2020 rule stated that “the fiduciary duty . . . does not require the voting of every proxy or the exercise of every shareholder right.” The final rule deletes this passage because it could suggest that “fiduciaries should be indifferent to the exercise of their rights as shareholders.” By removing this text, the DOL seems to be emphasizing the importance of plan fiduciaries generally exercising their right to vote the shares of stock that the plan owns.
  - The DOL removed two examples from the 2020 rules. The DOL was concerned that these examples would encourage fiduciaries to *refrain* from exercising voting rights “as the normal course.” Again, this change stresses “the importance of prudent management of shareholder rights in enhancing the value of plan assets or protecting the assets from risk.”
  - The third change in the final rules regarding proxy voting removes certain recordkeeping burdens for fiduciaries. These additional requirements in the 2020 rule “risk[ed] creating a misperception that proxy

voting and other exercises of shareholder rights are disfavored or carry greater fiduciary obligations than other fiduciary activities.”

## Practical Effects of the New Rule

The new, final rule may not have a big impact on many participant-direct retirement plans. Fiduciaries have typically offered a fairly broad array of investment choices, ranging from low-yield, principal-preservation funds to target date funds to more speculative small-cap funds. But these plan fiduciaries may now feel more comfortable offering funds that appeal more specifically to participants and beneficiaries who are inclined to favor certain ESG investment objectives. And while those responsible for selecting plan investment options must continue to adhere to the duties of prudence and loyalty to plan participants, they may also gain more latitude in offering prudent options that also accommodate those with ESG investment preferences.

Certain retirement plans—such as defined benefit plans and some defined contribution plans—rely on the fiduciary’s investment choices to meet funding obligations or to provide reasonable returns. Most fiduciaries—especially those subject to plan funding requirements—have a vested interest in providing high performing investments. Having the option to consider ESG factors could open a new realm of investment options that fiduciaries may have been reluctant to invest in until now. And for that relatively small number of defined contribution plan fiduciaries that do not allow participant direction, ESG investments may be more attractive than ever. If such a fiduciary considers environmental, social, and governance factors in the risk and return analysis—and reasonably determines that the investment is prudent in relation to other options—the fiduciary may select that investment with much more confidence under the final rule.

In our rapidly changing global economy, there may be plan investments that were unheard of just a few short years ago. And undoubtedly, new investment opportunities will arise that we do not yet contemplate. Fiduciaries may prudently invest plan assets for maximum returns while at the same time investing in enterprises that align with certain ESG objectives. Equipped with the DOL’s new approach, plan fiduciaries may be more inclined to select investments that do well—and do good.