December 1, 2022

DOL Revises ERISA Investment Rules to Facilitate Consideration of ESG Factors in Plan Investments and Proxy Voting

Under final rules released by the Department of Labor ("DOL") on November 22, 2022, ERISA fiduciaries will be able to consider environmental, social and governance ("ESG") factors when making investment decisions and exercising shareholder rights, including proxy voting. The revised rules, which largely align to the October 2021 proposal discussed in our prior memo, reverse rulemaking from the Trump administration but will come into force amid a wave of anti-ESG backlash. Led by state attorneys general and congressional representatives, such anti-ESG actions include state legislation curtailing the ability of state pension funds to consider ESG factors and boycotts of asset managers deemed to have ESG-aligned investment policies.

Use of ESG Factors. The final rule does not change the core tenet that ERISA's prudence standard requires an investment fiduciary to focus on relevant risk-return factors and to not subordinate the interests of participants to objectives unrelated to the provision of benefits under the plan. The revised rules clarify, however, that in determining the factors that are relevant to risk and return, a fiduciary may consider the economic impacts of climate-related risks and other environmental, social and governance factors.

The final rule also amends the existing "tie-breaker" test to provide greater flexibility for the consideration of ESG factors. Prior Trump-era regulations required that competing investments be economically indistinguishable before the fiduciary could consider collateral factors (other than investment returns), and imposed special documentation requirements. The final rule imposes a more flexible standard that competing investment choices "equally serve the financial interest of the plan" before enabling fiduciaries to consider collateral benefits, and do not apply special documentation requirements to ESG decisions. Fiduciaries would still need to meet ERISA's generally applicable standards, such as prudently documenting plan affairs.

Participant-Directed Plans. With respect to participant-directed account plans, the final rule provides that fiduciaries may consider participants' preferences when developing investment options for participant-directed individual account plans. Commenters had sought clarification whether participants' policy, social or value preferences could be used to construct menus for participant-directed investment options. Consistent with the proposed rule, the final rules also eliminate special standards applicable to qualified default investment alternatives ("QDIAs"), which, under the current Trump-era rule, may not include any investment fund, product or model portfolio "if its investment objectives or goals or its principal investment

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strategies include, consider, or indicate the use of one or more nonpecuniary factors." Instead, the DOL does not foreclose plan fiduciaries from considering a fund as a QDIA on the basis that the fund expressly considers climate change or other ESG factors, so long as it meets the otherwise applicable fiduciary standards.

Proxy Voting. The final rule implements the previously proposed amendments to encourage the exercise of shareholder voting rights in the context of all proposals, including on ESG matters, in recognition that prudent management of shareholder rights can impact the value of plan assets. The new regulations remove the Trump-era statement that "the fiduciary duty to manage shareholder rights . . . does not require the voting of every proxy or the exercise of every shareholder right." The final rule also eliminates two Trump-era safe harbors that the DOL believes encouraged "abstention as normal course" by allowing fiduciaries to rely on (i) a policy of limiting voting resources to particular types of proposals that the fiduciary deems important to the issuer's business activity or are expected to have a material effect on an investment's value, and (ii) a policy of refraining from voting on proposals when the plan's holding in an issuer is below a specified threshold relative to its total investments. Through these changes, the DOL aims to underscore the importance of prudent management of shareholder rights to plan returns and risk mitigation.

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The final rules reflect continued federal regulatory support for permitting the consideration of ESG investment factors in making investments under retirement plans and in exercising shareholder voting rights on behalf of such plans. However, certain state legislatures have sought to oppose and curtail such efforts. Boards and management should continue to monitor the evolving ESG landscape and priorities among different subsets of investors.

The final rule will be effective 60 days after publication in the Federal Register.

David M. Silk
David A. Katz
Alicia C. McCarthy
Carmen X. W. Lu
Ram Sachs