LEGAL UPDATE

DOL Rule Permits Consideration of Climate and ESG Factors and Codifies Proxy Voting Responsibilities

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[Editor's Note: This month's Legal Update continues our coverage of the new DOL Investment Duties Regulation. We provided an abbreviated introduction to the topic in the February issue. This month we cover the background and discuss the fiduciary duties of prudence and loyalty in context of the new Investment Duties Rule. In future issues of 401k Advisor we will cover proxy voting and the exercise of shareholder rights as well as some practical effects of the new rule.]

On November 22, 2022, the Department of Labor (DOL) issued a final rule modernizing and revising the long-standing Investment Duties Regulation. Among other things, the final rule clarifies that ERISA plan fiduciaries must consider facts and circumstances that could affect the risk/return of investments, which may include the economic effects of climate change and other environmental, social, or governance factors (ESG factors). ERISA fiduciaries may also consider collateral benefits when choosing between comparable investments and may consider participant preference when selecting investment menu alternatives. The final rule also clarifies and provides guidance for fiduciary exercise of proxy votes and other shareholder rights. The rule generally applies to investments made and investment courses of actions taken after January 30, 2023, though, as noted below, two of the proxy voting provisions take effect on December 1, 2023.

In finalizing the rule, the DOL has closed debate on whether and how ERISA fiduciaries can consider ESG factors or other collateral benefits in investment decisions. There is considerable challenge ahead, however, as ESG factors are being developed in real time, a challenge that will affect not only plan fiduciaries but also investment managers, advisors, and service providers.

Investment Duties Regulation

Originally promulgated in 1979, the Investment Duties Regulation, 29 C.F.R. § 2550.404a-1, explains how fiduciaries can exercise their fiduciary duties in evaluating and selecting ERISA plan investments. The DOL had supplemented the regulatory standard with informal guidance over the years, but had not amended it until 2021. The Investment Duties Regulation has been a major topic of discussion since June 2020 when the DOL proposed revising it in a way that would effectively chill fiduciary consideration of ESG factors in making investment decisions, and would make it nearly impossible for fiduciaries to consider an investment's collateral benefits, among other things. While the revised regulation, effective in January 2021, did not mention ESG factors, it retained restrictions on considering collateral benefits, set limitations on selecting qualified default investment alternatives, and channeled the anti-ESG sentiment of the proposed regulation.

With the change in Administrations, the DOL issued a nonenforcement policy on March 10, 2021, a new proposed regulation on October 14, 2021, and the new final regulation on November 22, 2022.

The revised Investment Duties Regulation provides guidance on complying with the fiduciary duties of prudence and loyalty in reviewing and selecting investments. While these duties overlap, they are inherently different. The duty of prudence is rooted in process—fiduciaries are expected to prudently consider relevant facts and circumstances and to act accordingly, documenting their decisions. The duty of loyalty is rooted in fidelity—fiduciaries are expected to act with "an eye single" to the interests of plan participants and beneficiaries. The revised Investment Duties Regulation presents guidance on each duty separately and in different forms.

Fiduciary Duty of Prudence

Subsection (b)(1) of the Regulation continues to provide that fiduciaries will satisfy the fiduciary duty of prudence if they give "appropriate consideration" to relevant facts and circumstances and act accordingly. The final rule maintains the structure of the original 1979 regulation, providing a nonexclusive list of factors that fiduciaries must consider, to demonstrate "appropriate consideration" of relevant facts and circumstances.

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The final rule modernizes the list in subsection (b)(2) so that fiduciaries must now compare investment options with "reasonably available alternatives with similar risks," a process that became the industry standard in the years since the original regulation. The final rule also clarifies how this standard applies to fiduciaries selecting investment menu alternatives for participant-directed individual account plans, which now outnumber defined benefit plans that have their own investment portfolios. The final rule retains certain standards from the original, explaining that fiduciaries must determine that an investment is reasonably designed to further plan purposes. In the case of plans other than participant-directed individual account plans, fiduciaries must consider a plan portfolio's diversification, liquidity, cash flow, current return, and projected return.

In a new subsection (b)(4), the final rule specifies that fiduciaries must evaluate potential investments using a risk/return analysis based on relevant economic factors, using appropriate investment horizons consistent with a plan's objectives, and considering a plan's funding policy. Relevant risk/return factors "may include the economic effects of climate change and other environmental, social, or governance factors." The final rule recognizes that whether any particular consideration is relevant to a risk/return analysis depends on the facts and circumstances, and that deciding how much weight to give to any factor should be based on a reasonable assessment of the factor's impact on the risk/return analysis.

While public discussion has focused on the impact of the new rule on fiduciary consideration of ESG factors, this is the only mention of ESG in the text of the final rule. That ESG factors are briefly mentioned is noteworthy, given that the 2020 proposed revision would have discouraged consideration of ESG factors, and the 2021 proposed rule would have included examples of potential economic impact of ESG factors. Another notable change is that the final version states that risk/return factors "may include" consideration of ESG factors rather than the proposed rule's "may often require" such consideration; this change in phraseology underscores that ESG considerations may or may not be relevant economic factors depending on the context. As the DOL explained in the preamble, the final rule clarifies that fiduciaries may consider any factors that they determine have economic impact, which could include ESG factors, without putting a "thumb on the scale" for or against any specific economic factors and without telling fiduciaries how to evaluate economic impact.

Fiduciary Duty of Loyalty

In contrast, subsection (c) of the final rule provides guidance on the duty of loyalty in the form of a familiar prohibition with newly articulated exceptions.

The revised regulation first explains that fiduciaries making investment decisions may not subordinate plan interests to other objectives, sacrifice investment return, or take on additional investment risk to promote unrelated goals or objectives. In other words, the duty of loyalty requires that plan financial interests be first and foremost, and thus fiduciaries may not place other interests ahead of a plan's financial interests.

The revised regulation also reformulated a "tiebreaker" rule, that fiduciaries are not prohibited from selecting investments based on potential collateral benefits when choosing between competing investments that would "equally serve" a plan's financial goals.

Finally, the revised regulation newly clarifies that fiduciaries of participant-directed individual account plans do not violate the duty of loyalty solely because they consider participants' preferences in evaluating and selecting investment menu options.

The original Investment Duties Regulation did not address the duty of loyalty, and the January 2021 version of the rule would have created new requirements. The now replaced 2021 language had expanded the rule that fiduciaries treat a plan's financial interests as paramount to mean that fiduciaries could only make investment decisions based on "pecuniary" factors, which would have made it difficult for fiduciaries to consider all relevant facts and circumstances. Similarly, the prior version of the tiebreaker rule had imposed recordkeeping and substantive limitations that made it nearly impossible for fiduciaries to be able to consider collateral benefits regardless of context. The revised final regulation gives fiduciaries more room to exercise their fiduciary duties in evaluating and selecting investments, considering all relevant facts and circumstances.

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