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

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



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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.

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

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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.

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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.

Proxy Voting and Exercise of Shareholder Rights

The revised Investment Duties Regulation added another new section addressing the exercise of shareholder rights. Like the recent history of regulatory guidance on the duties of prudence and loyalty, a final rule on proxy voting and shareholder rights had gone into effect in January 2021, and was also subject to the nonenforcement policy instituted in March 2021.

ERISA fiduciaries are generally allowed under applicable trust agreements to invest plan assets in shares of stock; a plan thus becomes a shareholder with the same shareholder rights as any other investor. Shares held by an ERISA plan, however, are plan assets held in trust. Thus, as explained in subsection (d) of the final rule, fiduciaries must carry out their duties of prudence and loyalty in deciding whether and when to exercise shareholder rights, including voting proxies, on behalf of a plan in its shareholder capacity.

The final rule echoes and applies the same principles for evaluating and selecting investments to fiduciary decisions on whether to exercise shareholder rights, explaining that fiduciaries must focus on a plan’s economic interests, which may not be subordinated to unrelated objectives, and consider the overall facts and

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circumstances, including any related costs.

The final rule explains that fiduciaries must act prudently in (i) selecting and monitoring persons to exercise or advise on exercising shareholder rights; (ii) that fiduciaries may not follow the recommendations of a proxy advisory firm without determining that its proxy voting guidelines are consistent with their fiduciary obligations; and (iii) that any plan proxy voting policy must be prudently designed to serve plan interests, be periodically reviewed, and allow fiduciaries to decide whether to vote proxies based on whether the outcome is expected to affect the value of the investment.

The final rule also recognizes that delegating authority to an investment manager to manage plan assets typically includes the authority to exercise shareholder rights. It further explains that compliance with the duty to follow governing documents requires that investment managers of pooled investment vehicles holding assets of more than one employee benefit plan attempt to reconcile differences in the various plans' investment policy statements and also vote proxies of the various plans in accordance with their respective proxy voting policies in proportion to each plan's economic interests in the pooled vehicle. In the alternative, the investment manager may develop an investment policy statement and proxy voting policy for the vehicle and require investing plans to adopt them as a condition of investing. In such cases, the fiduciaries for each plan must assess whether the investment manager's investment policy statement and proxy voting policy for the vehicle are consistent with plan objectives before deciding to invest in such vehicle.

The provisions on proxy advisory firms and pooled investment vehicles take effect on December 1, 2023. The DOL notes that this will allow time for transition, as commenters had requested.

Effects of the Rule

The extended debate over whether and how to revise the Investment Duties Regulation has spotlighted the growing global trend of considering climate change and ESG factors in evaluating investment opportunities. Now that the final rule clarifies that such consideration may be appropriate under relevant circumstances, the focus shifts to how this guidance might affect decision making going forward. The DOL's Regulatory Impact Analysis provides statistics and information that could be of interest to plan fiduciaries, legal counsel, policy groups, and service providers, including investment managers and proxy advisory services.

The DOL estimates that approximately 149,000 defined benefit and defined contribution plans covering more

than 28,000 participants may be affected by the final rule's acknowledgment that plan fiduciaries may consider climate change and ESG factors in evaluating investment options. Among other things, these estimates reflect that ESG investing is more prevalent in large plans and that not all individual account plans offer investment options that implicate ESG factors, though these are rapidly changing trends.

The DOL recognizes that determining the financial materiality of climate change and ESG factors can be challenging, noting that there is no standardized or generally accepted definition of ESG factors, and drawing no conclusions on the relationship of ESG factors to investment performance or overall return. For example, the DOL's literature review notes that some studies find that fees for ESG funds are higher than for other funds, though one study found no statistically significant difference when controlling for active management and assets under management.

The DOL's analysis recognizes that financial industry trends are developing and that the industry has not yet reached consensus on standards or measures for evaluating climate change and ESG factors. The fact that it is hard to evaluate these factors, however, does not preclude, require or, for that matter, permit avoidance of the analysis. Going forward, ERISA plan fiduciaries can consider information on climate change and ESG factors as it is available at the time they are evaluating investments, consistent with their fiduciary duty of prudence.

The DOL's Regulatory Impact Analysis also considers the effect of new guidance on the fiduciary duty of loyalty, including the nod to fiduciary consideration of participant investment preferences. Of particular interest, the DOL notes that there may be significant demand for ESG alternatives among participants in self-directed defined contribution plans. For instance, a survey by a financial institution found that 69% of participants ages 45–75 would increase their contribution rate if an ESG option were offered. The DOL recognizes that appealing to investor preference can help promote the policy goal of increasing retirement savings.

The revised tiebreaker rule may also have an impact on fiduciary evaluation of investment opportunities that could provide collateral benefits beyond investment performance. For example, in the regulatory preamble the DOL confirmed that an investment that “stimulates or maintains employment that, in turn, results in continued or increased contributions to a multiemployer plan” is a permissible example of a collateral benefit that fiduciaries could use in breaking a tie between investments that would equally serve a

plan's financial interests. Fiduciaries might also consider climate change and ESG factors in a similar vein, or any other potential collateral benefit, as long as they maintain their primary focus on a plan's financial interests.

Moreover, the DOL estimates that some 63,000 plans that hold stock directly or indirectly, including ESOPs and some welfare plans, may be affected by the proxy voting and shareholder rights provisions, including small plans that do not report their holdings as part of their Form 5500. The DOL estimates that these plans employ more than 17,000 service providers whose services may relate to shareholder rights, including trustees, trust companies, banks, investment advisors, investment managers, and proxy advisory firms. Among the transition and compliance costs, the DOL discusses legal review, updating proxy voting policies, and shifts from non-ESG to ESG investments.

The DOL's economic and statistical analyses should help the agency in defending the rule against legal challenges. Some commenters suggested, for instance, that climate and ESG issues are reserved to Congress under the Supreme Court's "major questions" doctrine. The DOL notes that it has express rulemaking authority under Title I of ERISA to provide guidance for fiduciaries in exercising their responsibilities, and that the new final rule was promulgated under that authority.

Final Thoughts for Plan Fiduciaries

- **Principles-Based:** While there is general agreement that the final rule provides helpful clarifications, it embodies a neutral policy that allows for a principles-based approach to ESG investing without being overly prescriptive. Unlike the predecessor rule, the final rule says ESG may be one of many factors that may be considered for investment decision making if it is relevant to the investment decision. Conversely, if ESG is not relevant to an investment decision, it should not be considered. This will enable fiduciaries to take a more facts-and-circumstances approach to the ESG question.
- **Participant Choice:** For the first time, fiduciaries may consider participant choice, and that will not be considered a violation of the duty of loyalty—provided that all the elements of the final rule are satisfied. Honoring participant choice is likely to increase plan participation. However, the rule does not address how to resolve competing or inconsistent participant choices. And what if the participant choice is not a prudent one? In that case, participant choice

cannot prevail.

- **Proxy Voting:** The final rule makes clear, in contrast to the predecessor rule, that proxy voting and exercise of shareholder rights and privileges is a fiduciary function, which should be exercised in the absence of a reason not to do so.
- **Tiebreaker:** The final rule allows for collateral benefits to be considered, provided that competing investment otherwise equally serve the interests of the plan. This is more realistic than the predecessor rule, which called for the competing investments to be indistinguishable.

Verification/Confirmation: In connection with investment decisions, ERISA fiduciaries may (and should) request information and/or confirmations from investment managers regarding the role of ESG factors in the relevant investment objectives. This will document that they engaged in a prudent, diligence process in compliance with the final rule.

Please contact Stephen Wilkes at swilkes@wagnerlawgroup.com, Israel Goldowitz at lgoldowitz@wagnerlawgroup.com, or John Sohn at jsohn@wagnerlawgroup.com with any questions.

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