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DOL Final Rule Embraces Principles-Based Approach to ESG Factors in Investments and Proxy Voting – Initial Reactions

On November 22, 2022, the U.S. Department of Labor (DOL) released its much-anticipated final rule (Final Rule) addressing investment selection and environmental, social and governance (ESG) considerations for ERISA-covered retirement plans (including 401(k) plans) and the exercise of shareholder rights, including voting proxies. The Final Rule is largely consistent with the DOL's 2021 proposal, but the changes it has adopted should make it significantly easier for ERISA plans to include investments that consider or focus on ESG attributes. The revised regulation may also open the door to plan sponsors adding ESG investment options to 401(k) plan menus.

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Below is a high-level overview of the Final Rule, which includes the key changes the DOL has made from the proposal (see our Alert [here](#) summarizing the proposal). Notwithstanding the changes, the Final Rule retains the DOL's core principle that the duties of prudence and loyalty require ERISA plan fiduciaries to focus on relevant risk-return factors and not subordinate the interests of participants and beneficiaries (such as by sacrificing investment returns or taking on additional investment risk) to objectives unrelated to the provision of benefits under the plan.

The Final Rule will take effect 60 days after publication in the Federal Register, other than certain sections pertaining to exercises of proxy voting and other shareholder rights, which will take effect one year after publication in the Federal Register.

- **ESG Factors May (or May Not) Be Relevant to an Investment's Risk/Return Analysis** – The Final Rule adopts a neutral approach to ESG investments, and it clarifies that a plan 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 pursuant to ERISA. The Final Rule states that such factors may include the economic effects of climate change and other ESG factors on the particular investment or investment course of action, but does not require the consideration of these factors. Whether any particular consideration is a risk-return factor depends on the individual facts and circumstances, and the weight that a fiduciary gives to a particular factor should appropriately reflect a reasonable assessment of its impact on risk-return.
 - *Observation / Practical Takeaway* – In revising this language, the DOL deleted the specific ESG-related examples (climate change-related factors, governance factors and workforce practices) that were enumerated in the proposal, in part, to avoid any perception of pro-ESG bias. The examples have been retained in the preamble, and the DOL explains how they are 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. Moreover, the preamble identifies a wide range of traditional financial factors as additional examples, such as a company's capital structure, long-term business plans and debt load, among others, which could effectively become one component of a checklist for fiduciaries (including the managers of ERISA funds) when it comes to prudently evaluating plan investments.
- **Retention and Simplification of the Tiebreaker Rule** – The Final Rule streamlines the longstanding "tiebreaker" standard, and confirms that when a fiduciary has prudently concluded that competing investments

equally serve the financial interests of the plan over the appropriate time horizon, the fiduciary is not prohibited from considering collateral benefits other than investment returns. This tiebreaker rule can be used without additional documentation, and in a change from the proposal, the DOL removed the additional disclosure requirement for designated investment alternatives in an individual account plan that were chosen using the tiebreaker rule.

- **Participant Preference May Be Considered** – The Final Rule addresses how plan sponsors can respond to participant demand for ESG investment options by adding a new provision that says plan fiduciaries do not violate their duty of loyalty under ERISA solely because they take participants’ preferences into account when constructing a menu of prudent investment options.
 - *Observation / Practical Takeaway* – This new language may ease the decision-making process for plan sponsors where the participant population wants the opportunity to invest in alternative assets, whether that is private equity, hedge funds, impact investments, or cryptocurrency.
- **No Separate Standard for QDIAs** – The Final Rule applies the same standard to qualified default investment alternatives (QDIAs) as to other investments—i.e., a focus on relevant risk-return factors. Although this is unchanged from the proposal, it represents a departure from the 2020 investment duties regulation, which explicitly prohibited the selection of an investment fund, product or model portfolio that included the use of one or more non-pecuniary factors as (or as a component of) a QDIA.
- **Exercising Shareholder Rights Like Proxy Voting Is A Core Fiduciary Responsibility** – The Final Rule retains the proxy voting concept from the proposed rule, eliminating the special standards and presumption against exercising shareholder rights that applied under the 2020 regulation. In doing so, it reiterates the DOL’s core principle that the fiduciary duty to manage plan assets that are shares of stock includes the management of shareholder rights appurtenant to those shares, such as the right to vote proxies.
 - *Observation / Practical Takeaway* – The Final Rule would require managers of commingled funds subject to ERISA to reconcile the proxy voting policies of each investing plan. This is not practicable in most cases. Investment managers that oversee ERISA plan asset funds will likely need to adopt a proxy voting policy and obtain investing plans’ approval, in order to avoid having to reconcile the various policies of the fund’s investing ERISA plans in proportion to each plan’s economic interest in the vehicle.

For managers that invest on behalf of public retirement plans, one area that will be important to monitor is whether the Final Rule influences the ongoing debate among the states as to what role ESG factors should play when it comes to investing state retirement assets. Most states use the same fiduciary standards as ERISA, so states that interpret this language to prohibit consideration of ESG factors may face pressure now that the DOL has declared that such factors can be part of a prudent investment selection process. Comprehensive information on these competing state investment considerations can be found at our [Navigating State Regulation of ESG Investments website](#).

We anticipate releasing further analysis of the Final Rule and the impact it may have on asset managers and plan sponsors at a later time.