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Multiemployer Benefit Plans Alert

DEPARTMENT OF LABOR RELEASES FINAL RULE ON ESG FACTORS & PROXY VOTING | DECEMBER 2022

BACKGROUND

On November 22, 2022, the U.S. Department of Labor ("DOL") released a final rule entitled "Final Rule on Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights" ("Final Rule"). The Final Rule largely reverses previously issued regulations in this area during the Trump administration (the "2020 rules"), and it is intended to clarify that ERISA plan fiduciaries *may* consider environmental, social, and corporate governance factors ("ESG" factors) when making decisions about where or how to invest plan assets. While the Final Rule is careful to avoid specific examples of ESG factors, the preamble states that such factors can include: climate change related factors, such as a corporation's exposure to the real and potential economic effects of climate change; governance factors, such as board composition, executive compensation, and compliance with laws and regulations; and workforce practices, including workplace diversity and labor relations. We understand that many investment management companies consider ESG factors when they design investment products, and according to Bloomberg, funds classified as ESG assets reached a total of $37.8 trillion worldwide at the end of 2021.

PERMISSIBILITY OF ESG FACTORS

Previous regulations on this subject, as well as the new Final Rule, have consistently retained the same core principle – that the duties of prudence and loyalty require ERISA plan fiduciaries to focus on relevant risk-return factors and they <u>must not</u> sacrifice investment returns or take on additional investment risk due to objectives unrelated to the financial interests of participants and beneficiaries. However, with the Final Rule the DOL reversed two principles in the 2020 rules that apparently caused confusion and may have had a "chilling effect" on the appropriate consideration of ESG factors in investment decisions. Specifically, the Final Rule eliminates the 2020 rules' general requirement that fiduciaries select investments based solely on consideration of "pecuniary factors," and instead states that a prudent investment decision must be based on factors the fiduciary reasonably determines are relevant to a risk and return analysis, "… and that such factors may include the economic effects of climate change and other ESG considerations…."

CHANGES TO QDIA PROVISIONS

The Final Rule also eliminates a special provision of the 2020 rules that prohibited the offering of an ESG fund as a "Qualified Default Investment Alternative" ("QDIA") in defined contribution plans that offer participant-directed investment programs. Instead, the Final Rule makes clear that the rules for QDIAs are the same as the rules for all other plan investments, and that QDIAs should be selected based on factors that a fiduciary reasonably determines are relevant to a risk and return analysis.

CLARIFICATIONS ON THE APPLICATION OF THE DUTY OF LOYALTY

The Final Rule also changes the 2020 rules' "tiebreaker" standard, which required that competing investments be "economically indistinguishable" before fiduciaries could consider other "non-pecuniary" or "collateral" factors to break the tie. The 2020 rule also required extensive additional documentation when these collateral factors were considered in investment decisions. The Final Rule replaces this standard with a requirement that if a fiduciary "prudently concludes" that similar investments would equally serve the financial interests of the plan over the same period of time, they may then apply any tiebreaking collateral factors. In such a case, the fiduciary is not prohibited from selecting the investment based on the consideration of benefits other than investment returns.

The Final Rule also adds a provision that clarifies that fiduciaries of a defined contribution plan do not violate their duty of loyalty when they take into account the "non-financial" preferences of participants when they select investment options for a participant-directed investment program. Of course, any investment option selected in a defined contribution plan must still be a prudent choice and adequately monitored by the fiduciary over time.

PROVISIONS ON SHAREHOLDER RIGHTS SUCH AS PROXY VOTING

The Final Rule maintains the DOL's core principle regarding the exercise of shareholder rights – that when a plan's assets include shares of stock, the fiduciary duty to manage plan assets encompasses the management of shareholder rights, including the right to participate when shareholders vote on corporate decisions (also known as proxy voting). The Final Rule eliminates provisions from the 2020 rules that were seen to encourage abstention from proxy voting by ERISA funds, which the DOL felt did not adequately protect the interests of participants and beneficiaries. Additional documentation requirements regarding the exercise of shareholder rights have also been eliminated.

R&R ANALYSIS

Overall, the Final Rule seems to be a balance between the 2020 rules, which discouraged the consideration of ESG factors and proxy voting, and a subsequent 2021 proposed rule, which was viewed in some circles as overly supportive of ESG investments. The Final Rule allows fiduciaries to fulfill their duty of prudence and loyalty with more flexibility when they evaluate investments, and it also eliminates some arguably duplicative documentation requirements. Additionally, the Final Rule's more positive stance toward proxy voting suggests that it may be a good time to examine your Fund's proxy voting policy (if applicable), and to work with your investment consultant if you'd wish to adopt a new approach toward exercising your Fund's shareholder rights.

The elimination of the 2020 rules' definitions of "pecuniary factors" and "non-pecuniary factors" is also notable, as some legal scholars believed those provisions had potential adverse effects on investments outside of the traditional ESG space. For example, under the 2020 rules it could be argued that a Taft-Hartley fund, selecting between two similar investments, was forbidden from considering whether a particular investment would utilize union labor, as that would likely have been a "non-pecuniary factor." The new Final Rule forecloses such an issue, and provides fiduciaries with more clarity and freedom when making decisions to invest plan assets.

The Final Rule will go into effect on January 30, 2023, other than certain provisions regarding proxy voting, which will go into effect on December 1, 2023. A copy of the DOL fact sheet on this Final Rule can be found here.

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