Proskauer Benefits Brief: DOL’s 2022 Final ESG Rules

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In this episode of The Proskauer Benefits Brief, Proskauer partners Ira Bogner and Adam Scoll and law clerk Tanusha Yarlagadda discuss the Department of Labor’s final ESG rules issued on November 22, 2022, and how those rules affect the consideration by ERISA fiduciaries of environmental, social, and governance or “ESG” factors when making investment decisions and exercising shareholder rights, such as voting proxies. Although these final rules generally became effective on January 30, 2023, they are currently being challenged both in the courts and in Congress.

Tanusha Yarlagadda: Hello and welcome to The Proskauer Benefits Brief: Legal Insights on Employee Benefits and Executive Compensation. I’m Tanusha Yarlagadda, a law clerk in the firm’s Boston office, and I’m here with Adam Scoll, a partner in our Boston office, and Ira Bogner, a partner in our New York office. Today we will be discussing the Department of Labor’s final ESG rules that were issued on November 22, 2022, and how those rules affect the consideration by ERISA fiduciaries of environmental, social, and governance or “ESG” factors when making investment decisions and exercising shareholder rights, such as voting proxies. These final rules generally became effective on January 30, 2023, except for certain proxy voting-related rules we will discuss later in the podcast, which will not take effect until December 1, 2023. The rules are, however, being challenged both in the courts and in Congress as we will note later in the podcast. Ira, why don’t you start us off by giving us a 50,000 foot view of how these final rules compare to the Trump administration’s 2020 regulations on the same topic?

Ira Bogner: The final rules are intended to be more supportive of ERISA fiduciaries considering ESG factors in investment decisions as compared to the 2020 regulations. Although the 2020 regulations did not specifically refer to "ESG" considerations, they distinguished between "pecuniary" and "non-pecuniary" factors, creating a perception that any consideration of ESG factors, even factors considered to be financially material, could expose ERISA fiduciaries to liability. The final rules provide some comfort that ESG considerations are not completely off limits, but the underlying principle that risk and return cannot be sacrificed has not changed. Adam, do you agree?

Adam Scoll: Thanks Ira, I agree. Although the final rules are warmer to ESG considerations than the 2020 regulations, the final rules retain ERISA's bedrock principle that an ERISA fiduciary cannot sacrifice investment returns or assume greater investment risk to promote collateral objectives. Like the 2020 regulations, the final rules preserve the long-standing requirement that a fiduciary give "appropriate consideration" to the facts and circumstances that the fiduciary knows or should know are relevant. The final rules go on to provide that "appropriate consideration" *may include* the economic effects of climate change and other ESG factors on the particular investment, but do not prohibit or in all cases require such consideration. So, the Final Rules eliminate the distinction between "pecuniary" and "non-pecuniary" factors, and instead provide that a fiduciary may consider *any* factor material to the risk/return analysis, including climate change and other ESG factors.

Tanusha Yarlagadda: The final rules also simplify a "tie-breaker" concept that has historically been included in Department of Labor guidance by making it easier to use ESG or other "collateral benefits" as a "tie-breaker" between competing investments. Now, instead of limiting a tie to a case where the applicable investments could not be distinguished based on "pecuniary factors" alone, the final rules define a tie as competing investments that "equally serve the financial interests of the plan over the appropriate time horizon". Also, the final rules eliminate the special documentation and disclosure requirements for a tiebreaker and instead apply the same documentation and disclosure principles as for all other investment decisions. Ira, can you highlight for us the changes under the final rules affecting participant-directed plans, such as a typical 401(k) or 403(b) plan?

Ira Bogner: Sure. The 2020 regulations prohibited a fund, product, or model portfolio that expressly considered ESG factors to be used as a Qualified Default Investment Alternative or QDIA under a participant-directed plan. However, the final rules do not include such a prohibition or any other special ESG-related rules with respect to QDIAs – QDIAs are treated just like any other investment option.

The final rules also include a new clarification that a fiduciary of a participant-directed plan does not violate the ***duty of loyalty*** solely because the fiduciary takes into account participants' preferences when setting the plan's investment lineup. Nonetheless, the clarification does not change the ***duty of prudence***, which still turns on an analysis of risk and return characteristics (without regard to what participants might want). It is important to note that the final rules do not mandate that fiduciaries factor participants' preferences into their decision-making, nor do they prescribe a methodology to account for such preferences.

Tanusha Yarlagadda: Thanks, Ira. It is also important to note that the final rules do not include a "safe harbor" for a fiduciary to treat ESG-themed funds as a separate asset class. Accordingly, ESG-themed funds must be evaluated relative to other alternatives in the particular asset class, and fiduciaries could be exposed to potential claims if an ESG-themed investment option underperforms its benchmark. To mitigate risk, fiduciaries should carefully document the reasons for their investment decisions relating to investment options, including, in the case of an option with an emphasis on ESG factors, the relevance of ESG considerations to risk and return objectives. The final rules also made changes with respect to proxy voting. Adam, why don't you walk us through those?

Adam Scoll: Sure. The final rules retain the core principle that a fiduciary's responsibility with respect to investment management includes the management of appurtenant shareholder rights, such as voting proxies. Driven by a concern that the 2020 regulations could discourage proxy voting activity by plan fiduciaries, the final rules remove the 2020 regulations' proxy voting safe harbors, as well as the statement that ERISA does not require the voting of every proxy, while acknowledging that a fiduciary may determine on a case-by-case basis that voting of a proxy is not in the plan's best interests. The final rules also eliminate burdensome recordkeeping requirements and underscore that proxy voting is a key tool in managing investments in issuers that should be taken seriously by ERISA fiduciaries. The Final Rules also remove special monitoring obligations for delegated proxy voting rights and advisory services, and special recordkeeping requirements regarding proxy voting activities.

Ira Bogner: Right. The final rules also continue to allow plan fiduciaries to establish investment policies that cover proxy voting, and they require investment managers of pooled "plan asset" funds to reconcile conflicting policies of participating plans to the extent possible. This could require that the fund manager exercise shareholder rights of the fund (voting or abstaining) in proportion to each plan's economic interest in the fund. Alternatively, the fund manager may develop its own investment policy statement that is consistent with Title I of ERISA and require participating plans to accept that investment policy statement, including any proxy voting policy, before they are allowed to invest (or in order to remain invested in the fund). Although the final rules generally became effective on January 30, 2023, these particular rules related to proxy voting will not take effect until December 1, 2023.

Tanusha Yarlagadda: Any other key takeaways worth noting?

Adam Scoll: Yes. Investment managers of separate accounts, private investment funds and other pooled investment vehicles that have contractually agreed to operate as if the fund, account or other vehicle were subject to ERISA or in accordance with the ERISA standard of care should consider whether any of these changes will or should affect their operations or investments. Also, while U.S. state "governmental plans" are not subject to ERISA, certain governmental plans are subject to rules that are similar to ERISA. However, a number of states have proposed or already enacted legislation or other guidance that includes express prohibitions on the consideration of ESG and other "collateral" factors when making public plan investment decisions. It remains to be seen how such state laws will be interpreted or applied.

Ira Bogner: Another item to note is that, as of March 13, 2023, legislation has been introduced by Congress that would nullify these final rules, and lawsuits have been filed in the Fifth Circuit and the Seventh Circuit challenging the validity of the final rules. We will keep you posted on any new developments in this regard.

Tanusha Yarlagadda: Thanks, Ira and Adam. That concludes our discussion of the DOL's 2022 final ESG rules. Thank you all for joining us on The Proskauer Benefits Brief. Stay tuned for more legal insights on employee benefits and executive compensation, and be sure to follow us on Apple Podcasts, Spotify and Google Podcasts.

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