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DOL Final Rule on ESG Factors to Take Effect February 1, 2023

The Final Rule clarifies the application of ERISA's fiduciary duties of prudence and loyalty to the selection of plan investments that incorporate ESG goals.

Key Points:

- The general applicability date of the Final Rule is February 1, 2023, but certain provisions involving proxy voting policies will not go into effect until December 1, 2023.
- The Final Rule specifically recognizes that ESG factors may be relevant to the risk-return analysis of potential investments.
- The DOL removed the term “pecuniary factors” from the Final Rule because it was concerned that the term could discourage consideration of ESG factors in investment decisions.
- The Final Rule revokes certain limitations that the prior rule had applied to qualified default investment alternatives (QDIAs).
- The Final Rule modifies the “tiebreaker” test to no longer require that investments be “indistinguishable” before considering collateral benefits, and states that collateral benefits may be considered as long as competing investments “equally serve” the financial interests of the plan.
- Under the Final Rule, consideration of participant preferences when constructing a menu of investment options for participant-directed accounts does not itself violate the duty of loyalty. This change permits fiduciaries to act on participant preferences as long as the resulting investments are prudent.
- The Final Rule omits prior language that indicated that the fiduciary duty does not require voting every proxy or exercising every shareholder right; however, the Final Rule does not change the substance of the regulation regarding how a fiduciary should decide when and how to vote.
- The Final Rule removes certain safe harbor examples for proxy voting policies that had permitted (i) a policy to limit voting resources to proposals that the fiduciary prudently determined were substantially related to the issuer’s business activities or were expected to have a material effect on the value of the investment and (ii) a policy of refraining from voting on proposals if the plan’s holding in a single issuer relative to its total investment assets were below a certain threshold.
- The Final Rule eliminates specific requirements on maintaining records on proxy voting activities and monitoring obligations when using investment managers or proxy voting firms.

On November 22, 2022, the US Department of Labor (DOL) released a final rule (Final Rule)¹ amending its “Investment Duties” regulation (29 CFR § 2550.404a-1) to clarify the application of the fiduciary responsibility duties under the Employee Retirement Income Security Act of 1974, as amended (ERISA), to the selection of plan investments that consider climate change and other environmental, social, and governance (ESG) factors. The Final Rule provides welcome clarity to plan fiduciaries in light of prior uncertainty as to how they may properly consider ESG factors in plan investment decisions. The Final Rule, while not as ESG-friendly as its proposal, takes what the DOL believes to be a position of “appropriate regulatory neutrality” with respect to the consideration of ESG factors. The changes made by the Final Rule may be relevant to many entities that play a role with respect to investing plan assets, including plan fiduciaries (such as plan investment committees and investment managers of plan assets) and other parties that market their investments to plan fiduciaries, including sponsors of non-plan asset funds. In addition, anyone dealing with state plans will need to consider the rapidly evolving state law landscape regarding investments that include an ESG component.

Background

Title I of ERISA establishes minimum standards that govern the operation of private-sector employee benefit plans, including fiduciary responsibility rules. These rules require that plan fiduciaries act (i) prudently and diversify plan investments to minimize the risk of large losses, unless under the circumstances diversifying is not prudent, (ii) solely in the interest of the plan’s participants and beneficiaries, and (iii) for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan.

The DOL has maintained a long-standing position that ERISA fiduciaries may not sacrifice investment returns or assume greater investment risks as a means of promoting collateral social policy goals. The DOL has a similarly long-standing position that the fiduciary act of managing plan assets that involve shares of corporate stock includes deciding on voting proxies and exercising shareholder rights.

On November 13, 2020, the DOL, acting under the previous administration, published a final rule to amend the Investment Duties regulation and require plan fiduciaries to select investments and investment courses of action based solely on consideration of “pecuniary factors.” Among the amendments was a prohibition against adding or retaining any investment fund, product, or model portfolio as a QDIA if the fund, product, or model portfolio included even one non-pecuniary objective in its investment objectives or principal investment strategies. On December 16, 2020, the DOL published another final rule further amending the Investment Duties regulation to establish regulatory standards for the obligations of plan fiduciaries under ERISA when voting proxies and exercising other shareholder rights in connection with plan investments in shares of stock. This Client Alert refers to these rules together as the “Prior Rule.”

In early 2021, the DOL engaged in outreach efforts to, in the DOL’s words, “better recognize the important role that climate change and other ESG factors can play in the evaluation and management of plan investments, while continuing to uphold fundamental fiduciary obligations.” In May 2021, the DOL noted that it would not enforce the Prior Rule.

Based on its outreach, the DOL determined that the Prior Rule had created a perception in the market that fiduciaries would be at risk if they included any ESG factors in the financial evaluation of plan investments, and that fiduciaries would need to have special justifications for even ordinary exercises of shareholder rights. The DOL believed that the Prior Rule resulted in a “chilling effect” and had “other potential negative consequences” with respect to the consideration of ESG factors.

On October 14, 2021, the DOL proposed further amendments (the Proposal) to the Investment Duties regulation. Following a notice-and-comment period, on November 22, 2022, the DOL issued a Final Rule to clarify the application of ERISA's fiduciary duties to considerations of ESG factors. The DOL explains in a preamble (the Preamble) to the Final Rule that these amendments were necessary because the Prior Rule had created uncertainty and was having the "undesirable effect of discouraging ERISA fiduciaries' consideration of climate change and other ESG factors in investment decisions," even in cases where it was in the financial interest of plans to take such considerations into account.

Summary of Final Rule

The Final Rule retains the 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 to objectives unrelated to the provision of benefits under the plan. However, the Final Rule defines the risk-return factors more broadly and explicitly includes the consideration of ESG factors as potential elements in the risk-return analysis.

The Final Rule also reiterates that when a plan's assets include shares of stock, the fiduciary duty to manage plan assets includes the management of shareholder rights related to those shares, including the right to vote proxies. Further, the Final Rule encourages voting rather than abstention by, among other things, removing certain safe harbors and eliminating certain requirements regarding maintenance of records on proxy voting activities.

Observations

- ✓ Although the Final Rule removes the requirement to document ESG considerations, fiduciaries would be well-advised to document their processes and reasoning for determining that consideration of ESG factors were relevant to the risk-return analysis in the event these decisions are later challenged. Similarly, investment managers looking to manage ERISA funds or otherwise receive investment from ERISA plans should consider including in their marketing materials explanations for why they believe that the climate and other ESG factors are relevant to a risk-return analysis. At the same time, managers should balance such discussions about ESG with potential disclosures that may be required under proposed Securities and Exchange Commission (SEC) rules.
- ✓ Fund managers now have more flexibility to market investment funds to particular participant preferences and to highlight ESG features. However, fiduciaries will still need to demonstrate that the fund is a prudent investment for the plan on an economic and risk-return basis.
- ✓ Internal recordkeeping continues to be important. Fiduciaries should clearly articulate how ESG considerations reflect their fiduciary duties within their internal corporate governance records and in their external disclosures.

Addition of Explicit Language Providing That Risk-Return Factors May Include ESG Factors

Previously, the Investment Duties regulation did not explicitly state that an evaluation of risk-return factors could (or should) include ESG factors. The DOL notes that the Prior Rule's overall framework and terminology were "confusing and susceptible to inferences of bias against the treatment of climate change and other ESG factors." The Final Rule clarifies that the risk-return factors that a fiduciary is required to consider "may include" the economic effects of climate change and other ESG factors. The DOL explains that the addition of this language is intended to "dispel the perception" that climate

change and other ESG factors are somehow “presumptively suspect” or “unlikely to be relevant” to the risk and return of an investment or investment course of action.

Of note, the Final Rule does not go as far as the Proposal with respect to its emphasis on ESG factors. The Proposal had specified that the risk-return analysis “may often” require an evaluation of the economic effects of ESG factors. The DOL deleted this “may often” language from the Final Rule because it was concerned that plan fiduciaries might “misinterpret” the rule as a mandate to consider ESG factors under all circumstances. Instead, the Final Rule makes clear that a fiduciary may exercise discretion when determining what factors are relevant to the risk-return analysis and the fiduciary remains free to determine that an ESG-focused investment is not in fact prudent.

Further, the Final Rule does not include the specific examples of ESG factors that had been included in the Proposal. The DOL explains that it wanted to avoid creating an “apparent regulatory bias in favor of particular investments or investment strategies.”

Removal of Pecuniary/Non-Pecuniary and Related Terminology

The Prior Rule required that a fiduciary’s evaluation of an investment be based only on “pecuniary factors,” which it defined as factors that a fiduciary “prudently determines” are expected to have a “material effect” on the risk or return of an investment.

The Final Rule amends the Prior Rule to delete the pecuniary/non-pecuniary terminology and to soften the prudence test to require that a fiduciary’s determination be based on factors that the fiduciary “reasonably determines” are “relevant” to a risk-return analysis, rather than factors that the fiduciary “prudently” determines are expected to have a “material effect” on the risk-return analysis.² The DOL explains that with these changes, the Final Rule removes the Prior Rule’s “thumb from the scale” so that fiduciaries will not be discouraged from considering climate change and other ESG factors when evaluating an investment option.

Changing the Standard for When to Apply “Tiebreaker” Test

The Investment Duties regulation includes a “tiebreaker” test that permits fiduciaries to “consider collateral benefits that are not related to the risk-return analysis (such as stimulating union jobs and investing in the region where participants live and work) as tiebreakers when the risk-return analysis is not dispositive. The Prior Rule’s version of the test required that competing investments be “indistinguishable” based on pecuniary factors before a fiduciary could turn to collateral factors. The DOL was concerned that this standard was “causing a great a deal of confusion, given that no two investments are the same in each and every respect” and that this standard was therefore “impractical and unworkable.”

The Final Rule replaces the tiebreaker language with a standard that requires the fiduciary to conclude prudently that competing investments, or competing investment courses of action, “equally serve the financial interests of the plan over the appropriate time horizon.”

Removal of Tiebreaker Documentation Requirement

The Prior Rule imposed a special documentation requirement for use of the tiebreaker test. The DOL was concerned that this requirement discouraged fiduciaries from using the test, including in cases involving ESG. It was also concerned that fiduciaries skewed their investment analyses to avoid acknowledging a tie because the requirement was a “red flag” that could encourage potential litigants to sue.

Although the Final Rule removes the special documentation requirement, the DOL cautions that this removal does not change ERISA’s general prudence obligations and standard of care with respect to documentation generally.

The Proposal included a separate disclosure requirement that would have required a fiduciary to “prominently” display any collateral benefits in disclosure materials provided to participants and beneficiaries. For similar reasons to the removal of the documentation requirement, the Final Rule does not include a disclosure requirement (although the DOL notes that it may revisit the disclosure requirement depending on ongoing ESG rulemaking by the SEC).

Observations

- ✓ The Investment Duties regulation now explicitly recognizes that a fiduciary may consider ESG factors when it “reasonably determines” that such factors are relevant to a risk-return analysis. The DOL effectively provides plan fiduciaries and investment managers with a roadmap on how to protect themselves from potential lawsuits and DOL investigations when considering ESG factors in their investment decisions. Fiduciaries and investment managers should document the “reasonable” basis for their decisions and explain why they reasonably believe that such factors are relevant.
- ✓ Of significance, the regulation stresses that the risk-return analysis must consider the plan’s investment horizon and objectives. The emphasis on investment horizons and objectives could be beneficial to those seeking to include ESG investments, because reasonable arguments can be made that although the short-term prospects of such investments may not show a marked improvement over other investments (and in fact may lag other investments), over the long term such investments may result in higher returns and less risk than other non-ESG focused investments. For example, a fiduciary may consider the impact climate change may have on a corporation’s future business challenges and include equity funds focused on climate change or industries thought to be less impacted by climate change.

Removal of Stricter Rules for QDIA

The Prior Rule disallowed a fund to serve as a QDIA if the fund had investment objectives, goals, or principal investment strategies that included, considered, or indicated the use of one or more non-pecuniary factors in its investment objectives, even if the fund was objectively economically prudent or even best in class. The DOL determined that this language would “only serve to harm participants” and would “effectively preclude fiduciaries from considering QDIAs that include ESG strategies” even when such strategies were otherwise prudent or economically superior to competing options.

The Final Rule rescinds the language that had distinguished the QDIA from other investment options. The DOL reminds fiduciaries that QDIAs are still subject to the separate protections accorded in separate regulations concerning QDIAs.

Participants’ Preferences May Be Taken Into Account Without Violating Duty of Loyalty

The DOL considers that permitting investment options to align with the preferences of participants in participant-directed accounts could be relevant to furthering the purpose of the plan, because accommodating these preferences could lead to greater participation and higher deferral rates, which would, in turn, lead to greater retirement security. The Final Rule, therefore, adds a new provision clarifying that fiduciaries do not violate their duty of loyalty solely because they take participants’

preferences into account when constructing a menu of prudent investment options for participant-directed individual account plans. The DOL cautions, however, that plan fiduciaries may not add imprudent investment options to menus just because participants request or prefer them; rather, the selection of investment options is grounded in the fiduciary's prudent risk-return analysis.

Observations

- ✓ The modern retirement landscape has shifted away from defined benefit plans toward defined contribution plans that have participant-directed accounts and investment menus. The updates to the Investment Duties regulation reflect the DOL's recognition that a menu of options for a defined contribution plan can be tailored to reflect the preferences of the current workforce. Plan sponsors may want to consider diversifying their investment options beyond the traditional mutual fund menu to make participation in the company plan more enticing for workers who may see greater value in non-traditional investment options (including ESG-focused funds), provided those options are still prudent investments for the plan. However, monitoring investment options on this basis may create new challenges, including the potential for continuously assessing whether participant preferences have changed over time.
- ✓ Although the DOL is clear that ESG factors can be considered under ERISA's duties of prudence and loyalty; when it comes to private equity and cryptocurrency investment, the DOL takes a different position. In prior non-regulatory guidance, the DOL has indicated that private equity investment is appropriate only in limited circumstances and that cryptocurrency investment is too risky. In a recent Information Letter and Supplementary Letter, the DOL concludes that while ERISA's fiduciary duties permit a plan fiduciary to select a professionally managed asset allocation fund with a private equity component as a designated investment alternative, the plan fiduciary is expected to possess the expertise or rely on a competent investment adviser to determine whether the investment arrangement complies with applicable requirements under securities, banking, or other relevant laws and regulations.³ In contrast, sub-regulatory guidance from the DOL warns retirement plan administrators of the risks associated with cryptocurrency, and the DOL has threatened sponsors with "investigative programs" if they include cryptocurrency in their plan investment options.⁴ Nevertheless, the Final Rules eliminate some barriers that plan fiduciaries previously faced when looking to introduce alternative investment options for plan participants and may provide a model for the application of ERISA's fiduciary framework to previously taboo investments.
- ✓ In the multi-employer plan context, a plan fiduciary may appeal to participant preference and authorize investments in entities that support union activities, so long as the fiduciary determines that the investment is otherwise a prudent investment for the plan.
- ✓ The process used by the plan fiduciary, and the documentation of that process, should prioritize evaluation of the economic impacts of any ESG factors for an investment option that appears to be based on ESG factors, such as a green mutual fund.

Removal of Statement That Fiduciary Duty Does Not Require Voting of Every Proxy

The Prior Rule included the statement that a fiduciary's duty to manage shareholder rights "does not require the voting of every proxy or the exercise of every shareholder right." The DOL was concerned that this statement could be misread as suggesting that plan fiduciaries should be indifferent to the exercise of their rights as shareholders, which could leave plan investments unprotected. In the Preamble, the DOL reiterates its long-standing position that proxies should generally be voted unless a responsible plan fiduciary determines that voting the proxy may not be in the plan's best interest. According to the DOL,

such a determination could be made, for example, when the voting proxies involve “exceptional costs or unusual requirements, such as the case of voting proxies on shares of certain foreign corporations.”

The Final Rule eliminates the statement that ERISA’s fiduciary duties do not require voting every proxy. However, the DOL cautions that the language’s removal “is not meant to indicate that fiduciaries must always vote proxies or engage in shareholder activism.” Rather, fiduciaries should “take steps to ensure that the cost and effort associated with voting a proxy is commensurate with the significance of an issue to the plan’s financial interests.” The solution to proxy-voting costs, according to the DOL, is for fiduciaries to “wherever possible ... rely on efficient structures (e.g., proxy voting guidelines, proxy advisors/managers that act on behalf of large aggregates of investors, etc.).”

Removal of Specific Recordkeeping Requirements When Voting Proxies

The Prior Rule included a requirement that, when deciding whether to exercise shareholder rights and when exercising shareholder rights, fiduciaries were required to maintain records on proxy voting activities and other exercises of shareholder rights. The DOL was concerned that the provision could “create a misperception that proxy voting and other exercises of shareholder rights are disfavored or carry greater fiduciary obligations, and therefore greater potential liability, than other fiduciary activities,” and that this could “chill plan fiduciaries from exercising their right or result in excessive expenditures as fiduciaries over-document their efforts.”

Although the Final Rule removes the documentation requirement, the DOL reminds fiduciaries that ERISA still “requires proper documentation both of the activities of the investment manager and of the named fiduciary of the plan in monitoring the activities of the investment manager,” including with respect to proxy voting. The DOL notes that in order for the named fiduciary to carry out its duty under ERISA to monitor the investment manager, the investment manager must keep accurate records as to its voting procedures and the actions it takes in individual situations.

Removal of Safe Harbors for Proxy Voting Policies

The Prior Rule included two safe harbors for voting policies permitted under the Investment Duties regulation. The first safe harbor permitted a policy to limit voting resources to particular proposals that the fiduciary had prudently determined were substantially related to the issuer’s business activities or were expected to have a material effect on the value of the investment. The second safe harbor permitted a policy of refraining from voting on proposals when the plan’s holding in a single issuer relative to the plan’s total investment assets was below a quantitative threshold. The DOL was concerned that the safe harbors “encourage[d] abstention in the normal course.”

Regarding its removal of the recordkeeping requirement, the DOL reiterates its “long-standing view” that proxies should be voted as part of the process of managing the plan’s investment in company stock “unless a responsible plan fiduciary determines voting proxies may not be in the plan’s best interest.”

The Final Rule removes both safe harbor examples.

Observations

- ✓ When deciding whether to exercise shareholder rights and when actually exercising shareholder rights, fiduciaries should act in a manner that upholds the duties of loyalty and prudence.

- ✓ Proxies should be voted unless a fiduciary determines that voting proxies is not in the plan's best interest. Fiduciaries should ensure that the cost and effort associated with voting a proxy enhance the value of plan assets or protect plan assets from risk.

Comparison to State Laws

While state and local governmental retirement plans are not subject to ERISA, many of the rules governing such plans are based on the federal law. As such, the Final Rule may inform the interpretation of those state and local laws. In recent years, several states and local governments have enacted (or proposed) rules specifically addressing considerations of ESG factors by state and local government retirement funds. In contrast to the DOL's relatively neutral approach, many of these rules have taken more aggressive positions, divided between those that are explicitly "pro-ESG" and those that are "anti-ESG."

For example, Florida endorsed the pecuniary/non-pecuniary language in a 2022 resolution that adopts the Prior Rule's core language, directing fund managers investing the state's retirement funds to make investment decisions "based only on pecuniary factors" and stating that its State Board of Administration "may not sacrifice investment return or take on additional investment risk to promote any non-pecuniary factors."⁵ South Carolina recently introduced two bills, one to prohibit investment by state pension funds in companies that "boycott" energy companies and another to prohibit consideration of various ESG factors in management of state pension funds. In contrast, states such as Maryland and Illinois have adopted policies directly providing for state retirement funds to consider relevant ESG factors.⁶

Observations

- ✓ This divergence in approach between federal and state law (and among states) can create particular challenges for asset managers that need to balance the demands of benefit plans subject to the laws of such states and those benefit plans subject to ERISA. Navigating these complications in the investment landscape will be an increasingly important consideration for investment managers seeking investments from both employee benefit plans subject to ERISA and those subject to state and local laws.
- ✓ Plan fiduciaries and those marketing to plan fiduciaries should develop clear and consistent documentation (including when drafting board minutes, marketing materials, and investment diligence materials) regarding the considerations and decisions taken with regard to ESG.
- ✓ The goal of considering ESG factors should be financial returns, and the record should clearly articulate why any choices regarding ESG-related investments are aligned with efforts to improve financial returns. Entities looking to obtain investment from retirement plan fiduciaries should focus on communicating how these ESG considerations contribute to the "value" side of the equation. While glossy reports about the philanthropy efforts of funds and companies in which they invest may receive positive feedback, these entities may quickly face scrutiny by regulators and investors if differing perspectives are not considered. The Final Rule's discussion of risk-return analysis can serve as a template on how to convey communications regarding ESG. Organizations should attempt to articulate, both internally and externally, an ESG factor's (i) contribution to management of risk and/or (ii) expected impact on return.

Applicability Date

The Final Rule has a general applicability date of February 1, 2023 (60 days after publication in the Federal Register). The applicability date is extended until December 1, 2023, with respect to the fiduciary's oversight obligations over the proxy voting guidelines of proxy advisory firms and the proxy voting policies of investment managers — specifically, the fiduciary's obligation to determine that a proxy advisor's guidelines or an investment manager's investment policy statement and/or proxy voting policy (to the extent a proxy advisor or investment manager are used) are consistent with the obligations set forth in the Final Rule. According to the DOL, this longer applicability period is intended in part to give plan fiduciaries additional time to review proxy voting guidelines and make any necessary changes in their arrangements with those firms.

If you have questions about this Client Alert, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

[Sarah E. Fortt](#)

sarah.fortt@lw.com
+1.737.910.7326
+1.202.637.2200
Austin / Washington, D.C.

[Betty M. Huber](#)

betty.huber@lw.com
+1.212.906.1222
New York

[Benjamin Rosemergy](#)

benjamin.rosemergy@lw.com
+1.312.876.7714
Chicago

[Krisa Benskin](#)

krisa.benskin@lw.com
+1.713.546.7444
Houston

[Aryeh Zuber*](#)

aryeh.zuber@lw.com
+1.213.891.8523
Los Angeles / New York
**Admitted to practice in
New York only*

[Karmpreet "Preeti" Grewal](#)

karmpreet.grewal@lw.com
+1.212.906.3093
New York

[Austin J. Pierce](#)

austin.pierce@lw.com
+1.713.546.7561
Houston

[Tal Simon*](#)

tal.simon@lw.com
+1.312.777.7075
Chicago
**Admitted to practice in
Ohio only*

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Endnotes

¹ 87 FR 73822.

² Notably the Preamble does not directly address the change from a “prudence” standard to one of “reasonableness,” which would seem to be significant, considering that ERISA specifically applies a duty of prudence.

³ See Information Letter from Louis J. Campagna to Jon W. Breyfogle, dated June 3, 2020, and the DOL’s December 21, 2021 supplemental statement.

⁴ See DOL Compliance Assistance Release No. 2022-01 (March 10, 2022).

⁵ Available at: <https://www.flgov.com/wp-content/uploads/2022/08/ESG-Resolution-Final.pdf>.

⁶ Md. Code Ann., State Personnel and Pensions § 21-116.1 (2022), <https://mgaleg.maryland.gov/mgaweb/laws/StatuteText?article=gsp§ion=21-116.1&enactments=false>; Illinois Sustainable Investing Act, 30 ILCS 238, <https://www.ilga.gov/legislation/ilcs/ilcs3.asp?ActID=4027&ChapterID=7>.