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DOL Issues Final Regulations on Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights

On November 22, 2022, the Department of Labor (DOL) released the final rule regarding fiduciary "investment duties" under Title I of the Employee Retirement Income Security Act of 1974 (ERISA). The final rule is intended to address uncertainties in the application of ERISA's fiduciary duties of prudence and loyalty to the fiduciary's consideration of climate change and other environmental, social, and governance (collectively, ESG) factors when making investment decisions and when exercising shareholder rights (including voting on shareholder resolutions and board nominations) on behalf of ERISA plan participants and beneficiaries.

The full text of the final rule is at https://www.dol.gov/sites/dolgov/files/ebsa/temporary-postings/prudence-and-loyalty-in-selecting-plan-investments-and-exercising-shareholder-rights-final-rule.pdf
The DOL Fact Sheet is found at https://www.dol.gov/sites/dolgov/files/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/final-rule-on-prudence-and-loyalty-in-selecting-plan-investments-and-exercising-shareholder-rights.pdf

Plans Impacted:
The final rule applies to all employee benefit plans that are subject to Title I of ERISA. An employee benefit pension plan is subject to Title I of ERISA unless it meets one of the following exceptions:

- A 401(a), 401(k), 403(b) or 457(b) plan of a governmental employer (including a public school);
- A top hat 457(b) plan of a nonprofit organization;
- A 401(a), 401(k), or 403(b) plan of a church or church-related entity unless the plan administrator has irrevocably elected to have ERISA apply to that plan;
- A 403(b) plan of a nongovernmental/non-church 501(c)(3) organization that meets the non-ERISA regulatory safe harbor rules; and
- IRAs that do not have employer contributions or active employer involvement.

Effective Date: The final rule is generally effective 60 days after its publication in the *Federal Register*. However, there is a delayed applicability date of 1 year after the date of publication in the *Federal Registe*r for certain proxy voting provisions to enable fiduciaries and investment managers additional time to review any proxy voting policies and guidelines and make any necessary changes.

Background
The final regulations amend the 2020 final regulations on "Financial Factors in Selecting Plan Investments" and "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights" (collectively, the 2020 Rules) which generally had required that plan fiduciaries evaluate investments and investment-based actions solely on "pecuniary" factors. The 2020 Rules became effective January 2021.

Pursuant to an executive order of President Biden, the DOL revisited the 2020 Rules, in furtherance of policies to mitigate climate-related financial risk and actions to help safeguard the financial security of America's families, businesses and workers from climate-related financial risk that may threaten the life savings and pensions of U.S. workers and families. As a result, in March 2021, the DOL announced that they would not enforce the 2020 Rules. In October 2021, the DOL published proposed rules to amend ERISA's Investment Duties regulations, seeking public comment.

Final Rule
The final rule addresses the Department's concern that the 2020 Rules have created uncertainty and are having the undesirable effect of discouraging ERISA fiduciaries' consideration of climate change and other ESG factors in investment decisions, even in cases when it is in the financial interest of plans to take such considerations into account. In addition, the DOL was concerned that the two safe harbors in the 2020 Rules could be construed as permission for plan fiduciaries to broadly abstain from proxy voting without properly considering their fiduciary duties as shareholders and to plan participants and beneficiaries.

Consideration of ESG Factors as an Investment Duty
The final regulations establish that relevant climate change and other ESG factors are no different than other "traditional" relevant risk-return factors that are part of a plan fiduciary's investment duties. A fiduciary's duty of prudence must be based on factors that the fiduciary reasonably determines are relevant to a risk and return analysis and such factors may include the economic effects of climate change and other ESG considerations of the particular investment or investment course of action. The weight given to any factor by a fiduciary should appropriately reflect a reasonable assessment of its impact on risk-return and be based on the facts and circumstances particular to the investment or investment course of action. The DOL cautions that it will not address specific risk and return factors, but notes that the DOL has previously concluded that plan contributions do not constitute a "return" on investment.

The final rule adds a new provision clarifying that fiduciaries do not violate their duty of loyalty solely because they take participants' non-financial preferences into account when constructing a menu of prudent investment options for participant-directed individual account plans. If accommodating participants' preferences will lead to greater participation and higher deferral rates, such preferences could be relevant to furthering the purposes of the plan.

Designated Investment Alternative Provisions Modified
The final rule removes the 2020 Rules requirement for designated investment alternatives (DIAs) that plan fiduciaries select investments and investment courses of action based solely on pecuniary factors rather than also considering non-pecuniary objectives in those investment objectives or principal investment strategies. The final regulations instead apply the same standards to DIAs as apply to other investments—namely, that a plan fiduciary must focus on material risk-return factors, including ESG factors as required by the facts and circumstances, 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 regulations also allow a plan fiduciary of a participant-directed defined contribution plan to select a fund to serve as a Qualified Default Investment Alternative (QDIA) if it, or any of its component funds in a fund-of-fund structure, has investment objectives, goals, or principal investment strategies that include, consider, or indicate the use of non-pecuniary factors in its investment objectives, a rescission of the 2020 Rule. The final regulations note that the term "designated investment alternative" does not include brokerage windows, self-directed brokerage accounts, or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan.

Improvements and Clarification of Application of the Tie-Breaker Test
The 2020 Rule imposed a requirement that competing investments be indistinguishable based on pecuniary factors alone before a fiduciary could turn to collateral factors to break a tie. The final rule replaces that requirement with a standard that instead requires a plan 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. In such cases, the plan fiduciary is not prohibited from selecting the investment or investment course of action based on economic or non-economic benefits other than investment returns.

The final rule also removes the 2020 Rules' special documentation requirements for ESG investments, noting that these create unnecessary burdens for the application of the tie-breaker provision which dampened the consideration of ESG factors, even when those factors are financially material to the investment decision. Observing that the Securities and Exchange Commission (SEC) is conducting a regulatory initiative designed to provide consistent standards for ESG disclosures, the DOL may revisit the need for collateral benefit reporting or disclosure depending on the findings of the SEC.

The proposal does not place parameters on what may be considered a collateral benefit. When ESG factors are not considered relevant to the risk/return analysis, they may still be a legitimate collateral benefit for consideration in a tie-breaker analysis. The DOL also notes that a fiduciary utilizing a tie-breaker analysis remains subject to ERISA's prudence requirements.

Shareholder Rights/Proxy Voting Provisions

The final regulations seek to align with the DOL's longstanding 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 interests, such as if there are significant costs or efforts associated with voting.

The final rule removes the two "safe harbor" examples in the 2020 Rules regarding proxy voting policies that would have permitted a fiduciary to:

- Limit voting resources to particular types of proposals that the fiduciary has prudently determined are substantially related to the issuer's business activities or are expected to have a material effect on the value of the investment; and
- Refrain from voting on proposals or particular types of proposals when the plan's holding in a single issuer relative to the plan's total investment assets is below a quantitative threshold.

The DOL notes that those safe harbors do not adequately safeguard the interests of plans and their participants and beneficiaries.

The final regulations remove the requirement that plan fiduciaries maintain specific records on proxy voting activities and other exercises of shareholder rights. According to the DOL, imposing such a requirement may create the misperception that proxy voting and other exercises of shareholder rights differ from other fiduciary activities. The final rule instead directs fiduciaries to the generally applicable ERISA fiduciary duties of prudence and loyalty.

This publication is meant only as a high-level summary of some of the key points contained in the final regulations. Plan sponsors should review the regulations with the plan's attorney to determine impact of these changes on the sponsor's retirement plan and investment decisions.

IRS Circular 230 Disclosure

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