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DOL Issues Final Rule Amending Investment Duties Regulation – Provides New Guidance on Consideration of ESG Factors in Plan Investing

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On November 22, the United States Department of Labor ("DOL") released its final rule (the "Final Rule") adopting certain revisions to its investment duties regulation under ERISA at 29 CFR Section 2550.404a-1 (the "Section 404a-1 Regulation"). The revisions in the Final Rule are intended to clarify the application to ERISA plan fiduciaries of the ERISA duties of loyalty and prudence in respect of investments and the use of written proxy voting guidelines and policies. The Final Rule clarifies that ERISA plan fiduciaries may consider climate change and environmental, social and corporate governance ("ESG") factors when making investment decisions and exercising shareholder rights for plans.

The Final Rule is the latest DOL action in the long-running back and forth in DOL guidance (depending on the political party of the administration in power) regarding the consideration of ESG factors in investment decisions. Briefly, the Final Rule modifies, and in some cases reverses, certain changes made in 2020 to the Section 404a-1 Regulation initiated under the Trump administration to address what the DOL noted at such time was a perceived heightened concern raised by ESG investing. In 2021, the DOL conducted a review of the 2020 changes to the Section 404a-1 Regulation and issued an enforcement policy statement providing it would not enforce the 2020 rule. In October of 2021, the DOL issued a Notice of Proposed Rulemaking to amend the Section 404a-1 Regulation. The DOL indicated that the intent of the 2021 proposed amendments was to address its concerns that the 2020 changes, and the discussion in the release applicable to such changes, created uncertainty around the consideration of ESG factors in investment and proxy voting decisions. In this regard, among other things, the DOL noted stakeholder concerns that the 2020 changes "had a chilling effect on appropriate integration of climate change and other ESG factors in investment decisions."

While the DOL made several changes in the Final Rule (as discussed below), the DOL stressed that the Final Rule does not change two important longstanding principles that: (1) the ERISA duties of prudence and loyalty obligate fiduciaries to focus on relevant risk-return factors and to not subordinate the interests of plan participants and beneficiaries to goals unrelated to the interests of participants and beneficiaries in their retirement income or other financial benefits under the plan; and (2) the fiduciary duty of managing plan assets that are shares of stock includes the management of rights appurtenant to such shares, including the right to vote proxies.

The following summarizes the most material (what the DOL characterizes in the preamble to the Final Rule as the "major") amendments to the Section 404a-1 Regulation:

(1) **Removal of "Pecuniary" and "Non-Pecuniary" Terminology.** The Final Rule removes the "pecuniary" and "non-pecuniary" investment terminology added to the Section 404a-1 Regulation by the 2020 amendments, which required fiduciaries to evaluate investments and investment courses of action based solely on pecuniary factors, except in certain limited circumstances. The Final Rule instead provides that a fiduciary's determination with respect to an investment or investment course of action must be based on factors the fiduciary reasonably determines to be relevant to a risk/return analysis, and that these factors may include the economic effects of ESG factors on such investment or course of action.

(2) **"Tie-breaker" Test Revisions.** The Final Rule revises the so-called "tie-breaker" test in the Section 404a-1 Regulation, which provided that a fiduciary may consider collateral benefits in certain circumstances as tie-breakers when choosing between investment alternatives. The 2020 amendments permitted a fiduciary to base an investment decision on non-pecuniary factors if the fiduciary is unable to distinguish between or among investments on pecuniary factors alone, provided the fiduciary satisfies certain documentation requirements. The Final Rule replaces this with a requirement that the fiduciary prudently conclude that competing investments or courses of action equally serve the financial interests of the plan over the appropriate time horizon. In such event, a fiduciary has flexibility to make a selection based on collateral benefits. The Final Rule also eliminates the specific documentation requirements applicable to the consideration of tie-breakers imposed by the 2020 amendments.

(3) **Elimination of Stricter Rules for QDIAs.** The Final Rule removes the restriction added to the Section 404a-1 Regulation in the 2020 amendments relating to "qualified default investment alternatives" (or "QDIAs"), which precluded plan fiduciaries from adding an investment option to a participant-directed defined contribution investment menu as a QDIA if such option's objectives, goals or principal investment strategies include, consider or indicate the use of one or more non-pecuniary factors. Under the Final Rule, a fiduciary selecting a QDIA is no longer subject to such a restriction, and must merely satisfy the otherwise applicable standard of care in the selection of a QDIA.

(4) **Clarification Regarding Consideration of Participant Preferences.** The Final Rule includes new language clarifying that fiduciaries do not violate the ERISA duty of loyalty solely by taking into account participant preferences when developing a menu of prudent investment alternatives for participant-directed defined contribution plans.

(5) **Removal of Certain Provisions Relating to Proxy-Voting.** Relating to proxy voting, the Final Rule removes language that the duty to manage shareholder rights appurtenant to shares of stock does not require voting of every proxy or the exercise of every shareholder right – the DOL expressed a concern that such language could be read to suggest that plan fiduciaries should be indifferent to the exercise of shareholder rights. The Final Rule also removes two “safe-harbor” examples relating to permissible voting policies that the DOL believes encourage abstention as the normal course. In addition, the Final Rule eliminates certain specific monitoring obligations and specific recordkeeping requirements added by the 2020 amendments.

The general effective date of the Final Rule is January 30, 2023. The DOL is delaying the applicability of certain provisions relating to proxy voting until December 1, 2023.