ERISA Alert

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DOL's Final ESG Investing and Proxy Voting Regulation – Impact on ERISA Fiduciaries and Private Fund Managers

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On November 22, 2022, the U.S. Department of Labor (DOL) issued a final regulation amending prior regulations, adopted in 2020, relating to environmental, social and corporate governance (ESG) considerations in investment and proxy voting decisions for Employee Retirement Income Security Act (ERISA) fiduciaries.

Highlights for ERISA Fiduciaries and Private Fund Managers

Under the final regulation:

- All ERISA fiduciaries, including private fund managers managing "plan assets" funds and other accounts:
  - MUST continue to make investment decisions and vote proxies based solely on financial considerations, except in very limited circumstances (which was required even before the prior regulations).
  - MAY include the economic impact of ESG factors when relevant to a risk and return analysis of an investment under consideration.
  - MUST vote proxies based on the proxy voting policies of investing ERISA plans unless the plans have agreed to accept the manager's proxy voting policies.
  - MUST review their investment and proxy voting policies and other offering materials for compliance with the final regulation.
  - MAY face enhanced risk of fiduciary breach claims for either (i) failing to properly evaluate ESG factors or (ii) justifying ESG investment decisions/proxy voting as pecuniary when in fact they are nonpecuniary.
- Non-ERISA fiduciaries such as private fund managers of hedge and private equity funds with less than 25 percent "benefit plan investor" participation:
  - SHOULD review their investment and proxy voting policies and other offering materials for compatibility with the final regulation to the extent raising capital from clients which are subject to ERISA's fiduciary standards (e.g., ERISA retirement plans).

    - Although such a manager is not directly subject to the final regulation, an ERISA plan investing in such a fund will need to make its own investment decision which now could include the underlying manager's ESG policies.
  - SHOULD NOT represent that their investment products are suitable for an ERISA investor or are otherwise consistent with the final regulation.

Background

The prior regulations reflected the Trump-Pence administration DOL's concern that ERISA fiduciaries would use nonpecuniary considerations when investing plan assets in violation of the "exclusive purpose rule" under ERISA. In particular, the DOL was especially concerned that an investment may sacrifice performance, forgo opportunity or take on additional risk to achieve ESG objectives. In short, the Trump-Pence administration DOL asserted that ERISA fiduciaries must never sacrifice investment returns, take on additional risk or pay higher fees to promote non-pecuniary benefits or goals.

Although the prior regulations were effectively a formalization of the DOL's prior pronouncements on ESG, the tone of the preamble made it clear that the Trump-Pence administration DOL was very skeptical that ESG should play any factor in an ERISA fiduciary's investment decision process or proxy voting decisions. Because of this perception, some were concerned that ERISA fiduciaries were placed in an untenable situation where they could never consider ESG factors in investment decisions, even if they presented legitimate risks.

In response to perceived "uncertainty" regarding whether an ERISA fiduciary may consider ESG and other factors in making investment and proxy voting decisions under the prior regulations and its preamble, on October 13, 2021, the DOL proposed significant amendments to the prior regulations. For an analysis of the proposed regulation, see here. While several changes to the proposal appear in the final regulation (those which are relevant are noted below), the final regulation largely continues the tone and impact of the proposal.

Final Regulation

The final regulation is designed to reflect the Biden-Harris administration's view that climate change and other ESG factors may be a part of an ERISA fiduciary's decision making process. In the news release relating to the final regulation, Acting Assistant Secretary for the Employee Benefits Security Administration Lisa M. Gomez said "The rule announced today will make workers' retirement savings and pensions more resilient by removing needless barriers, and ending the chilling effect created by the prior administration on environmental, social and governance factors in investments." She went on the say "Climate change and other environmental, social and governance factors can be useful for plan investors as they make decisions about how to best grow and protect the retirement savings of America's workers."

With this background in mind, the final regulation amends the prior regulations as follows:

- Eliminate the prohibition on investment funds serving as qualified default investment alternatives for 401(k) plans if they consider ESG matters.

- Specifically provide that, as part of its investment prudence duties, an ERISA fiduciary may consider any factor in the evaluation of an investment that is relevant to the risk-return analysis. Although no longer specifically referenced, the clear tone of the final regulation suggests that ESG factors form a part of the risk-return analysis.
- Provide that appropriate considerations of the projected return of a portfolio relative to the funding objectives of a plan **may** require an evaluation of the economic effects of climate change and other ESG factors on the particular investment or investment course of action. The final regulation does not include the three examples included in the proposed regulation, which specifically provided that climate change-related and governance factors and workforce practices shall be considered by a fiduciary when relevant to a plan's risk-return analysis. The DOL notes in the preamble to the final regulation, however, that these and certain other factors can be relevant to a risk/return analysis, but that the primary justification for removing them from the operative text of the final regulation is that the DOL is wary of creating an apparent regulatory bias in favor of particular investments or investment strategies. Similarly, the DOL deleted from the final regulation a statement from the proposed that determinations of projected investment returns "may often require" an evaluation of ESG factors. The DOL states in the preamble that this was done to dispel any notion that the final regulation creates a regulatory mandate that ESG factors be considered in investment decisions.
- Eliminate the need to specifically document the reason for using the so-called "tie-breaker rule" (e.g., if all things are otherwise equal, then "collateral benefits" may be used in making investment decisions). The final regulation also broadens the application of the tie-breaker rule such that a fiduciary may use collateral benefits to select among investment options when the fiduciary prudently concludes that the options "equally serve the financial interests of the plan." The final regulation does not include the requirement of the proposed regulation that a fiduciary's use of collateral benefits to select a designated investment alternative for a participant-directed individual account plan be prominently displayed in disclosure materials provided to participants.
- Reestablish the DOL's long standing policies that proxy voting is part of an ERISA fiduciary's duties and eliminates various provisions of the existing regulations that may have chilled a plan fiduciary from exercising its rights as a shareholder. In particular, the final regulation:
  - Eliminates the language in the prior regulations that ERISA does not require voting of every proxy. This elimination does not suggest, however, that an ERISA fiduciary must always vote, but rather must decide what is in the best interest of the plan.
  - Eliminates specific monitoring obligations where shareholder rights have been delegated to other parties such as investment managers.
  - Eliminates special requirements that would have required plan fiduciaries to maintain records on proxy voting activities.
  - Specifically provides that an investment manager of a pooled investment vehicle which includes "plan assets," such as a hedge fund with significant ERISA investor participation, that holds assets of more than one benefit plan may be

subject to an investment policy statement of one client plan which conflicts with another client plan. The final regulation requires the investment manager to either vote (or abstain from voting) the relevant proxies to reflect such policies in proportion to each plan's economic interest in the pooled vehicle or establish its own policies and require investing plans to accept such policies as a condition of investing.

Effective Date

The final regulation will generally be effective January 30, 2023. In a change to the proposed regulation, certain provisions of the final regulation applicable to the use of proxy advisory firms and proxy voting by managers of commingled "plan assets" funds will not be effective until December 1, 2023.

Impact on ERISA Fiduciaries and Private Fund Managers

On the surface, the final regulation does not change existing law or the ERISA fiduciary standard that requires fiduciaries to act with complete and undivided loyalty to plan participants and beneficiaries. The U.S. Supreme Court has held in the context of ERISA retirement plans that this standard must be understood to refer to financial rather than nonpecuniary benefits.

Recognizing that any attempt to require ERISA fiduciaries to consider nonpecuniary factors in making investment decisions would likely fail judicial scrutiny, the DOL carefully drafted the final regulation to retain the existing ERISA fiduciary standard, but specifically includes ESG factors as potential pecuniary considerations. In this regard, the final regulation is a radical departure from the prior regulations which, at the least, were skeptical that consideration of ESG factors can be consistent with the fiduciary requirements of ERISA.

At this point, an ERISA fiduciary would be well advised to act cautiously when considering ESG factors in investment decisions and voting. It is certainly possible, and maybe even likely, that a future administration with a different political view would seek to amend the final regulation. It is also not entirely clear that the final regulation would survive judicial scrutiny or provide liability protection for plan fiduciaries, especially in the context of individual account plans such as 401(k) plans, where investment decisions relating to ESG factors could always be second guessed by plaintiffs' attorneys. Perhaps ironically, the final regulation, by specifically listing ESG factors in what "may" be appropriate for an ERISA fiduciary to consider, could introduce a new avenue for potential liability for plan fiduciaries who are accused of not properly reviewing and promoting ESG factors in their decision making. At the same time, such plan fiduciaries could be accused of disguising nonpecuniary investment factors as pecuniary factors.

The final regulation is not specifically applicable to outside investment managers who do not otherwise manage "plan assets" (e.g., investment managers of collective investments funds that qualify as "venture capital operating companies" or managers of funds in which benefit plan investors do not own 25 percent or more of any class of equity interest of such fund). Nonetheless, the final regulation could have a potentially positive impact on raising ERISA-based capital for any investment fund or product that

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has a purpose of focusing on and/or promoting ESG factors and that is able to describe such factors in a manner which are consistent with the final regulation.

At this time, it is unclear what the impact (whether intended or unintended) will be on ERISA fiduciaries and those investment managers seeking to raise ERISA capital. We continue to caution investment managers against recommending and/or advertising that any of their investment products are appropriate for ERISA-based capital in particular, as that decision should be left to the ERISA plan's investment committee and/or manager deciding to make the investment.

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