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Kutak Rock Client Alert

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DOL Embraces ESG Investing in New Rule

On November 22, 2022, the Department of Labor ("DOL") released a final rule that permits retirement plan fiduciaries to consider environmental, social, and governance ("ESG") factors in plan investments and when exercising shareholder rights. The final rule is titled "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights" and will become effective 60 days after publication in the Federal Register.

History: In 2020, the Trump Administration released a rule on ESG investing that directed fiduciaries to select investments solely on pecuniary factors and cautioned against ESG considerations. The 2020 rule essentially prohibited ESG funds from being a plan's qualified default investment alternative ("QDIA"). It also outlined record maintenance requirements and specific steps fiduciaries must take when casting proxy votes.

The Biden Administration stated that it would not enforce the 2020 rule. As a result of uncertainty in this area, most retirement plan fiduciaries have been unwilling to make changes in their policy or approach to ESG investing. In 2021, the DOL released proposed rules endorsing ESG investing and contained language that could have been construed to require evaluation of climate change economic effects and other ESG factors. The final rule removed that language, making it clear that consideration of ESG factors is not mandatory but allowed. It is more amenable to ESG investing than the 2020 rule but does not take a clear stance in favor of ESG investing like the 2021 proposed rule. Ultimately, the final rule is a compromise that offers fiduciaries guidance when approaching ESG investing in retirement plans.

Final Rule: The new rule seeks to clarify the current DOL stance on ESG investing. It also strives to reverse any "chilling effect" the 2020 rule had on ESG investing by allowing retirement plan fiduciaries to consider ESG factors when making decisions about plan investments and menu design.

For all plan sponsors:

- The final rule removes language directing fiduciaries to assess only "pecuniary" factors.
- The final rule states that ESG factors are indeed relevant risk-return factors and should be treated like any other factor that touches on an investment's risk-return analysis. Fiduciaries may consider non-financial factors when determining appropriate investments for the retirement plan.

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For plan sponsors designing menus for participant-directed accounts:

- The final rule explains that fiduciaries do not violate the duty of loyalty solely by considering participants' non-financial preferences when curating participant-directed account menus.

- The final rule removes the special 2020 rules related to QDIAs. Now QDIA selection is subject to the same standards as other investments, which focus on risk-return factors and promoting the best interests of participants. This means an ESG fund could conceivably be a plan's QDIA if it is in the participants' best interests and has favorable risk-return outcomes.

For other plan sponsors:

- The 2020 rule discussed "tiebreakers," which allowed fiduciaries to factor in collateral benefits (non-financial) of an investment only if the competing investments were economically indistinguishable. The new standard instead instructs fiduciaries to prudently determine that an investment serves the financial interests of the plan over the appropriate time horizon and specifies that the determination may factor in non-financial benefits.

- The final rule makes it easier for plan representatives to exercise proxy voting rights on behalf of participants. The 2020 rule discouraged proxy voting if certain conditions were not met. The final rule encourages proxy voting by removing record maintenance requirements for proxy voting, eliminating monitoring obligations over investment managers or proxy firms, and deleting specific examples of acceptable proxy voting policies.

Looking Ahead: Because administrative rules are driven by presidential administrations, it is possible that ESG investing rules could change again. Regardless of the administration's position on ESG factors, any investment decision should be thoroughly documented and should adequately explain the process and rationale for adding or retaining an investment. The final rule reiterates and stresses fiduciaries' underlying ERISA duties of loyalty and prudence and how those duties involve examining risk-return factors of each investment. While fiduciaries may properly consider ESG factors, the duties of loyalty and prudence always require any investment decision to promote the participants' best interests and foster long-term returns.

For additional information, please contact a member of the Kutak Rock Employee Benefits Practice Group.

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