

Special Alert

SPECIALIZED TALENT & EXPERTISE TO SOLVE THE MOST COMPLEX OR STRAIGHTFORWARD CLIENT CHALLENGES.

With more than 30 legal professionals practicing solely in employee benefits law, Trucker Huss is one of the largest employee benefits specialty law firms in the country. Our in-depth knowledge and breadth of experience on all issues confronting employee benefit plans, and their sponsors, fiduciaries and service providers, translate into real-world, practical solutions for our clients.

A DIVERSE CLIENT BASE. We represent some of the country's largest companies and union sponsored and Taft-Hartley trust funds. We also represent mid-sized and smaller employers, benefits consultants and other service providers, including law firms, accountants and insurance brokers.

PERSONAL ATTENTION AND SERVICE, AND A COLLABORATIVE APPROACH. Since its founding in 1980, Trucker Huss has built its reputation on providing accurate, responsive and personal service. The Firm has grown in part through referrals from our many satisfied clients, including other law firms with which we often partner on a strategic basis to solve client challenges.

NATIONALLY-RECOGNIZED. Our attorneys serve as officers and governing board members to the country's premier employee benefits industry associations, and routinely write for their publications and speak at their conferences.

TRUCKER ♦ HUSS

A PROFESSIONAL CORPORATION
ERISA AND EMPLOYEE
BENEFITS ATTORNEYS

135 Main Street, 9th Floor
San Francisco, California 94105-1815

15760 Ventura Blvd, Suite 910
Los Angeles, California 91436-2964

329 NE Couch St., Suite 200
Portland, Oregon 97232-1332

Tel: (415) 788-3111
Fax: (415) 421-2017
Email: info@truckerhuss.com
www.truckerhuss.com

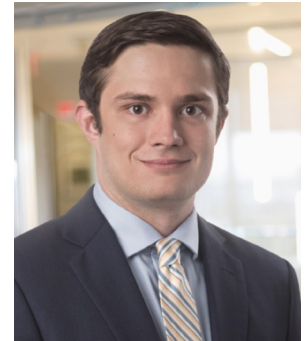
Reinterpreting ESG: DOL Releases Flexible Final Rule While Maintaining Long-Held Principles

ZACHARY ISENHOUR
AND ROBERT GOWER

NOVEMBER 2022

On November 22, 2022, the United States Department of Labor (DOL) issued a new final rule (the "2022 Rule") concerning climate change and environmental, social, and governance (ESG) considerations in selecting investments and exercising shareholder rights (including voting proxies) for plans subject to the Employee Retirement Income Security Act of 1974 (ERISA).¹ The 2022 Rule re-examines the interplay between ESG and ERISA's fiduciary duties of loyalty and prudence, relaxing the conditions under which it may be appropriate for plan fiduciaries to consider ESG factors when selecting investments and investment courses of action, and exercising shareholder rights (such as proxy voting). In doing so, the 2022 Rule enhances the ability for plan fiduciaries to consider ESG funds as prudent investment alternatives without running afoul of their fiduciary duties under ERISA.

The 2022 Rule is the (latest) culmination of over a decade's worth of sub-regulatory and regulatory guidance wherein the DOL has gone back and forth on the extent to which, if at all, ESG factors can play a role in plan investments and the exercise of shareholder rights. Shortly after the last change in presidential administration, on January 20, 2021, President Biden



¹ The 2022 Rule is awaiting publication in the Federal Register and a temporary version is available at the Department of Labor website: <https://www.dol.gov/sites/dolgov/files/ebsa/temporary-postings/prudence-and-loyalty-in-selecting-plan-investments-and-exercising-shareholder-rights-final-rule.pdf>

directed agencies to review regulations published during the prior administration for potential negative or contradictory impacts on the Biden Administration's climate-related initiatives. Such regulations included the Trump Administration's 2020 ESG rule, which generally inhibited a fiduciary's ability to prudently select ESG alternatives and created complex rules for voting proxies that implicated ESG concerns. Following an almost two-year regulatory process (including a Proposed Rule), the 2022 Rule curbs the course on the prior administration's regulations, removing an exclusive focus on "pecuniary factors" and giving plan fiduciaries greater latitude to determine the appropriate investments for their particular plan and participant population.

Even with the significance of the changes, the DOL emphasizes that the 2022 Rule still rests on two core principles: (1) that ERISA's duties of loyalty and prudence require fiduciaries to focus on relevant risk-return factors and not subordinate the interest of participants and beneficiaries to objectives unrelated to the provision of plan benefits; and (2) that fiduciary duties to manage plan assets consisting of shares of stock include exercising proxy rights appurtenant to those shares. Nevertheless, the 2022 Rule generally relies on obligations inherent in ERISA's core duties of loyalty and prudence rather than mandating special considerations or documentation when ESG factors play a role.

Ultimately, the 2022 Rule is more welcoming to the consideration of ESG investments through four key changes:

- ***Elimination of Pecuniary Factors Requirement***

The 2022 Rule abandons the distinction between "pecuniary/non-pecuniary," as the DOL understood this distinction to have created a "chilling effect to financially beneficial choices," leading plan fiduciaries to believe that any ESG considerations would be deemed non-pecuniary (or ancillary) in nature, and therefore imprudent. In removing the pecuniary factors requirement, the 2022 Rule provides that fiduciaries' investment decisions "must be based on factors that the fiduciary reasonably determines are relevant to a risk and return analysis." The 2022 Rule states, without the elaboration seen in the Proposed Rule, that the economic effects of climate change and other ESG considerations may be appropriate factors, leaving such effects open for analysis and interpretation by plan fiduciaries on a case-by-case basis. Notably, the 2022 Rule provides that economic factors of climate change (among other ESG

factors) may be relevant to an investment, or investment course of action, where the Plan's investment policy provides for an investment horizon supportive of such consideration. For plan governance purposes, plan fiduciaries should take the DOL's "risk and return" and "investment horizons" commentary into account when reviewing a Plan's investment policy statement to potentially accommodate ESG.

- ***ESG Factors Acceptable in a Qualified Default Investment Alternative (QDIA)***

The 2022 Rule eschews special rules for fiduciaries considering ESG as a component of a QDIA. This departs from the prior administration's rule which prohibited fiduciaries from designating a fund as a QDIA if it had investment objectives that included the use of non-pecuniary factors, even if the fund was objectively prudent from economic and risk/return perspectives. Rather, under the 2022 Rule, plan fiduciaries are to make decisions related to a QDIA under the same standards for other investments and the separate QDIA regulations. Notably, the 2022 Rule takes additional steps to further destigmatize ESG by no longer requiring an additional disclosure where ESG is a component of a QDIA, a requirement in the Proposed Rule that was the subject of significant public comment and concern.

- ***Elimination of the "Tiebreaker" Rule***

Under the prior regulation, a narrow exception called the tiebreaker rule generally permitted a fiduciary to consider ESG factors only when investments are indistinguishable on pecuniary factors, a situation that the preamble to the prior rule suggested was unlikely to occur. The 2022 Rule promulgates a standard that instead requires a fiduciary to conclude that competing investments "equally serve the financial interests of the plan over the appropriate time horizon." The 2022 Rule implicitly allows a fiduciary to consider ESG and climate change factors when determining whether investments are equal (as long as those factors fit within the risk-return analysis). When investments are "equal," a fiduciary may choose among investments based on collateral benefits. The 2022 Rule relies on ERISA's generally applicable duty to document plan affairs rather than a special documentation requirement when ESG factors are relevant.

- **Participants' Preferences**

A new provision in the 2022 Rule clarifies that plan fiduciaries do not violate their duty of loyalty solely because they consider participants' preferences (i.e., the desire or demand for an ESG investment alternative) when prudently selecting a menu of investment options. The preamble to the 2022 Rule contemplates that investment options that align with participants' preferences may further the purpose of the plan where a menu of such options increases participation and deferral rates, leading to increased participation in the plan. This undoubtedly comes as welcome news for plan sponsors who have long struggled with participant requests for ESG alternatives in a complex framework of fiduciary responsibility.

The 2022 Rule also wrestles with the role of climate change and ESG factors when plan fiduciaries manage shareholder rights attached to investments held by the plan (proxy and other shareholder votes). The Biden Administration believes that the prior administration's proxy voting regulations, which contain complex safe harbors, discourage plan fiduciaries from exercising their fiduciary duty regarding rights attached to the ownership of stock (much as the pecuniary factors test was seen to discourage consideration of ESG in investment selection). As such, the 2022 Rule eliminates the safe harbors in favor of a streamlined approach whereby fiduciaries are to consider exercising shareholder rights for the exclusive benefit of plan participants, including:

- (A) Acting solely in accordance with the economic interest of the plan and its participants and beneficiaries;
- (B) Considering any costs involved;
- (C) Not subordinating the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to any other objective;

- (D) Evaluating relevant facts that form the basis for any particular proxy vote or other exercise of shareholder rights; and
- (E) Exercising prudence and diligence in the selection and monitoring of persons, if any, selected to exercise shareholder rights or otherwise advise on or assist with exercises of shareholder rights, such as providing research and analysis, recommendations regarding proxy votes, administrative services with voting proxies, and recordkeeping and reporting services.

Interestingly, the DOL comments that, while plan fiduciaries may adopt proxy voting policies, those policies must be reviewed periodically and are **not immutable** if a fiduciary reasonably determines specific circumstances require exercising (or not exercising) shareholder rights. With this in mind, plan fiduciaries should exercise careful and *flexible* drafting on any proxy voting policies (commonly contained in an investment policy statement).

Finally, under the 2022 Rule, plan fiduciaries, subject to the terms of the plan document and monitoring obligations, may also rely on a proxy advisory firm, investment manager, or pooled investment provider to exercise shareholder rights. Notably, the 2022 Rule requires managers of commingled funds (such as collective investment trusts) to harmonize proxy voting policies of benefit plan investors, which is likely to result in such managers developing policies for review and consent by plan sponsors.

In sum, the 2022 Rule favors a standard of reasonableness based on the facts and circumstances relevant to a particular plan over the bright-line rules for selecting investments and exercising shareholder rights found in the prior administration's rules, aiming to allow plan fiduciaries more latitude when considering and selecting a menu of investment options or voting proxies.

The Trucker ♦ Huss Benefits Report is published monthly to provide our clients and friends with information on recent legal developments and other current issues in employee benefits. Back issues of Benefits Report are posted on the Trucker ♦ Huss web site (www.truckerhuss.com).

Editor: Nicholas J. White, nwhite@truckerhuss.com

In response to new IRS rules of practice, we inform you that any federal tax information contained in this writing cannot be used for the purpose of avoiding tax-related penalties or promoting, marketing or recommending to another party any tax-related matters in this Benefits Report.

Jahiz Noel Agard

jagard@truckerhuss.com
415-277-8022

Mia Butzbaugh

mbutzbaugh@truckerhuss.com
415-277-8073

Sarah Bowen

sbowen@truckerhuss.com

Adrine A. Cargill

acargill@truckerhuss.com
415-277-8012

Nicolas D. Deguines

ndeguines@truckerhuss.com
415-277-8036

Joseph C. Faucher

jfaucher@truckerhuss.com
213-537-1017

J. Marc Fosse

mfosse@truckerhuss.com
415-277-8045

Angel Garrett

agarrett@truckerhuss.com
415-277-8066

Robert R. Gower

rgower@truckerhuss.com
415-277-8002

Alaina C. Harwood

aharwood@truckerhuss.com
(415) 277-8047

R. Bradford Huss

bhuss@truckerhuss.com
415-277-8007

Zachary T. Isenhour

zisenhour@truckerhuss.com
415-277-8080

Ryan Kadevari

rkadevari@truckerhuss.com
415-788-3111

Clarissa A. Kang

ckang@truckerhuss.com
415-277-8014

Sarah Kanter

skanter@truckerhuss.com
415-277-8053

T. Katuri Kaye

kkaye@truckerhuss.com
415-788-3111

Elizabeth L. Loh

eloh@truckerhuss.com
415-277-8056

Brian D. Murray

bmurray@truckerhuss.com
213-537-1016

Kevin E. Nolt

knolt@truckerhuss.com
415-277-8017

Yatindra Pandya

ypandya@truckerhuss.com
415-277-8063

Barbara P. Pletcher

bpletcher@truckerhuss.com
415-277-8040

Mary E. Powell

mpowell@truckerhuss.com
415-277-8006

Catherine L. Reagan

creagan@truckerhuss.com
415-277-8037

Dylan D. Rudolph

drudolph@truckerhuss.com
415-277-8028

Robert F. Schwartz

rschwartz@truckerhuss.com
415-277-8008

Charles A. Storke

cstorke@truckerhuss.com
415-277-8018

Joelle Tavan

jtavan@truckerhuss.com
415-277-8059

Jennifer Truong

jtruong@truckerhuss.com
415-277-8072

Nicholas J. White

nwhite@truckerhuss.com
213-537-1018

PARALEGALS**Shannon Oliver**

soliver@truckerhuss.com
415-277-8067

Susan Quintanar

squintanar@truckerhuss.com
415-277-8069