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# ESG AND BENEFIT PLANS: KEY TAKEAWAYS FROM THE DOL'S FINAL ESG RULE

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How Morgan Lewis Can Help

# **ESG Basics and Overview**

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# ESG: Not Just Environmental

## Environmental

- Greenhouse gas emissions
- Climate change
- Energy use
- Water use
- Pollution
- Hazardous waste
- Recycling
- Sustainability
- Deforestation

## Social

- Corporate giving and philanthropy
- Working conditions / supply chain
- Workplace health and safety
- Compensation and benefits
- Internal pay equity
- Employee opportunity
- Labor and human rights
- Child and forced labor
- Diversity and inclusion
- Supplier practices

## Governance

- Board structure and composition (including tenure and diversity)
- Executive compensation
- Corruption
- Shareholder rights
- Enterprise risk management
- Audit oversight
- Disclosure and reporting
- Ethics and compliance
- Privacy and cybersecurity

# ERISA Issues Presented by ESG Factors

- The use of ESG factors in investment decision-making can implicate ERISA's fiduciary duties.
- The key issue is how ESG factors fit within ERISA's duty of loyalty and duty of prudence.
- The Duty of Loyalty: The duty to act for the exclusive purpose of providing benefits to participants and defraying reasonable expenses of administering the plan.
- The Duty of Prudence: The duty to act with the care, skill, prudence, and diligence under the circumstances then prevailing.

# Background on DOL Interest in ESG

- The role of ESG (and ESG-like) factors in fiduciary decision making has been the subject to DOL guidance for decades.
- The focus of the guidance has tended to change with the change in the party of the presidential administration, giving the area the feeling of a ping-pong match.
- But the DOL has maintained a consistent view that a fiduciary may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits to other objectives.
- The key difference is the extent to which the DOL believes that ESG factors are:
  - Part of the economic consideration of an investment or
  - Collateral to the economic considerations and instead reflect public policy or political objectives.

# ESG DOL Regulatory History

Clinton Administration	Bush Administration	Obama Administration	Trump Administration	Trump Administration	Biden Administration
<p><b>Interpretive Bulletin 94-1</b></p> <ul style="list-style-type: none"> <li>• “ETIs” are subject to the same standards as any other investment.</li> <li>• If an ETI can meet prudence requirements, a fiduciary can elect to invest in an ETI.</li> </ul>	<p><b>Interpretive Bulletin 2008-01</b></p> <ul style="list-style-type: none"> <li>• “ERISA’s plain text does not permit fiduciaries to make investment decisions on the basis of any factor other than the economic interest of the plan.”</li> <li>• ETI could be a tiebreaker in the case of two identical investments.</li> </ul>	<p><b>Interpretive Bulletins 2015-01 and 2016-01</b></p> <ul style="list-style-type: none"> <li>• ESG may be a proper component of the economic merits of an investment.</li> <li>• ESG factors are not “inherently suspect or in need of special scrutiny.”</li> </ul>	<p><b>Field Assistance Bulletin 2018-01</b></p> <ul style="list-style-type: none"> <li>• Walked back prior guidance.</li> </ul> <p><b>Regulation Amending 29 C.F.R. Section 404a-1</b></p> <ul style="list-style-type: none"> <li>• Added new standards, including on the use of ESG factors.</li> <li>• Added a new proxy voting standards.</li> </ul>	<p><b>First Ever Anti-ESG DOL Investigatory Activitiy</b></p>	<p><b>Regulation Amending 29 C.F.R. Section 404a-1 (2020 Rule)</b></p> <ul style="list-style-type: none"> <li>• Amends 2020 rule, but largely maintains structure of 2020 rule.</li> </ul>



## 2020 Rule

- Prior to the Final Rule, the most recent volley in this back-and-forth was a final regulation issued by the Trump DOL in late 2020 (the “2020 Rule”).
- The 2020 Rule was generally viewed as expressing skepticism that ESG factors could be used consistently with the duties of loyalty and prudence.
- It also changed long-standing DOL guidance on proxy voting and the exercise of shareholder rights.
- Shortly after taking office, the Biden-Harris administration announced a non-enforcement policy for the 2020 Rule.

# Overview of the Final Rule

- The Final Rule confirms that ESG considerations may be considered among the many factors that fiduciaries consider in making investment decisions.
  - **They need not be treated differently from other factors.**
- Rather than focusing on ESG factors specifically, the Final Rule instead sets forth a **principles-based approach** to the fiduciary investment decisionmaking process overall.
- Notably, and contrary to some public statements that have been made, the Final Rule **does not require** ERISA fiduciaries to consider ESG factors.
- The DOL emphasizes that the rule is not new, underscoring its attempt to build a **durable “middle-ground”** rule and help alleviate the “chilling effect” caused by uncertainty.

# Overview of the Final Rule

**Prudence Safe Harbor** An investment decision is prudent if the fiduciary has given “**appropriate consideration**” to facts and circumstances **relevant** to the investment and acted accordingly

This requires investment decision making to be relevant to:

- **A risk and return analysis**
  - Which considers *investment horizons*, *plan investment objectives*, and *plan funding policy*, and provides risk of loss and opportunity for gain similar to alternatives in asset class
  - **Risk return factors may include “the economic effects of climate change and other environmental, social or governance factors.”**
- The **purposes of the plan**
- (For a DB plan): **Portfolio diversification, liquidity** and cash flow and plan **funding objectives**

## **Duty of Loyalty**

- Cannot subordinate the interests in retirement income or financial benefits under the plan to other objectives
- May not sacrifice investment return or take on additional risk to promote benefits or goals unrelated to retirement income or financial benefits under the plan

**Collateral Benefit and Participant Preference Exceptions** So long as fiduciary duties otherwise met:

- Not prohibited from selecting (between two investments) based on collateral benefits
- In a DC plan, can consider participant preference

**Proxy Voting** The fiduciary duties include the management of shareholders rights appurtenant to shares

# **The Final Rule – Key Takeaways and Open Questions**

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# Final Rule Key Takeaways

Provides a more neutral, middle-of-the-road approach to ESG factors, clarifying that taking into account ESG factors is permissible but not prescribed.

Allows fiduciaries of participant-directed plans selecting plan investment options to consider participant preference, in certain circumstances.

Reframes the “tie-breaker” test to allow the consideration of collateral benefits in more circumstances.

Reaffirms the fiduciary duty to vote proxies and exercise shareholder rights.

# Key Takeaway 1: ESG May (But Not Must) Be Considered

- The Final Rule clarifies that ESG factors may be financially relevant factors considered and may appropriately be included as part of ERISA fiduciary investment decision making.
- While the proposed version of the Final Rule suggested there may be circumstances where consideration of certain ESG factors must be considered, the Final Rule includes no such requirement.
  - DOL: The rule **“was not intended to create an effective or de facto regulatory mandate.”**
- With the Final Rule, the DOL intentionally takes an approach intended to achieve “appropriate regulatory neutrality,” which may serve to insulate this rule from further regulatory ping-pong in the future.

## Key Takeaway 2: Tie-Breaker Test Is Now Collateral Benefit Exception

- The concept of the “tie-breaking” has been in DOL guidance for a long time.
- The 2020 Rule required investments to be indistinguishable to allow for consideration of collateral benefits.
- The Final Rule recognizes that “indistinguishable” investments are likely a myth.
  - DOL: The 2020 Rule caused “a great deal of confusion, given that **no two investments are the same** in each and every respect . . . [and] is **impractical and unworkable.**”
- Rather, it allows for consideration of collateral benefits where “competing investments . . . equally serve the financial interests of the plan.” Also, the Final Rule removes the additional documentation required for the tie-breaker analysis under the 2020 Rule.
  - DOL: Documentation requirements may have a “**chilling effect on the proper use** of climate change and other ESG factors” and singled out certain factors, “**contrary to the principles of neutrality.**”
- “Collateral benefits” are not defined, and the listed examples do not include ESG factors, in line with the Final Rule’s de-emphasis on ESG in particular.

## Key Takeaway 3: Participant Preference Can Be Considered

- The Final Rule adds a new provision not included in prior iterations of this regulation.
- Fiduciaries of participant-directed individual account plans do not violate the duty of loyalty solely by considering participant preferences as part of their investment decisionmaking process (as long as the other requirements under the Final Rule are met).
- The DOL states that this provision is not intended to be novel or a change in the DOL position.
- It is, however, the first time the DOL has explicitly addressed the role of participant preference in a regulation.
  - DOL: “[i]f accommodating **participants’ preferences will lead to greater participation and higher deferral rates**, then it could lead to greater retirement security.”



## Key Takeaway 4: Reversion to Long-Standing Proxy-Voting Rules

- The Final Rule reemphasizes a long-standing DOL principle that a fiduciary's duty to manage plan assets includes the appropriate exercise of shareholder rights related to those shares, including the right to vote proxies.
- But this does not mean a fiduciary must *always* vote proxies—rather fiduciaries should ensure that the “**cost and effort associated with voting** a proxy is **commensurate with the significance of an issue to the plan's financial interest.**”
- The Final Rule removes provisions included in the 2020 Rule that some read as increasing the regulatory burden for an ERISA fiduciary to vote proxies and exercise other shareholder rights.
- The Final Rule also addresses the role of proxy voting advisory firms, as well as proxy voting by managers of pooled funds.
- The proxy voting and shareholder rights portion of the Final Rule also reflects the DOL's intended shift to a more **neutral and principles-based approach.**

# The Final Rule: Open Questions

Will the Final Rule provide fiduciaries with the comfort they are looking for to incorporate ESG—whether it be as part of investment guidelines or the selection of an ESG fund?



Will fiduciaries take participant preference into account?



How much weight will courts give to a fiduciary's consideration of participant preference when the investment is challenged as imprudent?



# The Final Rule: Open Questions

How will the current political environment regarding ESG affect the Final Rule?

Would a Republican administration in January 2025 spell the end of the Final Rule?

What effect will the Final Rule have on the market for ESG products and services to ERISA plans?



# The Broader ESG Landscape

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# The Breadth and Growth of ESG (Beyond ERISA)

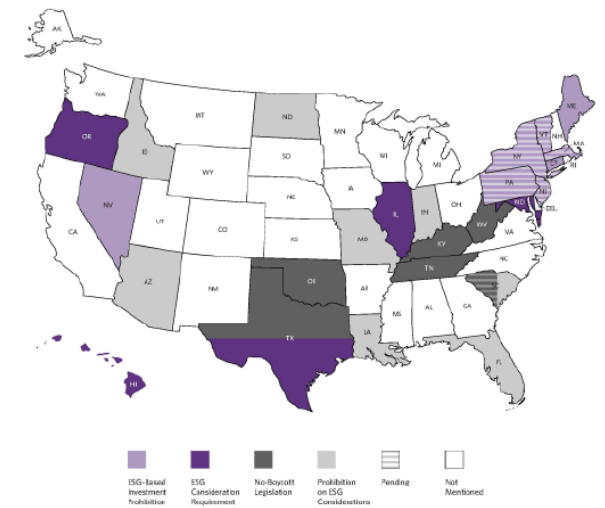


# Anti-ESG Movement

- With ESG considerations on the rise, states are now taking ESG legislation into their own hands.
- Dozens of states have proposed or enacted state-specific guidance that may impact whether and how advisors and fiduciaries can implement ESG investment strategies.
- These regulations vary across the states—some are supportive, while others take a more cautious and limited approach. The regulations are also in different stages of implementation.
- There have been similar “anti-ESG” positions coming from members of Congress.



ANTI-ESG LEGISLATION STATE TRACKER MAP



\*Prohibition on investing state funds in fossil fuel companies

## Anti-ESG Movement (con't)

The debate over ESG investing at the state and federal levels is rooted in the same underlying issue:

Are fiduciaries considering ESG factors because they prudently believe that those factors are appropriate financial considerations?

Alternatively, are fiduciaries considering ESG factors because of certain ethical or moral beliefs about certain industries and political attitudes?

The state anti-ESG movement (and similar statements coming from members of Congress may perpetuate an uncertain landscape.

# Considerations For Plan Sponsors

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# Plan Sponsor Engagement with ESG

## Plan Features and Investment Governance

- ESG funds as designated investment options (and potential engagement with plan participants) or component of DB plan
- ESG explicitly addressed in investment policy statement, such as screens or allocation to specific ESG mandates
- Use of advisers to support ESG consideration
- ESG in brokerage windows

## Asset Manager Relationships

- ESG in investment manager/investment fund guidelines
- Monitoring of manager/fund use of ESG factors
- Delegation of proxy voting and other shareholder rights to investment managers
- Direct engagement of proxy voting advisory firms
- Engagement by managers of proxy voting advisory firms

## Corporate ESG Considerations

- Corporate ESG positions and commitments
- Potential use of “tie-breaker” provision to allow for consideration of corporate ESG positions in plan investments
- Proxy battles over ESG offerings in retirement plans
- Consideration of anti-ESG movement risks

## ESG Due Diligence

For ESG usage (direct and indirect) **developing due diligence processes** based on Final Rule.

## ESG Documentation

For ESG usage (direct and indirect) draft appropriate **developing due diligence documentation** (e.g., investment policy statements and committee meeting minutes) based on Final Rule.



## Possible Plan Sponsor ESG Steps

## ESG External Interest

As needed, address external ESG interest, such as **pro ESG inquiries** (company ESG commitments, participant ESG requests, proxy voting battles) and anticipate **anti-ESG** initiatives in line with Final Rule.

## Other ESG Benefits Issues

Consider other ESG benefit issues, such as **compensation and benefits** tied to ESG goals and benefit **"equity audits"** in line with Final Rule.

# Considerations for Plan Sponsors

- There is a significant spectrum of where plan sponsors are with respect to ESG -- the plan sponsor's place on that spectrum informs the considerations to be taken from this rule.
- Consider whether engagement with participant preferences will be helpful to a plan fiduciary.
- There is more to ESG than offering an ESG-themed fund in a DC plan. Managers use ESG in a variety of ways
- Review proxy voting arrangements.
  - Has it been delegated to managers?
  - How do managers address proxy voting?
  - Does the plan or a manager use a proxy voting advisory firm?
  - How is that firm monitored?
  - When was the last time that the proxy voting advisory firm's proxy voting policies were reviewed?

# Considerations For Advisers and Asset Managers

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# Advisers and Asset Managers

## Dual Roles of Asset Managers:

- Asset allocation – assistance in constructing a menu
- Portfolio construction – developing the actual investments
- The rule applies in both contexts – only one provision [(b)(2)(ii)] singles out portfolio construction

This rule (like prior rules) creates challenges because it hinges in *\*why\** investment decisions are made:

- Acquiring solar panel stock because of growth prospects (economic analysis -- okay)
- Acquiring solar panel stock to support alternative energy initiatives (ethical analysis -- not okay)
- This has been consistent over time.

Consider documentation of process

Proxy voting and engagement considerations.

Review your disclosures!

# Next Steps

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# Coming Up Next...

## Rule Goes into Effect

- While the rule is final, it is not yet effective.
- Most the Final Rule is effective January 30, 2023
- The proxy voting provisions addressing duties of managers and proxy voting advisory firms are applicable on December 1, 2023 because they may require review or renegotiation of agreements.

## "Stickiness" of the Rule?

- It remains to be seen whether the anti-ESG forces can get traction for efforts to undermine, stop, or eventually reverse the Final Rule.
- And it remains to be seen if this uncertainty affects decisions by investment decisionmakers.

# How We Can Help

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# How We Can Help

## ESG & SUSTAINABILITY ADVISORY PRACTICE

### EMPLOYEE BENEFITS

We counsel retirement plan (and other employee benefit plan) clients and related service providers including investment consultants and asset managers on government efforts—particularly by the US Department of Labor (DOL)—to regulate employee benefit plan usage of environmental, social, and governance (ESG) factors. We help navigate our clients through applicable regulatory guidance to balance their fiduciary duties (particularly under ERISA) with marketplace demands, shareholder and retirement plan participant interest, and government enforcement efforts. We also assist non-ERISA retirement plans (e.g., government plans) with these issues.

### RETIREMENT PLAN FIDUCIARIES

We advise retirement plan fiduciaries on remaining agile in the shifting ESG investment environment. Our ESG work is comprehensive and covers the spectrum of ways that retirement plans encounter ESG issues (ranging from integrating ESG directly into fiduciary decision-making by, e.g., adding an ESG fund or ESG mandate, to indirect ESG exposure such as monitoring ESG usage by underlying asset managers).

Our ESG-related services for plan sponsor fiduciaries include the following:

- Counseling fiduciaries (e.g., investment committees) on appropriate consideration of ESG factors, including developing due diligence processes based on existing guidance and caselaw
  - We have developed an ESG checklist to assist with building out such due diligence processes
- Drafting appropriate language in due diligence documents (e.g., investment policy statements and committee meeting minutes)
- Assisting with responses to ESG stakeholder inquiries
- Advising on the risks related to pro- and anti-ESG legislative and regulatory initiatives
  - We maintain a chart of current anti-ESG state initiatives
- Counseling on ESG-related proxy voting issues, including pro-ESG proxy battles
- Advising on executive compensation ESG issues, including ESG performance targets
- Assisting with “equity-audits” of retirement plan and/or other benefit programs

### ADVISERS & ASSET MANAGERS

We assist advisers and asset managers in navigating ERISA (and similar fiduciary duty) ESG risks. These stakeholders can be subject to ERISA regulation where they provide ERISA fiduciary investment advice and manage ERISA assets.

Our ESG-related services for advisers and asset managers include the following:

- Counseling on appropriate consideration of ESG factors, including developing due diligence processes and appropriate ESG metrics
  - We have developed an ESG checklist to assist with building out such due diligence processes
- Drafting disclosure language in light of ERISA-specific risks
- Assisting with responses to ESG stakeholder inquiries
- Advising on the risks related to pro- and anti-ESG legislative and regulatory initiatives
  - We maintain a chart of current anti-ESG state initiatives
- Helping to navigate proxy voting and issuer engagement matters

### ADDITIONAL ESG SUPPORT

**ESG Regulatory Support.** We provide a comprehensive review of new and pending ESG regulations, including evolving industry standards, and assist with regulatory engagement (e.g., comment letters) or implementation (e.g., development of new policies and procedures).

**Investigation and Litigation Support.** We represent clients in ESG-related DOL investigations and other adversarial matters, including those related to anti-ESG state actions. We provide elite support and/or representation grounded in our experience assisting clients with similar matters and our extensive background in dealing with regulators—particularly the DOL.

**ESG Mock Exams/Regulatory Exam Readiness.** Building on our team’s significant ERISA enforcement and regulatory background, we provide an assessment of ERISA fiduciary compliance and risk, with a focus on ESG risks.

**ESG Training.** We conduct trainings targeted to relevant stakeholders—including fiduciary committees, boards of directors, and legal and compliance departments—on the particular risks of ESG usage by retirement plans in light of ERISA and similar regulatory requirements.

# Questions?

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**Julie** provides effective and practical solutions to clients' complex ERISA issues. She proficiently steers plan sponsors and investment managers through ERISA's fiduciary and prohibited transaction rules, and negotiates virtually every type of investment related agreement with employee benefit plans. Julie uses exceptional communication and interpersonal skills to advise clients on a wide range of ERISA topics, including effective fiduciary governance, risk management and the application of environmental, social, and governance (ESG) factors in plan investment decision-making.



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**Liz** advises clients advises employee benefit plan sponsors and service providers to those plans (including financial service firms) on US Department of Labor (DOL) ERISA enforcement investigations and regulatory matters, and ERISA fiduciary counseling and compliance. Liz is the deputy leader of the firm’s Fiduciary Duty Task Force and a co-leader of the ESG and sustainability advisory practice.

Her practice focuses on ERISA’s fiduciary responsibility provisions, prohibited transaction rules and exemptions, and the management of employee benefit plan assets. She negotiates investment-related agreements on behalf of plans and financial services providers; designs, implements, and administers employee benefit plans; and counsels clients on DOL investigations, plan fiduciary governance structures, ERISA reporting and disclosure obligations, ERISA litigation, and general benefit plan compliance considerations. Liz’s work experience includes several years at the DOL’s Office of the Solicitor.



**Rachel Mann**

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**Rachel** counsels publicly and privately held companies on executive compensation and employee benefits issues. Rachel handles complex matters involving equity and incentive compensation, employment, retention and severance arrangements, Employee Retirement Income Security Act (ERISA) compliance, and qualified retirement, pension, and health and welfare plans.

She frequently publishes on the intersection of ERISA and environmental, social, and governance (ESG) issues and regulations, and actively participates in and authors client communications for the firm's ESG Working Group.



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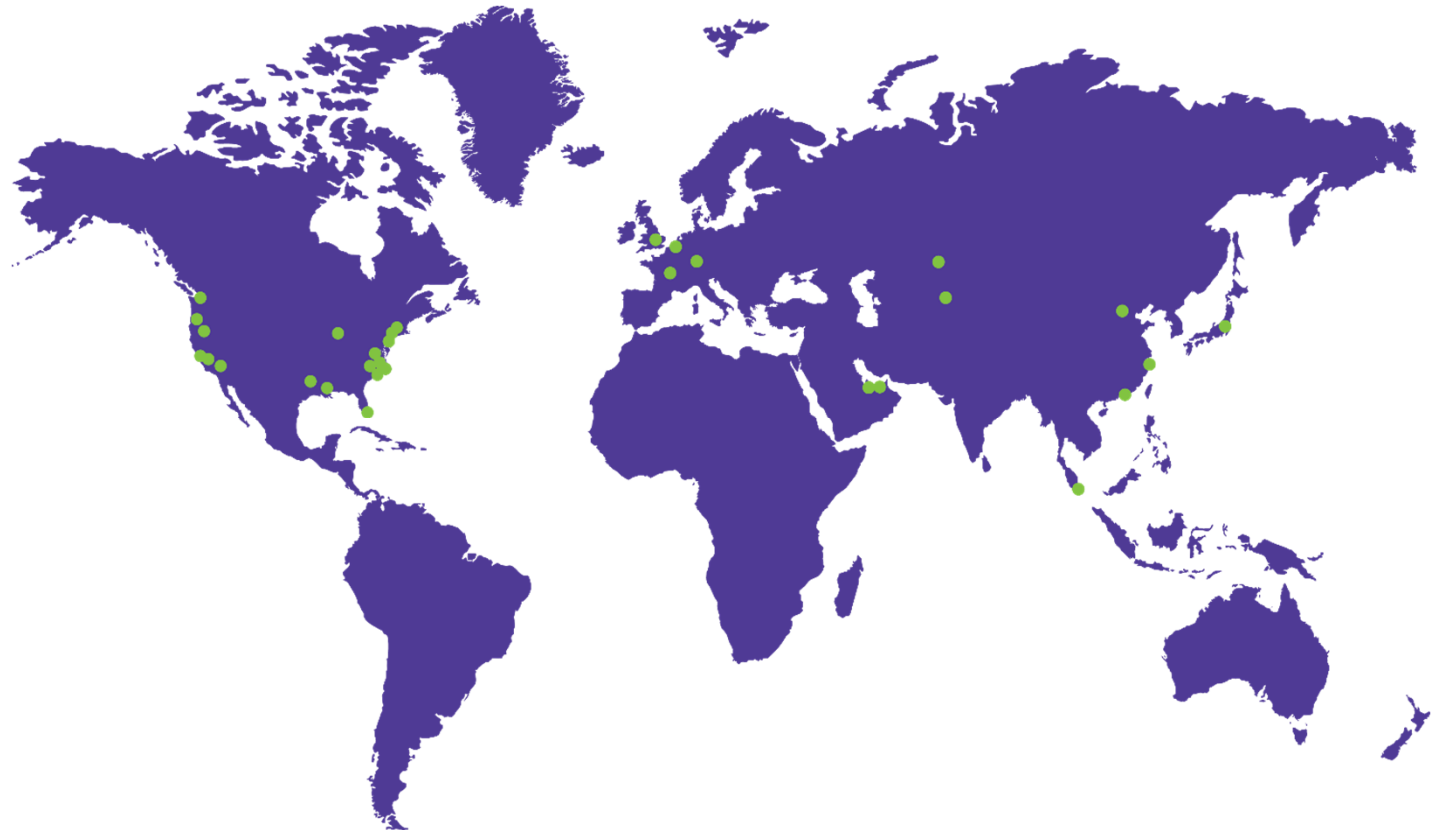
With more than a decade of experience as senior in-house counsel with global investment managers, **Lance** has a deep understanding of mutual fund law and operation and is fluent in the myriad regulations applicable to investment managers. He is well versed in the creation of investment products and environmental, social and governance (ESG) and sustainability matters. Lance works extensively on regulatory policy matters engaging with various financial services regulators, including the US Securities and Exchange Commission, US Department of Labor, Internal Revenue Service, and US Department of Treasury

## Our Global Reach

Africa  
Asia Pacific  
Europe  
Latin America  
Middle East  
North America

## Our Locations

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Brussels  
Century City  
Chicago  
Dallas  
Dubai  
Frankfurt  
Hartford  
Hong Kong\*  
Houston  
London  
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