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The Final 2022 DOL ESG Rule and Why 25 States Oppose It

ESG investing has become a lightning rod for debate and dissent.

KEY HIGHLIGHTS

- Both versions of the Department of Labor (DOL) ESG rule—drafted under the Trump and Biden administrations—state that fiduciaries must focus solely on retirement outcomes for participants and cannot sacrifice return or assume greater risk to achieve collateral social policy goals.
- Despite their similarities, the recently issued Prudence and Loyalty Rule, a replacement DOL ESG rule, triggered a Congressional Review Act challenge and attracted a lawsuit by 25 states.
- ESG investing continues to be a divisive and partisan topic, where even a seemingly neutral rule related to ESG investing has become a lightning rod for debate and dissent.

On December 1, 2022, the Department of Labor (DOL) published its final rule entitled Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights (Prudence and Loyalty Rule). Like the prior administration's rule that it replaced, the Prudence and Loyalty Rule makes barely any mention of environmental, social, or governance (ESG) factors, but it is still known as the "DOL ESG Rule."

In a surprising development, this rule—which makes only modest changes from the prior administration's rule—has been challenged in court by a group of 25 states. This article examines why that ESG moniker persists, why the rule is being opposed, and what impact the rule and subsequent challenges could have on retirement plan sponsors.

A BRIEF HISTORY

The DOL has long debated the extent to which considerations that are not purely economic can factor into the investment decisions made by a retirement plan fiduciary. Until the Trump administration, the debate had mostly occurred in the context of sub-regulatory guidance, as the latest investment fads swept through retirement plan circles. While each piece of guidance was flavored with the philosophy of the administration in office, all sub-regulatory guidance adhered to a central, consistent principle, regardless of politics: Fiduciaries could not sacrifice investment returns or assume greater investment risk to advance collateral social policy goals.

Guidance issued during Republican administrations generally viewed nonfinancial considerations less favorably, while Democratic administrations were likely to be more accommodating to nonfinancial considerations. Still, the differences in guidance over the years has been subtle. If the debate and resulting guidance were considered as a pendulum, the range of motion for the pendulum was very slight between Democratic and Republican administrations.

During the Trump administration, the DOL attempted to prevent any "swing of the pendulum" at all by codifying investment principles in a regulation. That effort resulted in the final 2020 rule entitled "Financial Factors in Selecting Plan Investments." This rule articulated generally neutral principles regarding investment duties but retained some skepticism toward the use of ESG as outlined in the administration's original proposal. Under the final 2020 rule, in order to act loyally, fiduciaries were

generally required to restrict their considerations to "pecuniary" factors, meaning factors that impact the risk or expected return of an investment.

In these cases, as the preamble to the final 2020 rule acknowledged, ESG factors were allowed as considerations only if and to the extent that they might have an impact on the investment. Nonpecuniary factors (including nonpecuniary ESG factors) could be considered only if there was a "tie," meaning that two alternatives were equivalent with respect to risk and return attributes. Fiduciaries were required to document the existence of the tie, and the reasons for the decision in favor of one alternative or another. Defined contribution fiduciaries were allowed greater leeway in investment menu selections but were prohibited from choosing a qualified default investment alternative (QDIA) that used nonpecuniary factors as an investment criterion.

Although the final 2020 rule omitted any mention of ESG, the Trump administration's original proposal, and indeed the bulk of the debate leading up to the final rule, centered on the propriety of considering ESG factors. The final rule, while declining to use the term ESG and remaining largely neutral, was still considered skeptical of ESG in its narrow distrust of fiduciary determinations of "ties" and in its prohibition on QDIAs that used nonpecuniary investment factors.

The Final 2022 Rule

In 2021, after President Biden's election on a platform that included climate action, the DOL issued a new proposed rule. Just as the initial Trump administration proposal sought to discourage ESG considerations, the initial Biden administration proposal, in contrast, appeared to elevate ESG considerations. Most notably, in the observation that a prudent analysis of financial factors "most often required" the examination of impacts on the environment and climate and in proposing a number of examples in which ESG factors would be financial factors.

The proposal also removed any prohibition on the use of ESG factors for QDIAs. The Biden administration's proposal retained the concept of using collateral factors in breaking ties but moved away from the mathematical precision of the 2020 rule by defining a tie as any situation in which two alternatives equally met the needs of participants and beneficiaries. The proposal eliminated any specific fiduciary requirement to document the tie, but if nonfinancial factors were used to select an investment, the 2021 proposal called for special disclosures to participants about the selection criteria. (The Biden administration's proposal also included a revision to the Trump administration's proxy voting rule, which is not discussed here.)

The DOL received over 895 comment letters and 21,000 petitions from individuals in response to the 2021 proposal. Just as occurred during the Trump administration, the DOL's consideration of the comments caused it to issue a final rule that was much more neutral than the proposal. As with the Trump administration's 2020 rule, the Biden administration's 2022 rule preserves the premise that fiduciaries must consider only financial factors unless there is a tie. The specific ESG factors elevated in the proposal—including environmental impacts and all the specific examples—were removed, as was the requirement for special disclosure when nonfinancial criteria were used to break a tie.

Unlike the final 2020 rule issued during the Trump administration, the final 2022 rule did preserve one reference to ESG. In describing the investment prudence duties, the rule requires fiduciaries to give "adequate consideration" to "facts and circumstances...relevant to the particular investment or investment course of action." The rule goes on to state:

> A fiduciary's determination with respect to an investment or investment course of action must be based on factors that the fiduciary reasonably determines are relevant to a risk and return analysis, using appropriate investment horizons consistent with the plan's investment objectives and taking into account the funding policy of the plan established pursuant to [ERISA]. ***Risk and return factors may include the economic effects of climate change and other environmental, social, or governance factors on the particular investment or investment course of action.*** Whether any particular consideration is a risk-return factor depends on the individual facts and circumstances. The weight given to any factor by a fiduciary should appropriately reflect a reasonable assessment of its impact on risk-return.

This reference, along with the debate surrounding the adoption of the 2022 rule, cemented the rule's nickname as the DOL ESG Rule.

The final 2022 rule makes one extremely important improvement over the initial Biden administration's proposal. The 2020 rule finalized during the Trump administration took the position that participant preference was generally a nonpecuniary factor, but because defined contribution fiduciaries were allowed some greater leeway in considering nonpecuniary factors, this view did not stop fiduciaries from acting prudently to accommodate participant investment preferences. The Biden administration's original

proposal removed the leeway given to defined contribution fiduciaries, deeming it unnecessary in light of other changes, but did not explicitly allow consideration of participant preferences as a financial factor.

The final 2022 rule cures that important oversight based on comments by T. Rowe Price and others. As the preamble to the final rule acknowledges, "...fiduciaries do not violate their duty of loyalty solely because they take participants' preferences into account when constructing a menu of prudent investment options for participant-directed individual account plans. If accommodating participants' preferences will lead to greater participation and higher deferral rates, as suggested by commenters, then it could lead to greater retirement security."

The Lawsuit

In the round trip between the final 2020 rule and the final 2022 rule, where two diametrically opposed administrations considered the same question of fiduciary investment selection, the "swing of the pendulum" was again very slight. Both the Trump administration's 2020 rule and the Biden administration's 2022 rule state that fiduciaries must focus solely on retirement outcomes for participants and cannot sacrifice return or assume greater risk to achieve collateral social policy goals. Both rules prohibit fiduciaries from substituting their own preferences or social views for sound, prudent consideration of the expected risk and return of investments. Both rules focus fiduciaries on financial or pecuniary factors, with leeway to consider collateral factors only in the case of a tie.

Given the similarities between the two rules, and the removal of any bias in favor of or against ESG considerations, the lawsuit filed on January 26, 2023, in the U.S. District Court for the Northern District of Texas by a coalition of 25 Republican-led states, two energy companies, one oil and gas producer trade group, and one plan participant was a surprise. According to the lawsuit, the DOL exceeded its authority and acted arbitrarily by issuing a rule that (1) contains an express acknowledgment that ESG factors can affect risk and return factors, (2) loosens the standard for what constitutes a tie, and (3) removes the requirement for fiduciary documentation of the reasons investment alternatives under consideration were tied. (The lawsuit also challenges details of the proxy voting aspects of the 2022 rule not addressed here.)

The most curious question is, why would states—whose own plans are not governed by ERISA—care about a DOL rule on plan investments? According to the complaint, the states have an interest because they believe that there will be reduced tax revenue, citing, in particular, reduced retirement distributions and the potential reduction in investment in oil and gas exploration.

While technical, this question of why states care may be central to the outcome of the lawsuit. In lawsuits, plaintiffs must have "standing," a legitimate basis for claiming that they have been harmed by the challenged conduct. In this case, the states' interest appears to be attenuated, especially without more validation as to why the rule will reduce tax revenues. Further, the lawsuit does not appear to grasp the pertinence of the 2020 DOL ESG Rule, which would also have allowed consideration of ESG factors that impacted risk and return of an investment.

Congressional Action

In another surprising development, members of Congress jumped into the fray and blocked the regulation through congressional action. Under the Congressional Review Act (CRA), Congress can rescind any administrative rule by a simple majority vote within 60 days of its effective date. On March 1, 2023, the Senate voted to overturn the 2022 DOL ESG Rule after the resolution passed in the House of Representatives. President Joe Biden vetoed the bill on March 20, 2023—the first veto of his presidency—and preserved the 2022 version of the rule.

Thoughts for Defined Contribution Plan Sponsors

Despite these challenges to the 2022 DOL ESG Rule, we believe there is very little reason for defined contribution plan sponsors to be concerned. Under both the 2020 and the 2022 versions, if ESG factors are relevant to potential risk or likely return, then these are factors that prudent fiduciaries should be taking into account when making investment decisions. Unless the lawsuit prevails, the Biden administration's version of the DOL ESG Rule applies. For plan sponsors who wish to err on the side of caution, they could consider taking the following actions (which were required under the 2020 version of the DOL ESG Rule): (1) carefully document any menu choices that result from the consideration of nonpecuniary factors as the deciding factor in a tie-breaking scenario, and (2) avoid any QDIA that includes (or has a component that includes) a nonpecuniary factor as an investment objective or principal investment strategy.

The Moral of the Story

It remains to be seen whether this rule will survive its court challenge. What we do know is that ESG investing continues to be a divisive and partisan topic in American politics because it crystalizes questions about the role of government in private industry and capital markets. Those who favor prioritizing ESG factors in investing fear that the government is not doing enough to promote broader societal goals in capital markets. Those who seek to exclude any consideration of ESG factors in investing fear that the government will use capital markets to impose its values on those who do not share them. In this highly politicized environment, even a neutral (and relatively uncontroversial) rule touching on ESG investing will be a lightning rod for debate and dissent over these issues.

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