



LACERS
LA CITY EMPLOYEES'
RETIREMENT SYSTEM



Board of Administration Agenda

REGULAR MEETING

TUESDAY, APRIL 25, 2023

TIME: 10:00 A.M.

MEETING LOCATION:

LACERS Boardroom
977 N. Broadway
Los Angeles, California 90012

Important Message to the Public

An opportunity for the public to address the Board in person from the Boardroom and provide comment on items of interest that are within the subject matter jurisdiction of the Board or on any agenda item will be provided at the beginning of the meeting and before consideration of items on the agenda.

Members of the public who do not wish to attend the meeting in person may listen to the live meeting via one-way audio on Council Phone by calling (213) 621-CITY (Metro), (818) 904-9450 (Valley), (310) 471-CITY (Westside) or (310) 547-CITY (San Pedro Area).

Disclaimer to Participants

Please be advised that all LACERS Board meetings are recorded.

LACERS Website Address/link:

www.LACERS.org

In compliance with Government Code Section 54957.5, non-exempt writings that are distributed to a majority or all of the Board in advance of the meeting may be viewed by clicking on LACERS website at www.LACERS.org, at LACERS' offices, or at the scheduled meeting. In addition, if you would like a copy of a non-exempt record related to an item on the agenda, please call (213) 855-9348 or email at ani.ghoukassian@lacers.org.

| | |
|----------------------|---|
| President: | Vacant |
| Vice President: | Elizabeth Lee |
| Commissioners: | Annie Chao Thuy Huynh Janna Sidley Sung Won Sohn Michael R. Wilkinson |
| Manager-Secretary: | Neil M. Guglielmo |
| Executive Assistant: | Ani Ghoukassian |
| Legal Counsel: | City Attorney's Office Public Pensions General Counsel Division |

Notice to Paid Representatives

If you are compensated to monitor, attend, or speak at this meeting, City law may require you to register as a lobbyist and report your activity. See Los Angeles Municipal Code §§ 48.01 *et seq.* More information is available at ethics.lacity.org/lobbying. For assistance, please contact the Ethics Commission at (213) 978-1960 or ethics.commission@lacity.org.

Request for Services

As a covered entity under Title II of the Americans with Disabilities Act, the City of Los Angeles does not discriminate on the basis of disability and, upon request, will provide reasonable accommodation to ensure equal access to its programs, services and activities.

Sign Language Interpreters, Communication Access Real-Time Transcription, Assistive Listening Devices, Telecommunication Relay Services (TRS), or other auxiliary aids and/or services may be provided upon request. To ensure availability, you are advised to make your request at least 72 hours prior to the meeting you wish to attend. Due to difficulties in securing Sign Language Interpreters, five or more business days' notice is strongly recommended. For additional information, please contact: Board of Administration Office at (213) 855-9348 and/or email at ani.ghoukassian@lacers.org.

- I. PUBLIC COMMENTS AND GENERAL PUBLIC COMMENTS ON MATTERS WITHIN THE BOARD'S JURISDICTION AND COMMENTS ON ANY SPECIFIC MATTERS ON THE AGENDA
- II. ELECTION TO FILL UNEXPIRED TERM OF THE VACANT OFFICE OF THE BOARD PRESIDENT PURSUANT TO LOS ANGELES CITY CHARTER SECTION 503(A) AND POSSIBLE BOARD ACTION
- III. IF VACANCY CREATED IN OFFICE OF THE VICE PRESIDENT BY BOARD ACTION ON AGENDA ITEM II, ELECTION TO FILL UNEXPIRED TERM OF BOARD VICE PRESIDENT, PURSUANT TO LOS ANGELES CITY CHARTER SECTION 503(A) AND POSSIBLE BOARD ACTION
- IV. BOARD PRESIDENT VERBAL REPORT
- V. GENERAL MANAGER VERBAL REPORT
 - A. REPORT ON DEPARTMENT OPERATIONS
 - B. UPCOMING AGENDA ITEMS
 - C. RECOGNITION OF SERVICE FOR PRESIDENT NILZA R. SERRANO
- VI. RECEIVE AND FILE ITEMS
 - A. [MONTHLY REPORT ON SEMINARS AND CONFERENCES FOR MARCH 2023](#)
 - B. [COMMISSIONER SUNG WON SOHN BOARD EDUCATION EVALUATION REPORT ON THE 95TH INTERNATIONAL ATLANTIC ECONOMIC CONFERENCE; ROME, ITALY; MARCH 22-25, 2023](#)
 - C. [ANNUAL CONTRACTOR DISCLOSURE COMPLIANCE REPORT FOR THE YEAR ENDED DECEMBER 31, 2022](#)
 - D. [2023 OPEN ENROLLMENT CLOSEOUT REPORT](#)
- VII. COMMITTEE REPORT(S)
 - A. INVESTMENT COMMITTEE VERBAL REPORT FOR THE MEETING ON APRIL 11, 2023
- VIII. CONSENT ITEM(S)
 - A. [APPROVAL OF MINUTES FOR THE REGULAR MEETING OF MARCH 28, 2023 AND POSSIBLE BOARD ACTION](#)
- IX. INVESTMENTS

A. CHIEF INVESTMENT OFFICER VERBAL REPORT INCLUDING DISCUSSION ON THE PORTFOLIO EXPOSURE TO GLOBAL EVENTS

B. [INVESTMENT MANAGER CONTRACT WITH EAM INVESTORS, LLC REGARDING THE MANAGEMENT OF AN ACTIVE U.S. SMALL CAP GROWTH EQUITIES PORTFOLIO AND POSSIBLE BOARD ACTION](#)

X. LEGAL/LITIGATION

A. [BOARD EDUCATION: FIDUCIARY DUTIES AND CORPORATE ENGAGEMENT](#)

XI. DISABILITY RETIREMENT APPLICATION(S)

A. **CLOSED SESSION PURSUANT TO GOVERNMENT CODE SECTION 54957(b) TO CONSIDER THE DISABILITY RETIREMENT APPLICATION OF RUBEN MARQUEZ AND POSSIBLE BOARD ACTION**

XII. OTHER BUSINESS

XIII. NEXT MEETING: The next Regular meeting of the Board is scheduled for Tuesday, May 9, 2023 at 10:00 a.m., in the LACERS Boardroom, at 977 N. Broadway, Los Angeles, California 90012-1728.

XIV. ADJOURNMENT

Agenda of: APR. 11 2023

Item No: VI-A

**MONTHLY REPORT ON SEMINARS AND CONFERENCES
ATTENDED BY BOARD MEMBERS ON BEHALF OF LACERS
(FOR THE MONTH OF MARCH 2023)**

In accordance with Section V.H.2 of the approved Board Education and Travel Policy, Board Members are required to report to the Board, on a monthly basis at the last Board meeting of each month, seminars and conferences they attended as a LACERS representative or in the capacity of a LACERS Board Member which are either complimentary (no cost involved) or with expenses fully covered by the Board Member. This monthly report shall include all seminars and conferences attended during the 4-week period preceding the Board meeting wherein the report is to be presented.

BOARD MEMBERS:

Vice President Elizabeth Lee

Commissioner Annie Chao

Commissioner Thuy Huynh

Commissioner Janna Sidley

Commissioner Sung Won Sohn

Commissioner Michael R. Wilkinson

| DATE(S) OF EVENT | SEMINAR / CONFERENCE TITLE | EVENT SPONSOR (ORGANIZATION) | LOCATION (CITY, STATE) |
|-------------------------|-----------------------------------|---|-----------------------------------|
| | NOTHING TO REPORT | | |

**LOS ANGELES CITY EMPLOYEES' RETIREMENT SYSTEM (LACERS)
TRAVEL/CONFERENCE EVALUATION REPORT**

| | |
|--|----------------------------|
| Name of Attendee: Sung Won Sohn | |
| Title of Conference/Seminar: 95th International Atlantic Economic Society (IAES) | |
| Location: Rome, Italy | No. of Education Hours: 19 |
| Event Sponsor: IAES | Date(s) Held: March 22-25 |

Report for:

- Travel
- Conference/Seminar Attendance Only

I. Nature/Purpose of Travel (if applicable):

Attend the 95th International Atlantic Economic Society (IAES) in Rome, Italy

II. Significant Information Gained:

1. European economic conditions and outlook with impact on the global economy
2. Central Bank Digital Currency Development in the Euro-zone and U.S. implications
3. European debt overhang and fiscal policy with global implications
4. Inflation outlook in Europe with global implications by head of the Bank of Italy
5. Banking crisis in Europe and its U.S. connection. What lies ahead.
6. ESG, AI, Climate issues in the Euro-zone. +

III. Benefits to LACERS:

Investment. About 50 percent of S&P 500 earnings come from overseas, especially the Euro-zone. LACERS portfolio is heavily exposed to the global economy. Looking ahead, LACERS' dependence on the global economy is expected to increase.

IV. Additional Comments:

The annual IAES meeting allows economists from all over the world, not just Europe, to meet, exchange ideas and connect going forward. I am a member of the Executive Committee of IAES, which is considered a great honor in my profession. A former president of IAES won a Nobel prize in economics.

SUBMIT TO THE LACERS COMMISSION EXECUTIVE ASSISTANT,
WITHIN 30 DAYS AFTER ATTENDING THE CONFERENCE/SEMINAR



REPORT TO BOARD OF ADMINISTRATION
From: Neil M. Guglielmo, General Manager

MEETING: APRIL 25, 2023
ITEM: VI - C

Neil M. Guglielmo

SUBJECT: ANNUAL CONTRACTOR DISCLOSURE COMPLIANCE REPORT FOR THE YEAR ENDED DECEMBER 31, 2022

ACTION: CLOSED: CONSENT: RECEIVE & FILE:

Recommendation

That the Board receive and file the Annual Contractor Disclosure Compliance Report for the period January 1, 2022 to December 31, 2022.

Executive Summary

Last August 13, 2019, the Board adopted the Contractor Disclosure Policy to:

- Provide transparency and confidence in LACERS' decision-making process and ensure that investment and procurement decisions are made solely on the merits of goods or services provided by the Contractors to LACERS; and,
- Enhance contractors' disclosure by requiring periodic reporting of conflicts of interest whether actual, potential, or perceived after the contract is awarded and during their engagement with LACERS.

This policy applies to new agreements entered into by LACERS after the adoption date, and to all existing agreements with changes or amendments in contract terms and conditions after the adoption date. Changes in contract terms and conditions include: extension of contract period; increase in contract or commitment amount; and, increase in fees and compensation paid to contractors.

Exceptions to this policy include: contracts that are \$20,000 or less with not more than 1 year period; low cost equipment maintenance agreement of \$2,000 or less; contracts with less than 3 months in duration; and, piggy-backed City/State/Federal contracts.

LACERS Internal Audit is responsible for reviewing and compiling a Board report that contains contractor-submitted information such as: campaign contributions, other contributions, gifts, list of contacts/meetings, and intermediary’s information.

Based on Internal Audit’s review and evaluation of contractors’ disclosures, no anomalies or improprieties were found.

LACERS achieved 100% compliance from contractors. Internal Audit received all 123 requested disclosure reports for calendar year 2022, as shown in the following table.

| FILING TYPE | NO. REQUIRED | NO. RECEIVED |
|---------------------------------------|---------------------|---------------------|
| CONTRACTOR DISCLOSURE REPORT REQUESTS | 123 | 123 |

Section H (Penalties) of the Contractor Disclosure Policy provides that in the event of material omission or inaccuracy in the Contractor Disclosure or any other violation of this Policy (e.g., non-compliance/non-submission), the Board in its sole discretion may impose the following penalties:

1. Whichever is greater, the reimbursement of any contractor, management or advisory fees paid by LACERS for one year or an amount equal to the amounts that the Contractor has paid or promised to pay to the Intermediary, in connection with LACERS investments.
2. LACERS shall have the authority to terminate the agreement, without penalty.
3. The Board of Administration may take action to ban Contractor and/or the intermediary who materially violated this Policy from future contracting opportunities with LACERS for a period of up to five years. However, the prohibition may be reduced by a majority vote of the Board, at a public session, upon showing of good cause.

Contractors are initially given 45 days from the end of the reporting period to submit their signed reporting forms (with or without information to disclose). If no response is received, additional reminders to comply are sent by both internal audit and respective contract administrators.

For this reporting period, including the additional time given after the original deadline, contractors had approximately three months from the end of their reporting period to submit the required disclosure reports.

Attachment 1 lists the contractors' contributions, list of contacts/meetings, gifts, and intermediary's information. Attachment 2 pertains to LACERS Contractors' Disclosure Policy.

Strategic Alignment

Discussion of the Contractors' Disclosure Report is consistent with the Board's Governance Goal to "uphold good governance practices which affirm transparency, accountability and fiduciary duty."

Fiscal Impact Statement

None

Prepared By: Maria Melani Rejuso, Departmental Audit Manager

NMG/MR

Attachments: 1. Contractors Disclosures Summary
2. LACERS Contractors' Disclosure Policy

ATTACHMENT 1

**CONTRACTORS DISCLOSURES SUMMARY
LOS ANGELES CITY EMPLOYEES' RETIREMENT SYSTEM
FOR THE PERIOD JANUARY 1, 2022 TO DECEMBER 31, 2022**

| OUTSTANDING DISCLOSURES | | | | | |
|--------------------------------|-------------------------------|----------------------|------------------|--|----------------------------------|
| Account Number | Vendor / Contract Name | Contract Term | | Responsible Section | Reason for non-disclosure |
| | | Start Date | Exp. Date | | |
| | None | | | None | |
| CAMPAIGN CONTRIBUTIONS | | | | | |
| Contract Number | Vendor / Contract Name | Contract Term | | Campaign Contribution Information | |
| | | Start Date | Exp. Date | | |
| C-134865 | Foley & Lardner LLP | 12/1/2019 | 11/30/2023 | <p>Byron McLain, Partner at Foley & Lardner contributed \$1,500 on 8/2/2022 to Mayor Karen Bass for 2022 General election when she was a Mayoral candidate</p> <p>Robert DuPuy, Partner at Foley & Lardner contributed \$500 on 10/10/2022 to Mayor Karen Bass for 2022 General election when she was a Mayoral candidate</p> <p>Brandee Diamond, Partner at Foley & Lardner contributed \$500 on 10/02/2022 to Mayor Karen Bass for 2022 General election when she was a Mayoral candidate</p> <p>Antoinette Konski, Partner at Foley & Lardner contributed \$500 on 10/10/2022 to Mayor Karen Bass for 2022 General election when she was a Mayoral candidate</p> <p>Dennis Cardoza, Public Affairs Director at Foley & Lardner contributed \$1,500 on 10/10/2022 to Mayor Karen Bass for 2022 General election when she was a Mayoral Candidate</p> <p><i>(Note: Per person contribution limits for 2022 Regular Elections according to City/State/Federal Finance Laws as published by LA City Ethics Commission are: City Council a limit of \$800 per election; Mayor, City Attorney and Controller a limit of \$1,500 per election: and LAUSD a limit of \$1,300 per election . Primary and general are considered separate elections.)</i></p> | |

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|-----------------------|------------------------------------|-----------|-----|--|
| LAC96, Private Equity | Fortress Investment Group (Fund V) | 8/31/2020 | N/A | <p>Damien Wilson, spouse of Olga Wilson who works as a registered representative of Fortress Capital Formation (FCF) but is not involved in LACERS relationship, contributed \$500 on 04/21/2022 to Mayor Karen Bass for 2022 election when she was a Mayoral Candidate</p> <p><i>(Note : Per person contribution limits for 2022 Regular Elections according to City/State/Federal financial laws as published by LA City Ethics Commission are: City Council a limit of \$800 per election; Mayor, City Attorney and Controller a limit of \$1,500 per election: and LAUSD a limit of \$1,300 per election . Primary and general are considered separate elections.)</i></p> |
|-----------------------|------------------------------------|-----------|-----|--|

| Contract Number | Vendor / Contract Name | Contract Term | | Other Contribution Information |
|-----------------|------------------------|---------------|-----------|--------------------------------|
| | | Start Date | Exp. Date | |
| | None | | | None |

DISCLOSED CONTACTS- 24 MONTH PERIOD PRIOR TO BOARD APPROVAL

| Contract Number | Vendor / Contract Name | Contact Date | Contact Information |
|-----------------|--|---------------------------------------|---|
| Legal Services | Bleichmar Fonti & Auld LLP (BFA). Effective November 1, 2022 | Did not specify | BFA regularly communicates with members of the outside counsel oversight division of the Los Angeles City Attorney's office in the regular course of performing their contract and monitoring LACERS' portfolio for securities fraud class actions. |
| Non-US Equity | Lazard Asset Management LLC, extended on May 24, 2022 for another 1 year | Between February 2022 to October 2022 | Contractor reported that they had conference calls with LACERS staff and an in person office visit by an investment staff during the calendar year 2022 for Portfolio reviews. |

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| PE | Lightbay Management LLC, effective January 31, 2022 | 11/10/2021 | Lightbay reported that they held a video conference with LACERS' Investment team to give them an overview of the investment opportunity in Lightbay. The meeting was also attended by Aksia's representative. |
| PE | Technology Crossover Ventures (TCV), Fund XI was effective 10/02/2020 and Fund XII was effective 06/13/2022 | Did not specify | Held meetings with LACERS staff to discuss matters related to LACERS' investments in TCV. |
| PE | Nordic Capital, effective April 29, 2022 | Between January 2022 to November 2022 | Nordic reported that they held meetings/calls with LACERS investment staff during calendar year 2022. |

DISCLOSED GIFTS

| Contract Number | Vendor / Contract Name | Gift Date | Gift Information |
|------------------------|---|--------------------|---|
| 26-63281 | Advent Global Technology II | November 8-9, 2022 | <p>Veronica Bateman, Aksia's employee (<i>LACERS Private Equity Consultant</i>) was presented with a welcome gift during an annual Contractor's investor meeting. The value of the gift was approx. \$66 (60 in euros). However, Advent was not sure whether the welcome gift was taken by the attendee. The Limit set by the State/City law on gifts is \$100 per restricted source (e.g., contractor of the agency) per year, and per individual (receiver of gift).</p> <p>Note: LACERS' disclosure policy states that value of food and beverage items provided to LACERS staff and consultants at networking events, annual general meetings and/or advisory meetings that are open to general public or other investors, and which in aggregate do not exceed annual limit of \$50 are not required to be reported. While the City requires gifts over \$50 to be reported in the individual's Statement of Economic Interest Form (Form 700).</p> |
| C-22357 | Anthem, Blue Cross, contract is from 08/27/2019 to 12/31/2023 | December 27, 2022 | <p>Felicia Guerra, Strategic Account Executive at Anthem reported to have given LACERS Health Benefits team a Holiday Gift Basket on December 27, 2022. The total value of the gift was \$99. The limit set by the State/City law on gifts is \$100 per restricted source (e.g., a contractor of the agency) per year, and per individual (receiver of gift).</p> <p>Note: the City requires gifts over \$50 to be reported, by the individual, in their Statement of Economic Interest (Form 700).</p> |

INTERMEDIARY INFORMATION

| Contract Number | Vendor / Contract Name | Intermediary Name | Compensation | Disclosure Date | Notes |
|------------------------|---|--|--|------------------------|---|
| PE | Arsenal Capital Partners, effective December 10, 2021 | Ms. Patricia Grad is the Head of Investor Relations | Compensation are salary and discretionary bonus | 2/15/2023 | Ms. Grad receives a base salary for her full time role as head of investor relations at Arsenal, and from time to time may receive a bonus. None of her compensation is related to any specific investor, including LACERS. |
| PE | Auldbrass Partners, effective July 7, 2022 | Auldbrass Partners entered into a placement agreement with Aviditi Financial LLC | Pays 2% of the Investors' commitment amounts after 12/31/2021. | 2/2/2023 | Aviditi assists with fund raising for Auldbrass Partners Fund III by introducing potential investors to Auldbrass partners. |

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| RE | Cerberus Institutional Real Estate Partners V, LP, effective 09/14/2020 | Greg Gordon is the Senior Managing Director of Cerberus Capital Management, LP. He is an employee of Cerberus Capital Management LP. | As an employee, Mr. Gordon receives an annual salary and discretionary bonus | 1/24/2023 | Mr. Gordon helps to discuss with potential clients the opportunity to invest in Cerberus' new funds. |
| PE | Clearlake Capital Group, LP, effective 12/10/2019 for Fund VI and 09/17/2021 for Fund VII | Credit Suisse Private Fund Group (the PFG), acting through Credit Suisse Securities USA LLC (CS), has been engaged by Clearlake as the Company's non-exclusive advisor and non-exclusive placement agents. | CS is compensated with a non-refundable cash retainer and a scaled fee based on a percentage of certain aggregate principal amount of securities sold to certain investors. | 3/27/2023 | CS acted as non-exclusive advisor and non-exclusive placement agent for Fund VI and Fund VII as well as the Firm's previous funds Fund V and Opportunities Partners II. |
| PE | CVC Capital Partners/ CVC Capital Partners VIII, effective on May 22, 2020 | Robert Squire and Dimia Fogam are employed by CVC Funding which acts as distributor of CVC Capital Partners. They help manage current and prospective investors. | Investments with LACERS maybe a factor in calculating their bonuses, however this bonus is discretionary and is not charged to LACERS or the Fund. | 3/31/2023 | Contractor reported that they do not compensate non-CVC placement agents. Robert Squire and Dimia Fogam are their distributor's employees and are part of CVC's Investor Relations Team. |

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| RE | GLP Capital Partners IV, effective 03/30/2021 | PJT Park Hill (placement agent) operates as the alternative asset advisory and fundraising services practice group of PJT Partners, an SEC registered broker-dealer. | Paid a fee based on a percentage of interests raised. | 2/14/2023 | The intermediary is a placement agent utilized for all clients of GLP Partners. |
| PE | Fortress Investment Group (Fund V), contract was effective August 31, 2020 | Fortress Capital Formation, LLC | Base salary and discretionary bonus. | 02/14/2023 | Contractor reported that it relies on its employees thru Fortress Capital Formation, LLC to sell interests in investment vehicles managed by Fortress. Fortress personnel who are dedicated to raising capital are compensated for doing so. However no payments or reimbursements are contingent upon LACERS' investing in Fortress Fund. |

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| PE | Harvest Partners IX, effective December 15, 2021 | The Credit Suisse Private Fund Group (PFG) acts as the primary placement agent for HP VIII and HP IX. | Credit Suisse is compensated with a fee based on a percentage of a certain aggregate principal amount of securities of Harvest. | 4/11/2023 | Credit Suisse was not directly involved in soliciting an investment from LACERS. |
| PE | Hellman & Friedman Capital Partners X, effective May 5, 2021 | Ms. Susanna Daniels, Ms. Suzanne Kim Tomlinson, Ms. Catie Barile, and Ms. Sara Ho (Morgan) are employees or Partners of Hellman & Friedman LLC | Compensation are salary and discretionary bonus | 3/2/2023 | None of the intermediaries is compensated or has the firm agreed to compensate (whether on commission, contingent percentage or other similar basis) specifically in connection with any investment or potential investment by LACERS in Hellman & Friedman. |

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| PE | KPS Capital Partners, effective October 10, 2019 | The intermediary, Shavonne Correia, is a full time employee of KPS. She serves as the Head of Investor Relations & Marketing and is a registered lobbyist in the State of California. | Compensation is not based on the procurement of any investment or business with LACERS | 3/30/2023 | Ms. Correia helps to discuss with potential clients the opportunity to invest in KPS funds. |
| PE | Lightbay Management LLC, effective January 31, 2022 | UBS Securities LLC (UBS) has been engaged as the placement agent for Lightbay Investment Partners II, LP. | UBS is paid a market-based fee based on capital raised for the Fund. However, this cost is borne by the General Partner as an offset against Management fee or otherwise. | 1/9/2023 | UBS assists in the preparation of confidential private placement memorandum and supplements and amendments thereto together with an investor presentation describing the Company and the Fund. |

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| RE | Oaktree Capital Management, LP, effective December 4, 2020 | OCM Investments, a subsidiary of Oaktree, has acted as a placement agent for the limited purpose of marketing Oaktree-managed funds. | OCM Investments is reimbursed on a cost-plus 10% basis for its costs and expenses. This reimbursement is paid quarterly by Oaktree. Oaktree employees, including associated persons of OCM Investments, are compensated in the ordinary course of business and will not receive commissions or any compensation based in whole or in part upon an investment by LACERS in the Fund. | 3/2/2023 | OCM Investments is not compensated for its role as placement agent on a transaction basis and was not involved in soliciting LACERS' prospective investment. |
| PE | OceanSound Partners Fund, LP, contract was effective 06/02/2020 | SixPoint Partners, LLC, a Placement Agent | Subject to the customary carve-outs for certain public plans that prohibit the use or payment to placement agents, Sixpoint earns 1% on all capital commitments and/or investments accepted by the Fund. | 03/01/2023 | Sixpoint provides several advisory and fundraising services and is utilized with all prospective clients, except in certain limited circumstances or for entities that prohibit payment of fees to placement agents. |

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|---------------|---|--|--|-----------|--|
| Non-US Equity | State Street Global Advisors Trust Company (Multi Passive Index), effective 06/01/2021 | Ms. Sonya Park is an internal employee of SSGA and not a third party placement agent or intermediary. A registered lobbyist in the State of California | Paid a base salary plus an annual discretionary bonus. | 2/15/2023 | Bonus is not paid based upon activity from any one client. |
| PE | Technology Crossover Ventures (TCV), Fund XI was effective 10/02/2020 and Fund XII was effective 06/13/2022 | Julia Novaes Roux is Partner and Head of Investor Relations at TCV | Paid a salary and bonus from TCV and holds interests in certain investment funds, all of which is not dependent on LACERS decision to invest with TCV. | 4/14/2023 | No compensation is specifically allocable to time spent on LACERS investments. |

Los Angeles City Employees' Retirement System

ETHICS RESPONSIBILITIES FOR BOARD MEMBERS, THE GENERAL MANAGER, LACERS STAFF, CONTRACTORS, AND INVESTMENT CONSULTANTS

CONTRACTOR DISCLOSURE REPORTING POLICY

A. PURPOSE

It is LACERS' policy for Contractors to disclose conflicts of interest - - actual, potential, and perceived.

The goal of this Policy is to prevent impropriety or the appearance of impropriety, to provide transparency and confidence in LACERS' decision-making process, and to help ensure that investment and procurement decisions are made solely on the merits of the goods or services proposed to be provided by Contractors to LACERS.

This Policy sets forth the circumstances under which LACERS requires the full and timely periodic disclosure of ex parte communications with, relationships with, and payments to, entities such as placement agents, third party marketers, lobbyists, and other Intermediaries. This Policy is intended to apply broadly to all Contractors with whom LACERS conducts business.

This Policy shall apply in addition to, and is intended to supplement, LACERS' Marketing Cessation policy, Third Party Marketer Compliance policy, Conflict Governance policy; any applicable state and City ethics, campaign finance, and lobbying laws found in the City's Charter, Governmental Ethics, Lobbying, and Campaign Finance Ordinances; the California Political Reform Act; and the California Constitution. Unless otherwise specified or required by the context, all terms used but not defined herein shall have the same meanings ascribed to them in **Appendix A.**

The Board recognizes that the flow of communication through staff between Contractors or Consultants and Board members is beneficial to the conduct of LACERS business. However, there are instances wherein Contractors or Consultants may have ex parte communications directly with Board members. In those instances where the ex parte communication reasonably might give the appearance of being an attempt to influence the outcome of a Board or staff decision or Consultant recommendation, the Board recognizes that there might be the potential for misunderstanding, misinformation, or conflicting instructions, and therefore such communications reasonably could be interpreted as inappropriately affecting the Board, staff, or Consultant. Such communications do not always rise to the level of "Undue Influence" as defined in this policy, but nevertheless are subject to disclosure.

B. APPLICATION AND EXCLUSIONS

1. APPLICATION

This policy applies to all agreements with Contractors that are entered into after the date this Policy is adopted. Additionally, this Policy applies to existing agreements with Contractors if, after the date this Policy is adopted, (a) the term of the agreement is extended, (b) there is any increased commitment of funds by LACERS pursuant to the existing agreement, or (c) there is an amendment to the substantive terms of an existing

Los Angeles City Employees' Retirement System

ETHICS RESPONSIBILITIES FOR BOARD MEMBERS, THE GENERAL MANAGER, LACERS STAFF, CONTRACTORS, AND INVESTMENT CONSULTANTS

agreement, including the fees or compensation payable to the Contractor to the extent that LACERS' consent is required.

2. EXCLUSIONS

The following contracts are excluded from this Policy:

- 1) Contracts in the amount of \$20,000 or less and for not more than a one-year period for which the Board has authorized the General Manager to approve service agreements, pursuant to Administrative Code section 10.1.1.
- 2) Low cost equipment maintenance agreements and service for equipment repair. "Low cost" is defined as \$2,000 or less.
- 3) Contracts for which contract terms are less than 3 months in duration.
- 4) City or state contracts/agreements for which LACERS utilizes the existing City or state contract or agreement.

C. CAMPAIGN CONTRIBUTION - PERIODIC DISCLOSURE

Except as otherwise provided in this policy, every Contractor shall disclose any and all monetary contributions and/or other financial benefits made directly or indirectly by such Contractor and/or any of its Officers, marketing representatives, relationship representatives, portfolio managers, members of the investment committee, and/or Intermediaries (and, in the case of individuals, the Family Members of any of them) that are involved with the product or service provided, or sought to be provided, to LACERS, to any Elected Official, Candidate, Appointed Official or Applicable City Employee (collectively, "Contractor Campaign Contribution Disclosure"). Such Contractor Campaign Contribution Disclosures shall include contributions made during the twenty-four month period prior to Board approval of a new agreement or investment, or extension of or amendment to an existing agreement, or an increase in funding of an existing investment commitment. For private equity partnerships, disclosure information for the prior twenty-four month period shall be provided at the time that Staff and Consultants consider a new or additional investment in a private equity fund, and annually afterwards. All other Contractors shall disclose campaign contributions made during the terms of the agreement semi-annually.

For each such monetary contribution or financial benefit, the Contractor Campaign Contribution Disclosure shall include the following information:

- (1) The name and address of the contributor and the connection to the Contractor;
- (2) The name and title of each person receiving the contribution and the name of the Elected Official, Candidate, or Appointed Official or person for whose benefit the contribution was made;
- (3) The amount of the monetary contribution or financial benefit; and
- (4) The date of the monetary contribution or financial benefit.

Exemption: Monetary contributions and/or financial benefits given by any person to an Elected Official or Candidate for whom such person was entitled to vote at the time of the contributions and which in the aggregate do not exceed \$100 to any one Elected Official or Candidate per election are not required to be reported pursuant to this disclosure policy.

Los Angeles City Employees' Retirement System

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D. OTHER CONTRIBUTIONS/PAYMENTS - PERIODIC DISCLOSURE

Every Contractor shall disclose any and all monetary contributions and/or other financial benefits, including but not limited to contributions to charitable organizations, not covered by other sections of this Policy. The contributions/benefits to be disclosed can be made directly or indirectly by such Contractor and/or any of its Officers, marketing representatives, relationship representatives, portfolio managers, investment committee members, and/or Intermediaries (and, in the case of individuals, the Family Members of any of them) that are involved with the product or service provided, or sought to be provided, to LACERS.

Disclosure shall include monetary contributions and/or other financial benefits which were solicited directly or indirectly by any Elected Official, Candidate, Appointed Official, or Applicable City Employee. Disclosure shall also include situations where contributions/benefits were made to an organization of which any Elected Official, Candidate, Appointed Official or Applicable City Employee is, to the best knowledge of the person paying the monetary contribution or financial benefit, an officer, employee, or member of the board of directors, advisory board, or any similar board or committee (collectively, "Contractor Miscellaneous Contribution Disclosures").

Such Contractor Miscellaneous Contribution Disclosures shall include contributions made during the twenty-four month period prior to Board approval of a new agreement or investment, or extension of or amendment to an existing agreement, or an increase in funding of an existing investment commitment. For private equity partnerships, disclosure information for the prior twenty-four month period shall be provided at the time that Staff and Consultants consider a new or additional investment in a private equity fund, and annually afterwards. All other Contractors shall also disclose any monetary contributions and/or financial benefits paid during the term of the agreement or investment semi-annually.

For each such monetary contribution and/or financial benefit, the Contractor Miscellaneous Contribution Disclosure shall include the following information:

- (1) The name and address of the contributor and the connection to the Contractor;
- (2) The name of the organization and the name and title of each person receiving the contribution, and the name of the Elected Official, Candidate, or Appointed Official or person for whose benefit the contribution was made;
- (3) The amount of the monetary contribution or financial benefit; and
- (4) The date of the monetary contribution or financial benefit.

Exemption: Value of food and beverage items provided to LACERS staff or Consultants at networking events, annual general meetings and/or advisory meetings that are open to general public or other investors, and which in aggregate do not exceed annual limit of \$50 are not required to be reported pursuant to this disclosure policy.

E. APPLICABILITY OF SECTIONS C AND D

Disclosures required by Sections C and D of this Policy include, but are not limited to, any monetary contribution or financial benefit to any of the following:

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ETHICS RESPONSIBILITIES FOR BOARD MEMBERS, THE GENERAL MANAGER, LACERS STAFF, CONTRACTORS, AND INVESTMENT CONSULTANTS

1. Any Elected Official (and any of his or her controlled committees), Candidate (and any of his or her controlled committees), Appointed Official, or Applicable City Employee.
2. Any account or trust set up through motion of the Los Angeles City Council that would seek funds controlled by an Elected Official or Candidate.
3. Any third party at the behest of an Elected Official, Candidate, or Appointed Official or for the purpose of supporting or opposing an Elected Official, Candidate, or City ballot measure.
4. Any Elected Official, Candidate, Appointed Official, or Applicable City Employee for the sale of private property.
5. Any charitable or other organization or individual at the behest of an Elected Official, Candidate, Appointed Official, or Applicable City Employee.

F. GIFTS - PERIODIC DISCLOSURE

1. GIFTS MADE BY CONTRACTORS

Every Contractor shall disclose all Gifts made directly or indirectly by such Contractor and/or any of its Officers (and the Family Members of any of them), or made directly or indirectly by marketing representatives, relationship representatives, portfolio managers, investment committee members, and/or Intermediaries (and, in the case of individuals, the Family Members of any of them) that are involved with the product or service provided, or sought to be provided to LACERS, to any Elected Official, Candidate, Appointed Official, or Applicable City Employee, or to LACERS' private equity Consultant, general investment Consultant, or real estate Consultant.

For each such Gift, the Contractor shall disclose:

- (1) The name and address of each person providing the Gift and each such person's connection to the Contractor;
- (2) The name and title of each person receiving the Gift;
- (3) The value of the Gift;
- (4) A description of the Gift; and
- (5) The date of the presentation of the Gift.

Such disclosures shall include Gifts made during the term of the agreement or investment (as applicable) and during the twenty-four month period prior to Board approval of a new agreement or investment, or extension of and/or amendment to an existing contract, or an increase in funding of an existing investment commitment. Disclosures shall be made semi-annually for all Contractors (end of June and December of each year); except for private equity partnerships and their general partners, which shall be required to make such disclosures annually, no later than 45 calendar days after December 31st each year.

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2. FINANCIAL INCENTIVES AND GIFTS RECEIVED BY INVESTMENT CONSULTANTS

- (a) LACERS' private equity Consultant, general investment Consultant, and real estate Consultant (each individually, an "Investment Consultant") shall disclose all Gifts received directly or indirectly from Contractors and/or any of their Officers (and the Family Members of any of them), or directly or indirectly from their marketing representatives, relationship representatives, portfolio managers, investment committee members, and/or Intermediaries (and, in the case of individuals, the Family Members of any of them) that are involved with any product or service provided, or sought to be provided, to LACERS.

For each such Gift, the Investment Consultant shall disclose:

- (1) The name and address of each person providing the Gift and each such person's connection to the Contractor;
- (2) The name and title of each person receiving the Gift;
- (3) The value of the Gift;
- (4) A description of the Gift; and
- (5) The date of the presentation of the Gift.

- (b) Investment Consultants shall also report any financial incentive, compensation, consideration, or benefit received from others in connections with Investment Consultant's recommendations of funds, products, or services made to LACERS.

For each such financial incentive or compensation, the Investment Consultant shall disclose:

- (1) The name and address of the firm or organization providing the incentive;
- (2) A description of the financial incentive arrangement;
- (3) The value of the incentive;
- (4) The alternative fund(s), product(s), or service(s) considered along with the recommended fund, product, or service;
- (5) Factors used to select the recommended fund, service, or product over the alternative(s).

Such disclosures shall include Gifts and/or financial incentives received during the term of the Investment Consultant's service agreement with LACERS, and shall be made semi-annually by the private equity Consultant; and annually by the general investment Consultant and real estate Consultant with regard to all Contractors, and otherwise as required by LACERS in relation to any particular contracting process.

Exemption: Value of food and beverage items provided to LACERS staff or Consultants at networking events, annual general meetings and/or advisory meetings that are open to general public or other investors, and which in aggregate do not exceed annual limit of \$50 are not required to be reported pursuant to this disclosure policy.

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G. RESPONSIBILITIES

1. Each Contractor is responsible for:
 - a. Providing to Staff, as part of the Contractor Disclosure, the following information for existing agreements and prior to hiring for new agreements:
 - (1) A statement whether the Contractor, or any of its marketing or relationship representatives, portfolio managers, or members of the investment committee (or any Family Members of any of them) that are involved with the product or service provided to LACERS, or any of its Officers (or Family Members of any of them), within the twenty-four month period prior to either (a) Board approval of a new agreement or investment, or (b) extension of or amendment to an existing agreement, or (c) an increase in funding of an existing investment commitment, has compensated or agreed to compensate, directly or indirectly, any person (whether or not employed by the Contractor) or entity to act as an Intermediary in connection with any investment or procurement by LACERS.
 - (2) Notice to LACERS that if any person working on behalf of the Contractor with, or assigned on behalf of the Contractor to, a LACERS contract is a current or former LACERS Board member, employee or Consultant or a Family Member of any such person.
 - (3) A description of all compensation provided or agreed to be provided directly or indirectly by the Contractor to any Intermediary or to any employee of the Contractor who was hired specifically to solicit an investment or other business with LACERS or is compensated on the basis of the procurement of any such investment or business. The description of such compensation shall include the nature, timing and amount thereof and any condition precedent to receiving the compensation.
 - (4) For investment and consulting contracts, a List of Contacts made by the Contractor with Appointed or Elected Officials within either 1) the three month period prior to the interview regarding a new agreement or investment; or, 2) the search period; whichever is longer. The List of Contacts shall include the date and names of the contact(s) and the nature of the contact.
 - (5) For investment and consulting contracts and except for private equity partnerships who are required to disclose annually, Contractors shall also disclose any contacts with Appointed or Elected Officials **during the term of the agreement, contract, or investment on a semi-annual basis.**

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ETHICS RESPONSIBILITIES FOR BOARD MEMBERS, THE GENERAL MANAGER, LACERS STAFF, CONTRACTORS, AND INVESTMENT CONSULTANTS

- (6) With regard to each Intermediary identified pursuant to Section G.1.a (3) above, each Contractor shall provide:
 - (i) A description of the services to be performed by the Intermediary and a statement as to whether the Intermediary is utilized by the Contractor with all prospective clients or only with a subset of the Contractor's prospective clients (and if a subset, describe the subset), and a resume of each officer, partner, and principal of the Intermediary detailing the person's education, professional designation, regulatory licenses, and investment work experience. Work experience need not be provided in connection with agreements unrelated to investments.
 - (ii) With regard to procurement of business from LACERS, a copy of all written agreements between the Contractor and the Intermediary and a description of any agreement that is not in writing.
 - (iii) A List of Contacts made by the Intermediary, on behalf of the Contractor, with Appointed Officials, Elected Officials, or staff within the 24 months period prior to Board approval of a new agreement or investment. The List of Contacts shall include the date and names of the contact(s) and intermediary(ies).
 - (iv) The names of all persons who suggested the retention of the Intermediary and a description of how the Intermediary was selected.
 - (v) A listing for the Intermediary and/or any of its affiliates showing registration with the Securities and Exchange Commission or the Financial Industry Regulatory Association or any similar regulatory agency or self-regulatory organization outside the United States, and either the details of any such registration or an explanation of why registration is not required.
 - (vi) A listing for the Intermediary, and/or any of its affiliates, showing registration as a lobbyist with any local, state or national government and the details of any such registration.
- b. Providing a representation and warranty signed by the Contractor's chief executive officer or head of the business unit that provides, or will be providing, the service to LACERS, of the accuracy of the information included in the Contractor Disclosure in any final written agreement.

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ETHICS RESPONSIBILITIES FOR BOARD MEMBERS, THE GENERAL MANAGER, LACERS STAFF, CONTRACTORS, AND INVESTMENT CONSULTANTS

- c. All information required in the Contractor Disclosure shall be sent to LACERS internal audit staff as follows:

Los Angeles City Employees' Retirement System Internal Audit Section
202 West First Street, Suite 500 Los Angeles, CA 90012
Office: 800-779-8328
Email address: auditor@LACERS.org

The Contractor Disclosure of all contacts, monetary contributions, other financial benefits, and/or Gifts, as required pursuant to this Disclosure Policy, is due 45 calendar days after June 30th or December 31st of each year, as applicable.

2. LACERS Staff are responsible for all of the following:
 - a. Section managers are responsible for providing Contractors with a copy of this Policy with all Requests for Proposals at the time that due diligence in connection with a prospective investment or engagement begins.
 - b. Section managers are responsible for confirming that the Contractor Disclosure has been received prior to the completion of due diligence and any recommendation to proceed with the engagement of the Contractor or the decision to make any investment or procurement.
 - c. For new agreements and/or amendments to agreements existing as of the date of the Policy, Section managers are responsible for confirming that the final written agreement between LACERS and the Contractor provides that the Contractor shall be solely responsible for, and LACERS shall not pay (directly or indirectly), any fees, compensation or expenses for any Intermediary used by the Contractor.
 - d. Section managers are responsible for excluding any Contractor or Intermediary from the solicitation of new investments or business from LACERS for a time period determined by the Board up to a maximum of 5 years after they have committed a material violation of this Policy, as determined by the Board in its sole discretion, and promptly informing the Board of any such action. Refer to Penalties in Section H.
 - e. Staff of the section responsible for the administration of the contract will provide the Board, including the relevant Committee, with a copy of the Contractor Disclosure information prior to the Board making or approving any decision to invest or procure with a Contractor.
 - f. LACERS internal audit staff will compile a semi-annual Board report containing the names and amount of compensation agreed to be provided

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ETHICS RESPONSIBILITIES FOR BOARD MEMBERS, THE GENERAL MANAGER, LACERS STAFF, CONTRACTORS, AND INVESTMENT CONSULTANTS

to each Intermediary by each Contractor; the campaign contributions and Gifts of each Contractor as reported in the Contractor Disclosures; the List of Contacts; and the List of Exclusions.

- g. Reporting to the Board immediately any conduct that the Staff reasonably believes constitutes a material violation of the Policy, to enable the Board to make a determination whether the conduct constitutes a material violation.
3. Contractors shall comply with the Policy and cooperate with Staff in meeting Staff's obligations under this Policy. All parties responsible for implementing, monitoring and complying with this Policy should consider the spirit as well as the literal expression of the Policy. In cases where there is uncertainty whether a disclosure should be made pursuant to this Policy, the Policy shall be interpreted to require disclosure.

H. PENALTIES

For new agreements and/or amendments to agreements existing as of the date of this Policy, the Contractor, in the final written agreement with LACERS, will agree to provide LACERS with any or all of the following remedies in the event that there was or is a material omission or inaccuracy in the Contractor Disclosure or any other violation of this Policy, as determined by the Board in its sole discretion:

1. Whichever is greater, the reimbursement of any contractor, management or advisory fees paid by LACERS for one year or an amount equal to the amounts that the Contractor has paid or promised to pay to the Intermediary in respect of LACERS.
2. LACERS shall have the authority to terminate the agreement, without penalty.
3. The Board of Administration may take action to ban Contractor and/or the Intermediary who materially violated this Policy from future contracting opportunities with LACERS for a period of up to five years. However, the prohibition may be reduced by a majority vote of the Board at a public session upon showing of good cause.

I. NO RIGHT OF CONFIDENTIALITY

All Contractor Disclosures and attachments thereto shall be public records subject to disclosure under the California Public Records act and the Ralph M. Brown Act. No confidentiality restrictions shall be placed on any Contractor Disclosures or any information provided by Contractors pursuant to this Policy.

REVIEW

This policy shall be reviewed every 3 years.

See APPENDIX A – DEFINITIONS

Los Angeles City Employees' Retirement System

ETHICS RESPONSIBILITIES FOR BOARD MEMBERS, THE GENERAL MANAGER, LACERS STAFF, CONTRACTORS, AND INVESTMENT CONSULTANTS

APPENDIX A – DEFINITIONS

Definitions are based on current laws. To the extent that Board policies are not updated subsequent to changes in law, each Board Member, LACERS employee and Consultant is responsible to comply with current laws and changes thereto.

Applicable City Employee

(1) A LACERS employee or (2) a lawyer in the Public Pension General Counsel, the Outside Counsel Oversight Division of the Los Angeles City Attorney's Office, or one who is in the direct supervisory chain of command over the lawyers in those divisions

Appointed Official

An appointed LACERS Board Member (including a person who has been appointed to the LACERS Board, pending confirmation)

Candidate

A person who has filed to run for an Elected Office

City

The City of Los Angeles

Consultant

A Contractor that is hired to provide advice or recommendations to LACERS on the selection of investment funds/strategies, fund managers, or the procurement of goods and/or services from other firms. All LACERS Consultants are also considered Contractors under the terms of this Policy.

Contractor

A person who, or entity that, seeks to be and/or is hired to provide goods and/or services to LACERS. The individuals with reporting responsibility are those at a firm that would have any contact with or responsibility for a LACERS investment or agreement.

Contractor Disclosure

Collectively, the information required from Contractors as described in Sections **C through G** of this Policy.

Elected Official or Office

Mayor of the City of Los Angeles
Members of the Los Angeles City Council
Los Angeles City Attorney
Los Angeles City Controller
Elected LACERS Board Member

Family Member

The spouse or domestic partner of a Contractor or Intermediary.

Los Angeles City Employees' Retirement System

ETHICS RESPONSIBILITIES FOR BOARD MEMBERS, THE GENERAL MANAGER, LACERS STAFF, CONTRACTORS, AND INVESTMENT CONSULTANTS

Financial Benefits

Other financial benefits include having direct or indirect financial relationship with or beneficial ownership in securities, investments, funds, companies or products being recommended to LACERS.

Gift

Pursuant to **Los Angeles Municipal Code Section 49.5.8 et seq., which references the Political Reform Act and California Constitution, and Section 82028 of the Political Reform Act 2019**, a “Gift” means, except as otherwise provided in this definition, any payment that confers a personal benefit on the recipient, to the extent that consideration of equal or greater value is not received and includes a rebate or discount in the price of anything of value unless the rebate or discount is made in the regular course of business to members of the public without regard to official status. Any person, other than a defendant in a criminal action, who claims that a payment is not a gift by reason of receipt of consideration has the burden of proving that the consideration received is of equal or greater value. The term “gift” does not include:

- (1) Informational material such as books, reports, pamphlets, calendars, periodicals. No payment for travel or reimbursement of any expenses shall be deemed “informational material.”
- (2) Gifts which are not used and which, within 30 days after receipt, are either returned to the donor or delivered to a nonprofit entity exempt from taxation under Section 501(c)(3) of the Internal Revenue Code without being claimed as a charitable contribution for tax purposes.
- (3) Gifts from an individual’s spouse, child, parent, grandparent, grandchild, brother, sister, parent-in-law, brother-in-law, sister-in-law, nephew, niece, aunt, uncle, or first cousin, or the spouse of any such person; provided that a gift from any such person shall be considered a gift if the donor is acting as an agent or Intermediary for any person not covered by this paragraph.
- (4) Campaign contributions required to be reported under Chapter 4 of the Political Reform Act of 1974, as amended.
- (5) Any devise or inheritance.
- (6) Personalized plaques and trophies with an individual value of less than two hundred fifty dollars (\$250).

Intermediary

A person or entity (1) who is hired, engaged or retained by or acting on behalf of a Contractor as a placement agent, finder, lobbyist, solicitor, marketer, consultant, broker or other type of agent to raise money or investments from or obtain access to LACERS, directly or indirectly, and (2) who engages in, either personally or through an agent, any written or oral direct communication with any LACERS representative in furtherance of obtaining an investment or a contract with LACERS. This definition also includes agents of Intermediaries commonly referred to as sub-agents.

Investment Consultant

LACERS’ private equity Consultant, general investment Consultant, and real estate Consultant. Investment Consultants are also considered Contractors under the terms of this Policy.

Los Angeles City Employees' Retirement System

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LACERS

The Los Angeles City Employees' Retirement System.

Officers

The Chief Executive Officer, Chief Operating Officer, Chief Financial Officer or functional equivalent in the Contractor's firm.

Undue Influence

The employment of any improper or wrongful pressure, scheme, or threat by which one's will is overcome and he or she is induced to do or not to do an act which he or she would not do, or would do, if left to do freely.



REPORT TO BOARD OF ADMINISTRATION

From: Neil M. Guglielmo, General Manager

Neil M. Guglielmo

MEETING: APRIL 25, 2023

ITEM: VI - D

SUBJECT: 2023 OPEN ENROLLMENT CLOSEOUT REPORT

ACTION: CLOSED: CONSENT: RECEIVE & FILE:

Recommendation

That the Board receive and file this report.

Executive Summary

On an annual basis, the Health, Wellness and Buyback Division (HWABD) provides the Board of Administration (Board) a summary of the health plan enrollment activities stemming from LACERS' annual Open Enrollment.

Discussion

LACERS conducts Open Enrollment each year, from October 15 to November 15 for the upcoming plan year. Open Enrollment provides Members the opportunity to enroll in, change, and/or add dependents to LACERS health plans without the need for a qualifying event.

Open Enrollment Results

Staff analyzed the 2023 Open Enrollment activity and prepared graphs detailing the results. These results are found in the attached 2023 Open Enrollment Closeout Report Handouts. Of note among these results are:

- 409 unique Members participated in the Open Enrollment, a 3% increase from the preceding Open Enrollment (409 vs. 396)
- 462 completed requests¹ for New Enrollment, Plan Changes, and/or the Addition of Dependent(s) were received and processed (53 of the 409 unique Members made multiple requests); 62 requests to Add Dependents, 99 New Enrollments, and 259 Plan Changes
- 106 unique dependents were added to the plans; 80 into the dental plans, 50 into the medical plans (24 of the 106 unique dependents added to both medical and dental)

¹ Completed requests exclude those that Members did not respond to staff's requests for missing documentation or those that Members subsequently withdrew.

- 31.9% and 55.3% of new medical enrollments went into Kaiser HMO/Kaiser Senior Advantage (Kaiser) and Anthem PPO/Medicare Preferred (Anthem Nationwide PPO Plans) respectively
- 70.7% of those who changed medical plans migrated into the Anthem Nationwide PPO Plans
- 43.2% and 25.6% of those Members who changed from one medical plan to another vacated Kaiser and UHC respectively

Anthem Nationwide PPO Plans

Following the auto-transition from Anthem Medicare Supplement plan to Anthem Medicare Preferred PPO plan in January 2022, the 2023 Open Enrollment was the first open enrollment where Members can make a change in their health plans without the need for a qualifying event. It was observed that 70% of the Members who made a plan change switched to the Anthem Nationwide PPO Plans and only about 6% of those who made a plan change vacated this plan. Of the Members who newly enrolled in a LACERS plan, 55% selected the Anthem Nationwide PPO plans.

Trends

In addition to the slight increase in the number of unique participating Members, there is also a 7% increase in the number of completed requests from the preceding Open Enrollment (462 vs. 431). This trend will likely continue as we have seen steady increases since 2018. LACERS anticipates returning to in-person meetings for 2024 Open Enrollment after three years of virtual open enrollment meetings. The number of Open Enrollment meeting participants have dropped significantly since 2018, partly because the meetings were conducted virtually. With in-person meetings being brought back, the number of meeting participants will likely increase.

Strategic Plan Impact Statement

The annual Open Enrollment process supports the Strategic Plan Goal III: Maximize value and minimize costs of our health and welfare program.

Prepared By: Ada Lok, Senior Benefits Analyst I, Health, Wellness and Buyback Division.

NMG/DWN/KF/al

Attachments: 1) 2023 Open Enrollment Closeout Report Handouts
2) Memo to Karen Freire, Chief Benefits Analyst – Open Enrollment Detailed Update

Board Mtg: 04/25/23

Item: VI-D

Attachment 1

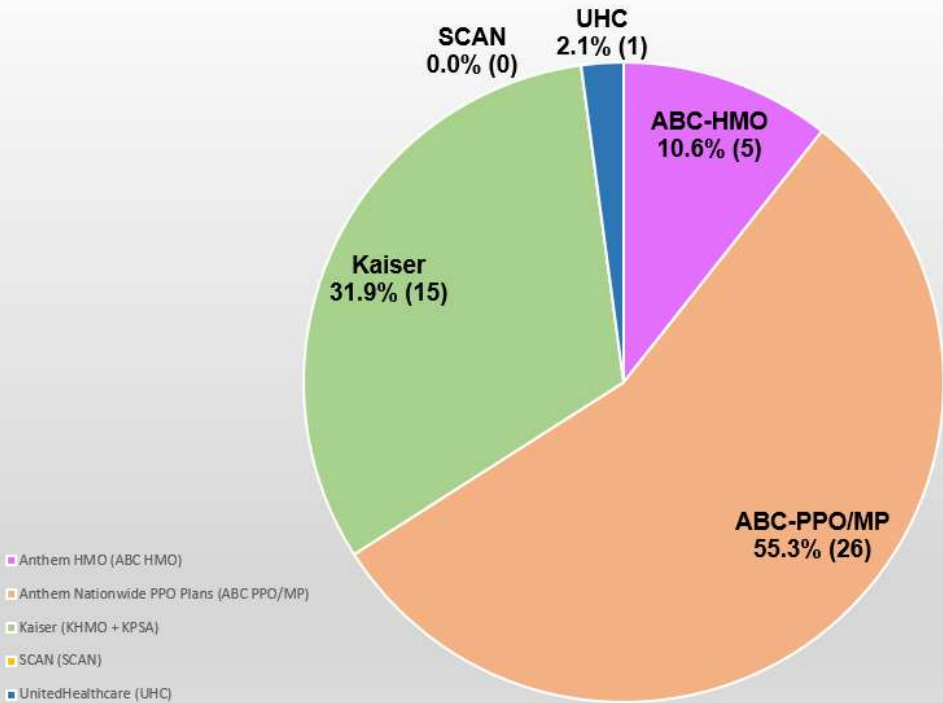


2023 Open Enrollment Closeout Report Handouts

**Health, Wellness and Buyback Division
April 25, 2023**

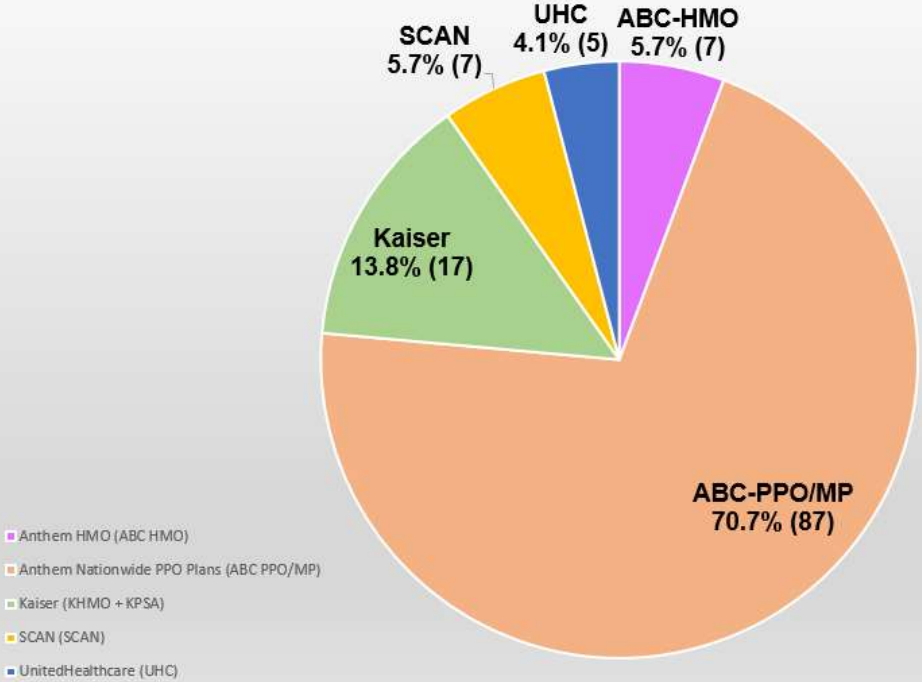


2023 Open Enrollment: New Medical Plan Enrollments



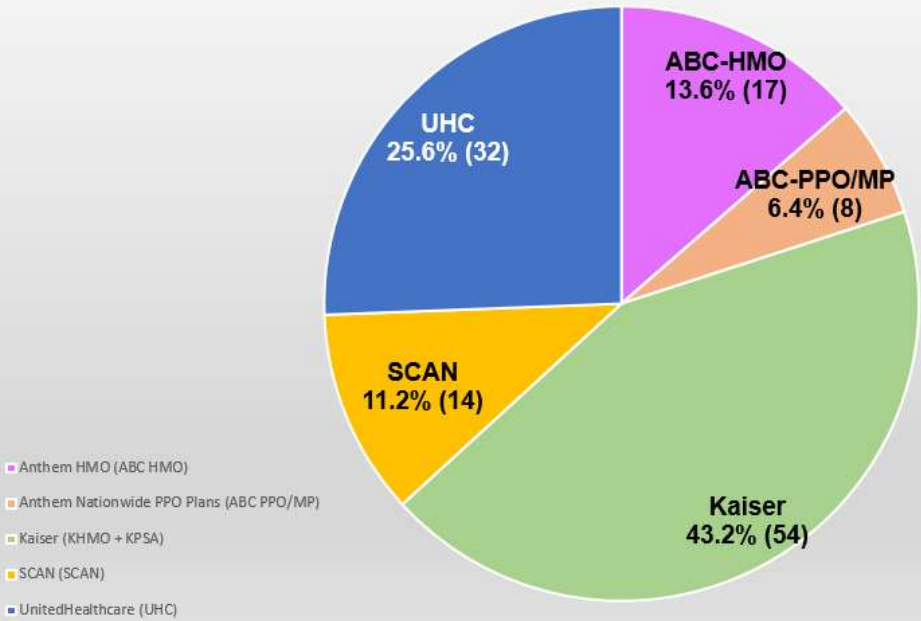
New enrollments are the Members who have not been enrolled in a LACERS medical plan for at least a year before 1/1/2023. Over 50% selected Anthem Nationwide PPO Plans (ABC PPO/MP).

2023 Open Enrollment: Medical Plan Changes - Moves Into



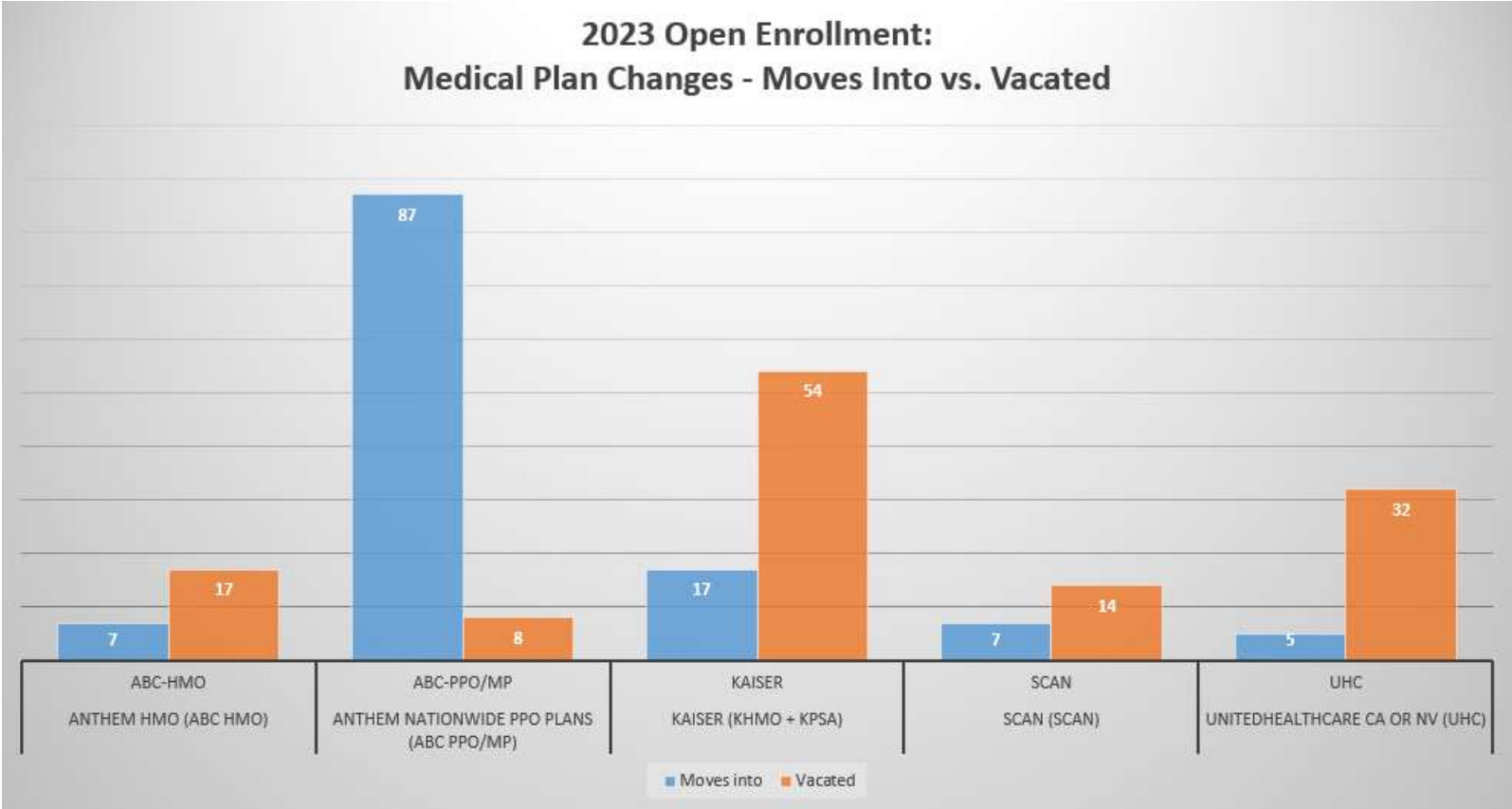
Of the Members who made a medical plan change during the 2023 OE, over 70% selected to switch to Anthem Nationwide PPO Plans (ABC PPO/MP).

2023 Open Enrollment: Medical Plan Changes - Plans Vacated

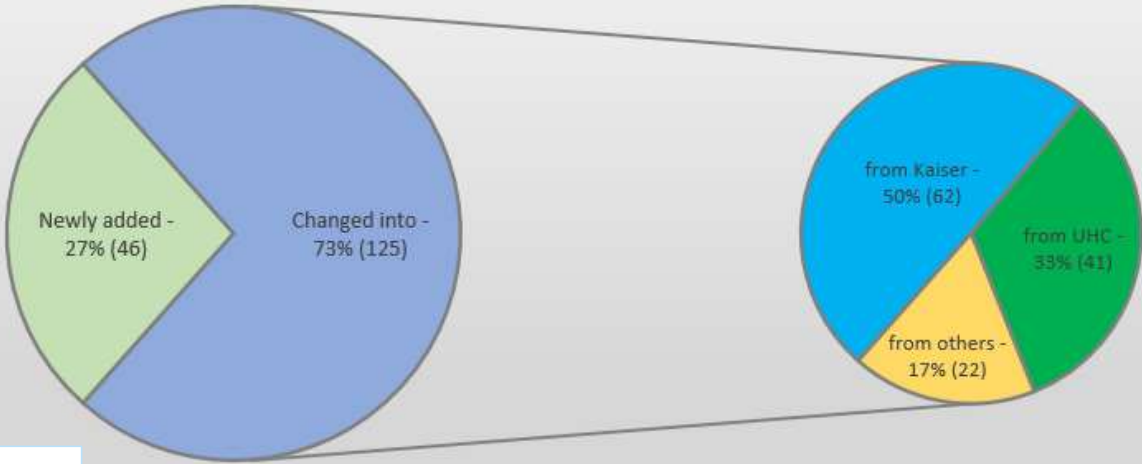


Of the Members who made a medical plan change during the 2023 OE, close to 70% of them vacated Kaiser and UHC while only 6.4% vacated Anthem Nationwide PPO Plans (ABC PPO/MP).

2023 Open Enrollment: Medical Plan Changes - Moves Into vs. Vacated

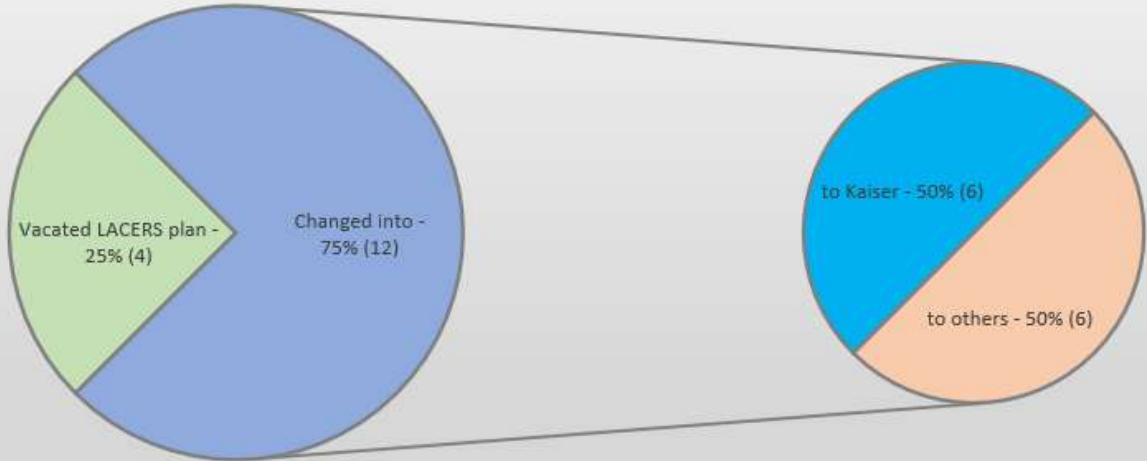


2023 Open Enrollment: Members and Dependents enrolling in Anthem Nationwide PPO Plans

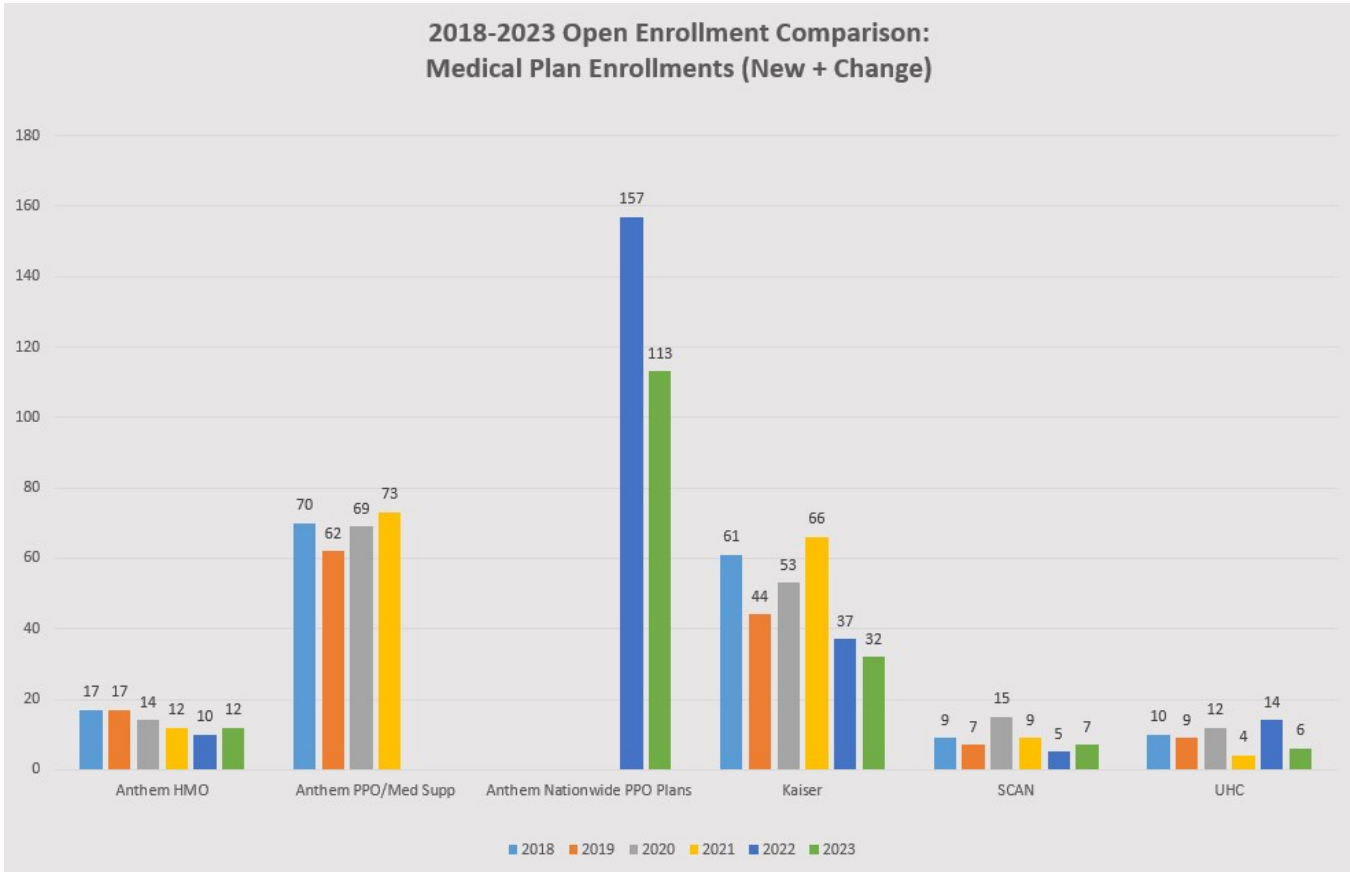


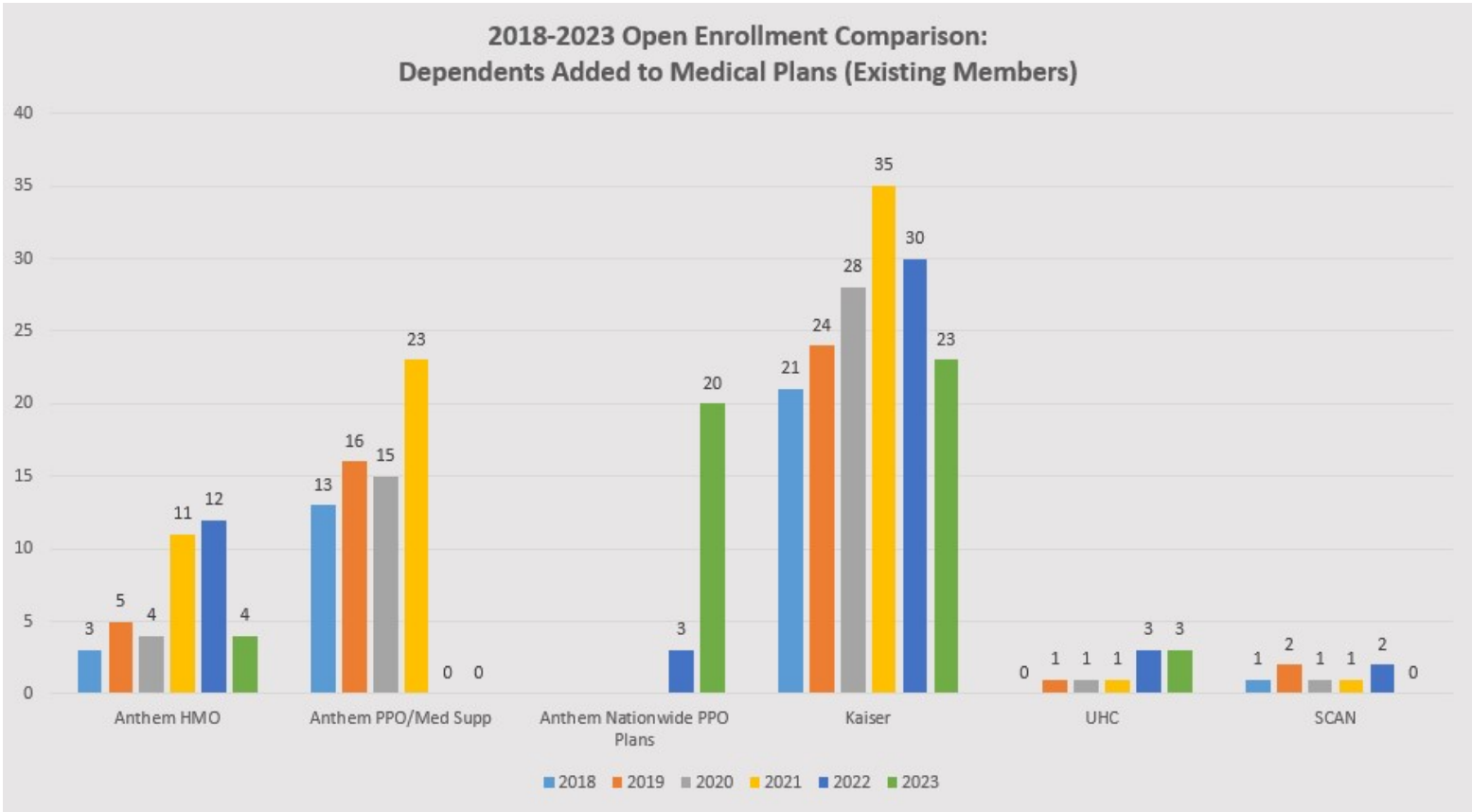
2023 OE was the first OE after the auto-transition to Anthem Blue Cross Medicare Preferred (PPO) plan. There was a good number of Members and dependents switching to or first time enrolling in Anthem Nationwide PPO Plans (ABC PPO/MP).

2023 Open Enrollment: Members and Dependents vacated Anthem Nationwide PPO Plans

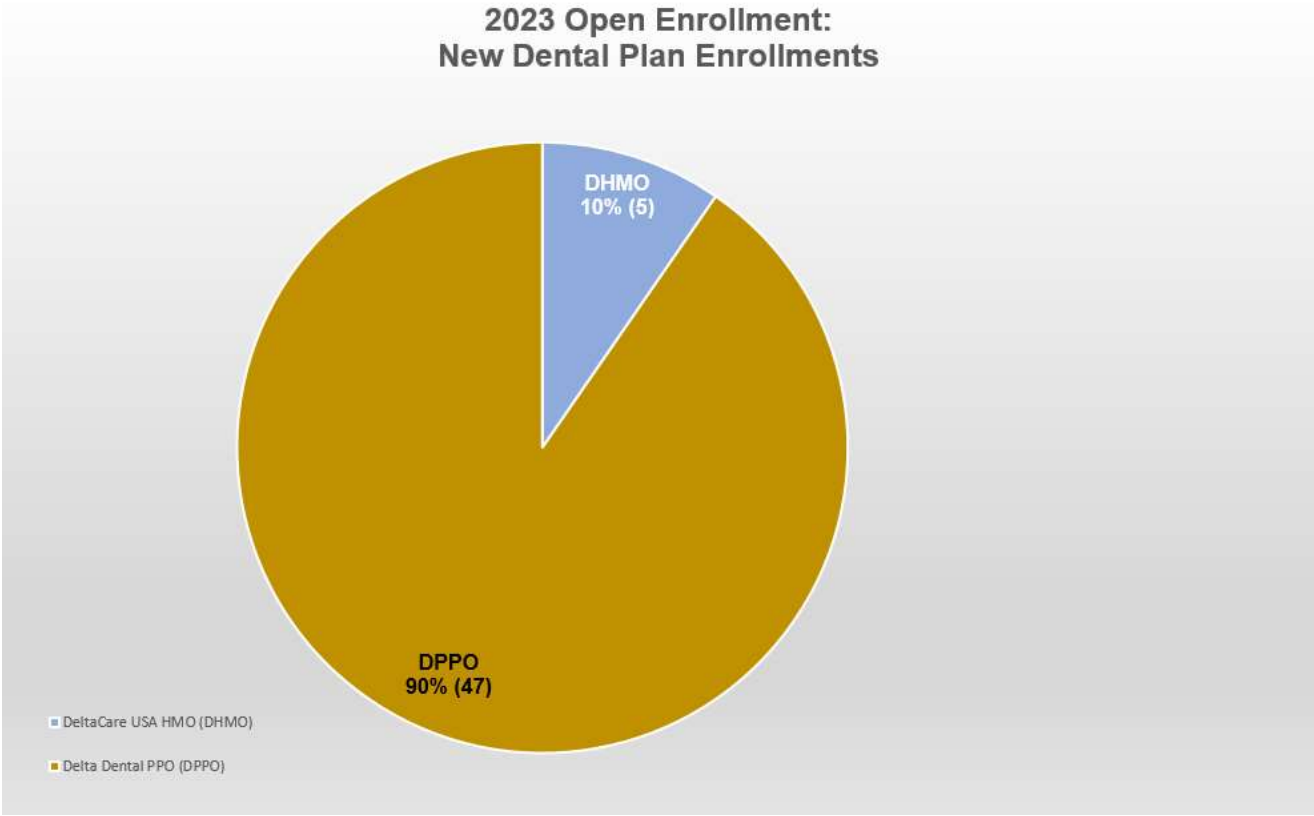


The number of Members and dependents vacated Anthem Nationwide PPO Plans (ABC PPO/MP) was much lower than those who enrolled into the plans.

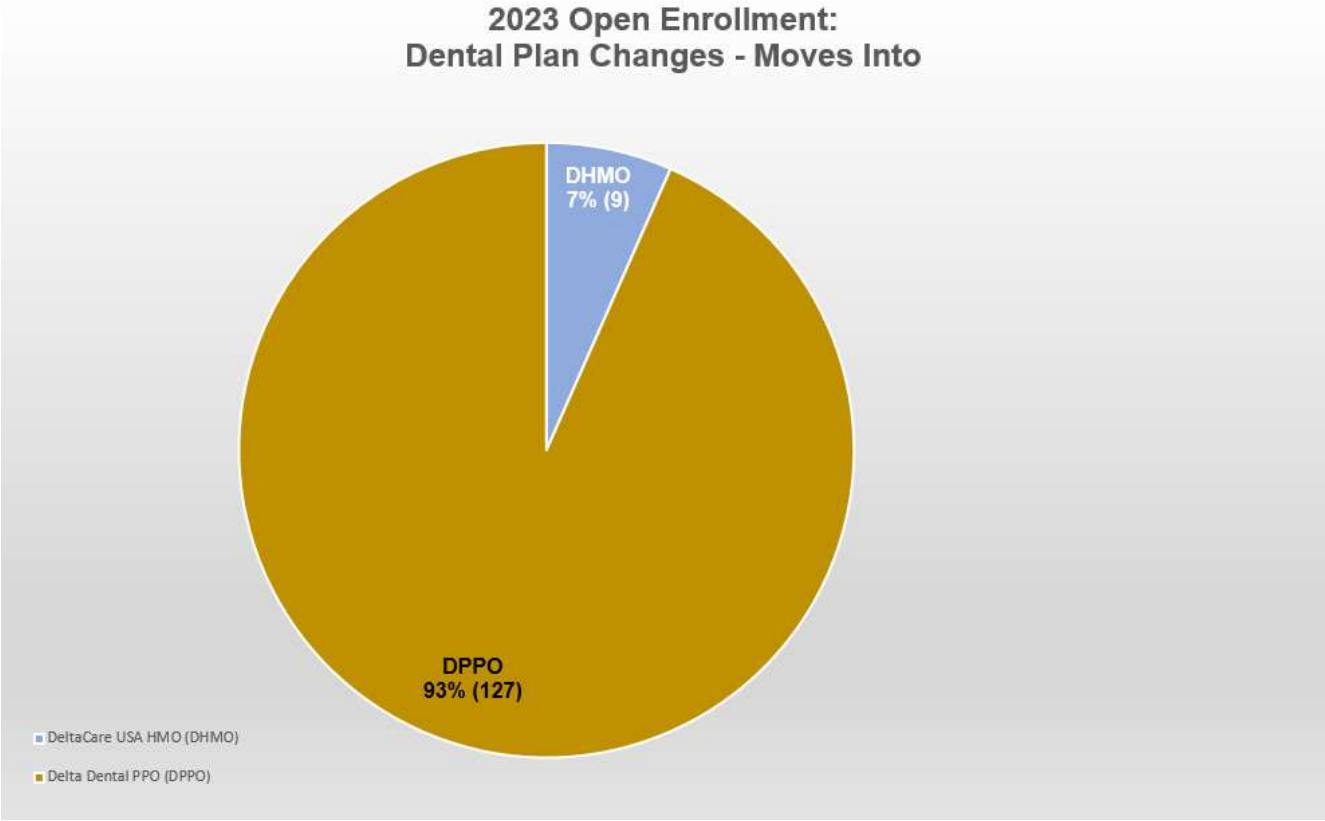




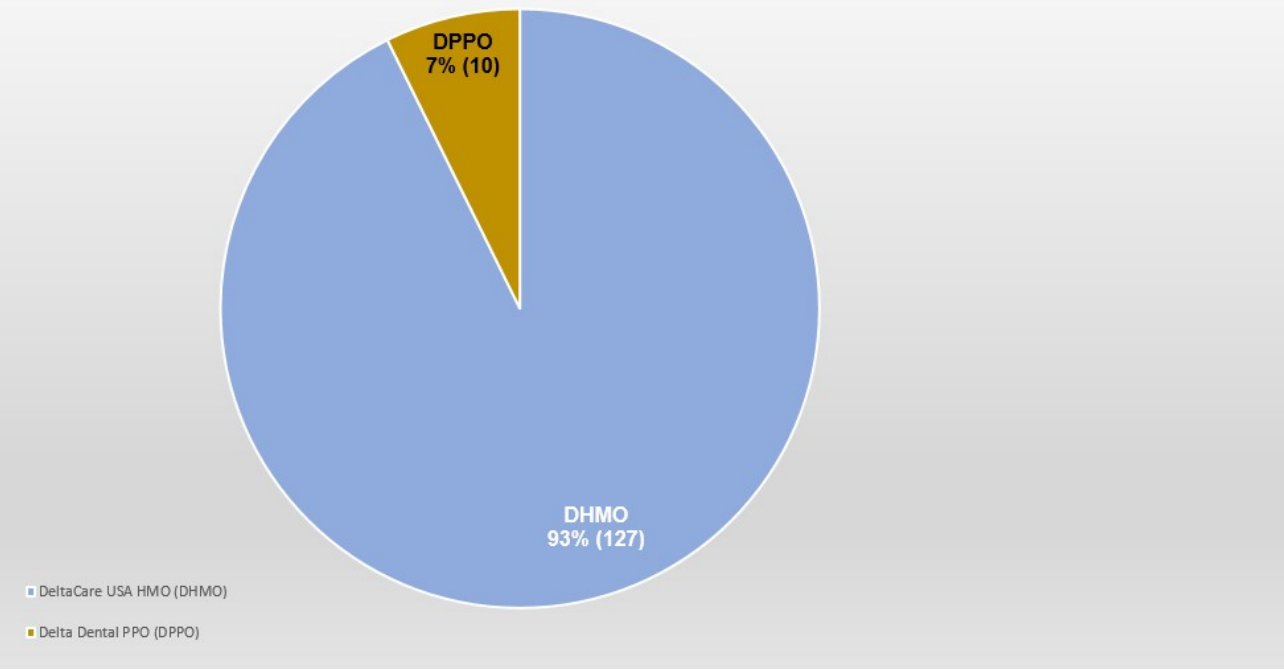
2023 Open Enrollment: New Dental Plan Enrollments

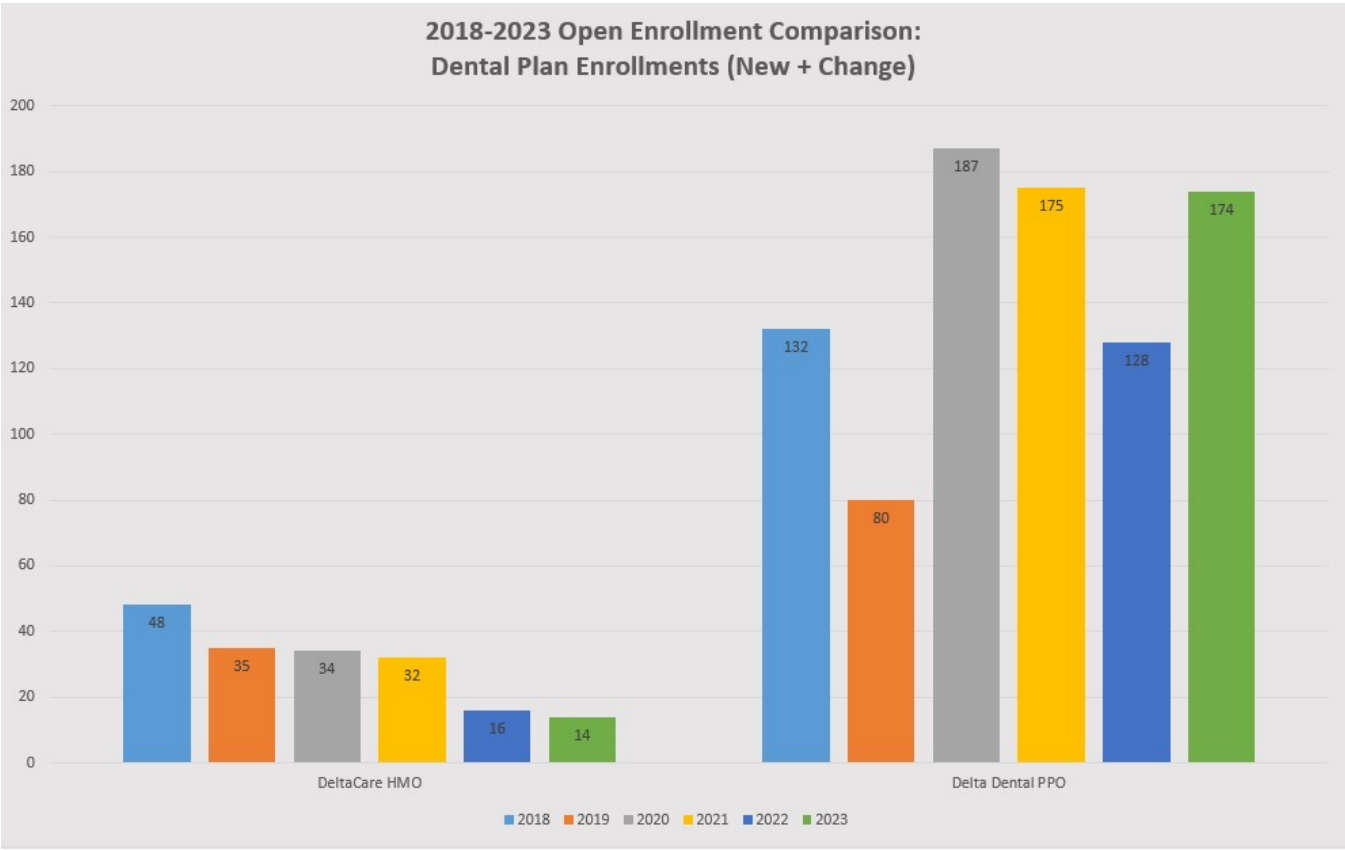


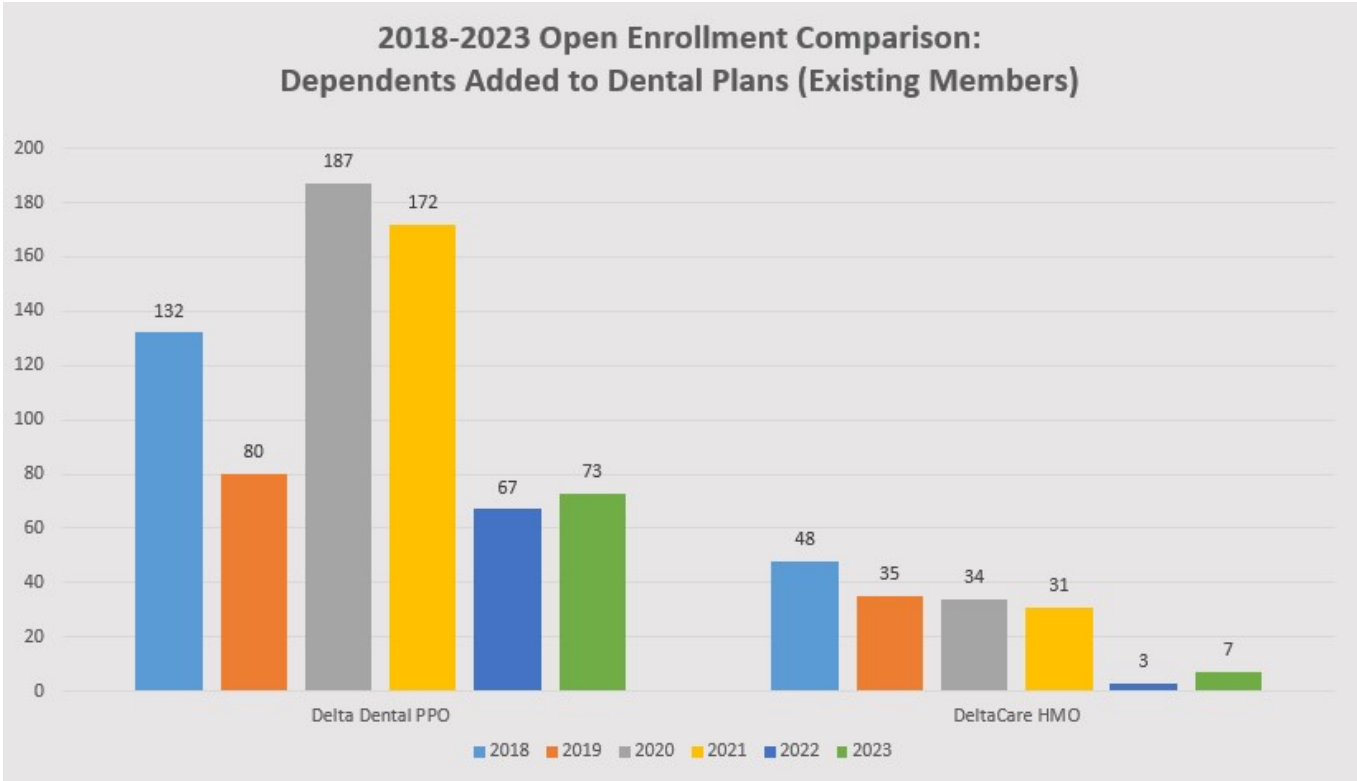
2023 Open Enrollment: Dental Plan Changes - Moves Into



2023 Open Enrollment: Dental Plan Changes - Plans Vacated

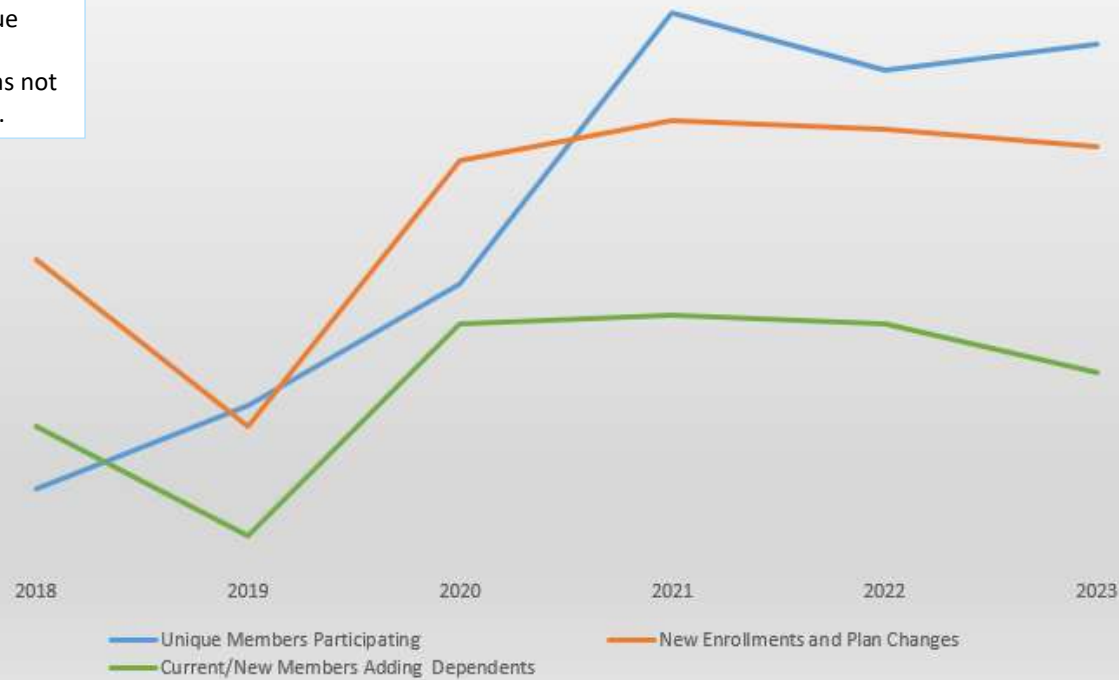




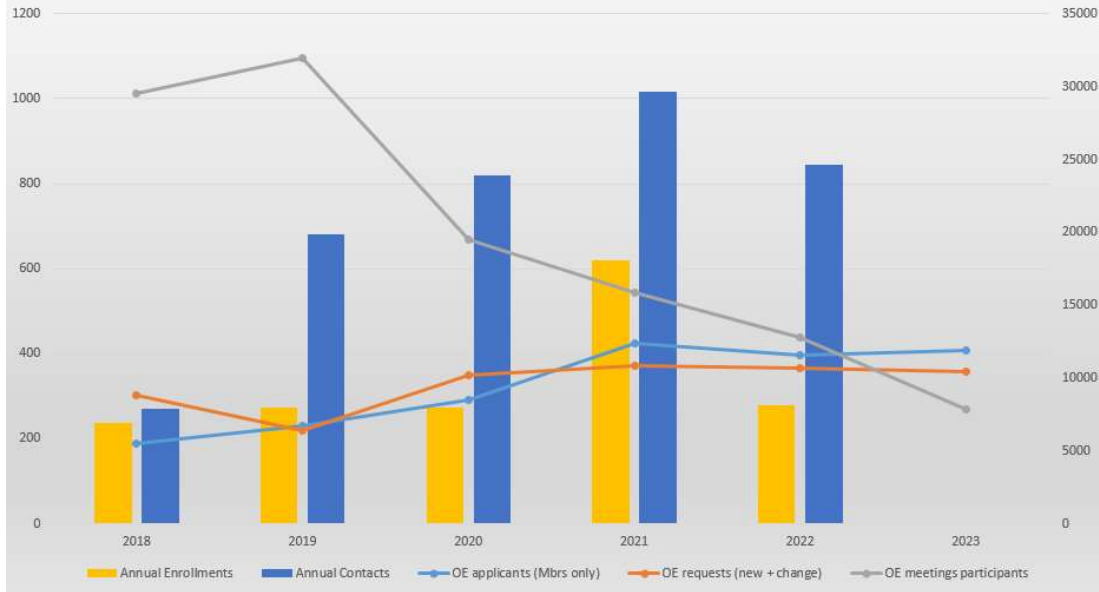


2018-2023 Open Enrollment Comparisons: Trends in Requests and Member Participation

There was a slight increase (3%) of unique Members participated in OE from the preceding OE (409 vs. 396), but there was not a significant difference in request trends.



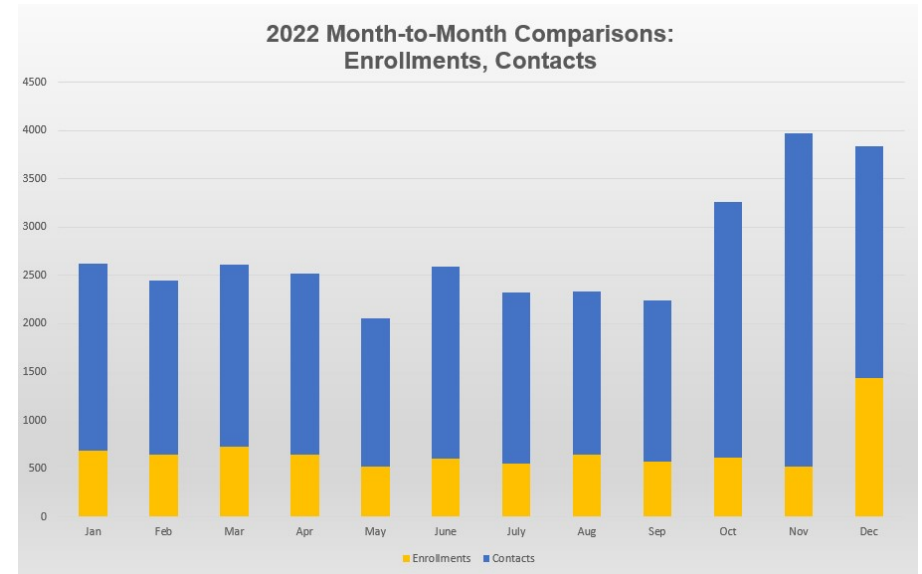
2018-2023 Year-to-Year Comparisons: Open Enrollment, Annual Enrollments, Annual Contacts



The blue and yellow bars on both charts provide the caseload of Enrollment and Advocacy Units for reference.

The number of OE applicants and requests stayed flat over the past two years, but the number of OE meeting participants dropped significantly, partly because the meetings were conducted virtually due to the COVID-19 pandemic. With in-person meetings returning in 2024 OE, the number of meeting participants will likely increase.

2022 Month-to-Month Comparisons: Enrollments, Contacts



Board Mtg: 04/25/23

Item: VI-D

Attachment 2

Date: April 4, 2023**To:** Karen Freire, Chief Benefits Analyst
Health, Wellness, and Buyback Division**From:** Ada Lok, Senior Benefits Analyst I,
Enrollment Unit
Health, Wellness, and Buyback Division**SUBJECT:** Detailed Open Enrollment Update

Detailed below is the Open Enrollment Update activities:

Open Enrollment Activities

The planning and execution of Open Enrollment began in March and finished early in the new plan year. LACERS Health Staff worked with our Health and Welfare Consultant, Keenan and Associates (Keenan), our Carriers, and other sections within LACERS throughout the process. The following is the abstract of the planning and implementation of the LACERS Open Enrollment in general, the activities completed in 2022, and the summary of the results:

- March through June: Request for Renewal (RFR) process began
 - RFR was sent to each carrier to provide the proposed premium for the following year and to cost additional benefits that could impact premiums, such as new programs, plan design modifications, or alternative plans and/or pricing. The premium changes and the associated costs, assumptions, and methods used to develop the premium were negotiated with each carrier requesting them to reconsider certain costs, assumptions, and/or methods, based on Keenan's review.
 - Existing publications, forms, information sheets, Member communications, Health Benefits Guide, paycheck flyer, e-blast, newsletter, were updated for the new plan year.
- June – Review of renewal proposals and planning
 - Keenan, in consultation with LACERS, submitted counter proposals to the respective carrier and negotiated for the most beneficial benefits packages for our Members.

- Weekly or as-needed meetings were conducted with the various Health units, carriers, Health consultants, and other LACERS sections to plan out the Open Enrollment activities.
- July – Finalized premium rates and recommended changes
 - The plan design changes were presented to the Benefits Administration Committee (BAC) and then the full Board for approval.
- July through September – Publication Update
 - LACERS publications for the Open Enrollment Packet, including all Health documents were revised with rate and plan changes. Approximately 20,000 packets were mailed out for the 2023 Open Enrollment.
- July through December – System Update
 - The Pension Administration System was revised to accept new carriers and the premiums and subsidies for the new plan year.
- October through December – Requests received and processed
 - On October 17, 2022, Open Enrollment started. Members started submitting their Open Enrollment selection(s) by mail, fax and/or email. Over 1,600 emails were received at LACERS.Health@lacers.org between October and December 2022.
 - The majority of Members' Open Enrollment selections were inputted into PAS in December payroll. However, additional inputs were processed in January and February payrolls, after staff conducted audits of Open Enrollment Submissions.

Member Outreach

The 2023 Open Enrollment included the following outreach activities:

- Open Enrollment Webinars
LACERS conducted three Open Enrollment Webinars. There were 343 Members and dependents who responded and 248 (72%) who attended. In total, 282 Members, staff, Health Consultant, and carriers who attended the webinars.
- Outreach to LACERS Members with or without a Health plan
 - In August, the Paycheck Flyer Announcement was sent
 - From September through October, LACERS Website posted Open Enrollment Announcements, information, and materials
 - In October, the Annual Open Enrollment Packet with Overview and 2023 Health Benefits Guide were sent

- Miscellaneous outreach to Members/dependents
 - In November, the LACERS Retired Members November Update eBlast to retirees notified those who are enrolled in Anthem Medicare Preferred PPO, Anthem HMO with Part B only, and Anthem PPO with Part B only would receive new Anthem Rx cards in mid-December 2022.

Open Enrollment Packets

- The mailing was delayed from October 4 to October 13, 2022 for various reasons, e.g., technical delay in generating Open Enrollment Health Plan Statements in the Pension Administration System (PAS). As a result, the Open Enrollment period was extended from November 17 to November 23, 2022.
- 8,271 packets were mailed to Members who were enrolled in a non-Medicare plan, not enrolled in a LACERS medical plan, or not enrolled in any plan. The packets contained the Member's Open Enrollment Statement and 2023 Open Enrollment Overview, along with information on how to request a 2023 Health Benefits Guide.
 - 143 of these packets were returned to LACERS by U.S. Postal Service for a variety of reasons. The most common was that the Member had moved and their new address was not in LACERS database as of the packets mailing.
- 11,601 packets were mailed to Members enrolled in a LACERS Senior Plan (Medicare). The packets contained the Members' Open Enrollment Statement, 2023 Open Enrollment Overview and 2023 Health Benefits Guide.
 - 136 of these packets were returned to LACERS by U.S. Postal Service for a variety of reasons. The most common was that the Member had moved and their new address was not in LACERS database as of the packets mailing.
- 267 Members requested a 2023 Health Benefits Guide be mailed to them. Approximately 100 Members requested that a guide be emailed to them.

Open Enrollment Health Plan Statement

- For 2023, final premium rates from carriers were received later than the target date, thereby delaying the Board's adoption of premiums and subsidies by two weeks, as well as set-up and testing of the premiums and subsidies in our Pension Administration System (PAS).
- The statement file of over 23,000 records were reviewed and filtered in order to print the statements. Due to logic limitations, this review and filtering took 50 staff hours spread out over several days.
- In addition to the delay caused by the late approval of the final premiums and subsidies for 2023, the production of the Open Enrollment statement file encountered several issues between June 2022 and October 2022. Corrected statements were mailed to these Members in November. These Members had until December 5, 2022 to submit their Open Enrollment forms.

Open Enrollment Health Staffing and Caseload

- The Open Enrollment Planning Team included staff from the Health Division including the Wellness Team, Member Engagement and Service Center, Systems, and the Pension Administration System (PAS) support team. From July through November, the Team met weekly to plan and to address/resolve issues that were discovered. In the Health Division, all units in Health assisted with the Open Enrollment planning and implementation; however, the bulk of the work was conducted by the Enrollment and Advocacy Units.
- In 2022, the significant increase of workload was addressed with overtime by the Enrollment and Advocacy Units.
 - Given two vacancies (one Benefits Specialist and one Admin Intern) that could not be filled in the Enrollment Unit during this crucial period, each staff handled approximately 80 Open Enrollment cases in a two-month period from December to January payroll, in addition to regular cases. Additional staffing for the Enrollment Unit will be requested in the Fiscal Year 2023-24 budget to reduce this caseload to a more manageable level as well as address recruitment difficulties.
 - The Advocacy Unit, consisting of one supervisor, three counselors, and two part-time staff handles 40%, or approximately 3,300 calls made to the Health Division. In the four-month period from October 2022 to January 2023, this translated to approximately 391 contacts per staff/month.

Cc: Dale Wong-Nguyen, Assistant General Manager
Benefits Bureau

MINUTES OF THE REGULAR MEETING
BOARD OF ADMINISTRATION
LOS ANGELES CITY EMPLOYEES' RETIREMENT SYSTEM

March 28, 2023

10:01 a.m.

| | | |
|----------|----------------------|---|
| PRESENT: | President: | Vacant |
| | Vice President: | Elizabeth Lee |
| | Commissioners: | Annie Chao Thuy Huynh Janna Sidley Sung Won Sohn Michael R. Wilkinson |
| | Legal Counselor: | Anya Freedman |
| | Manager-Secretary: | Neil M. Guglielmo |
| | Executive Assistant: | Ani Ghoukassian |

The Items in the Minutes are numbered to correspond with the Agenda.

I

PUBLIC COMMENTS AND GENERAL PUBLIC COMMENTS ON MATTERS WITHIN THE BOARD'S JURISDICTION AND COMMENTS ON ANY SPECIFIC MATTERS ON THE AGENDA – Vice President Lee asked if any persons wanted to make a general public comment to which there was no public comment cards submitted.

II

ELECTION TO FILL UNEXPIRED TERM OF THE VACANT OFFICE OF THE BOARD PRESIDENT PURSUANT TO LOS ANGELES CITY CHARTER SECTION 503(A) AND POSSIBLE BOARD ACTION – Neil M. Guglielmo, General Manager, advised that the nominations for Board President were being considered. Commissioner Sidley moved to wait on the vote for President until the new Commissioner is confirmed, seconded by Commissioner Huynh. Mr. Guglielmo called for the vote on the motion: Ayes, Commissioners Huynh and Sidley -2, Nays, Commissioners Chao, Sohn, Wilkinson, and Vice President Lee -4. The motion did not pass. Commissioner Wilkinson nominated Commissioner Chao, Commissioner Sidley nominated Vice President Lee, and Commissioner Chao nominated Commissioner Sohn. Mr. Guglielmo called for the vote on the nomination of Commissioner Chao as President: Ayes, Commissioners Chao, Sohn, and Wilkinson -3; Nays, Commissioners Huynh, Sidley, and Vice President Lee -3. The nomination for Commissioner Chao did not pass. Mr. Guglielmo called for the vote on the nomination of Vice President Lee as President: Ayes, Commissioners Huynh, Sidley, and Vice President Lee -3; Nays, Commissioners Chao, Sohn, and Wilkinson -3. The nomination for

Vice President Lee did not pass. Mr. Guglielmo called for the vote on the nomination of Commissioner Sohn as President: Ayes, Commissioners Chao, Sohn, and Wilkinson -3; Nays, Commissioners Huynh, Sidley, and Vice President Lee -3. The nomination for Commissioner Sohn did not pass. This item will be continued to the next Board meeting.

III

IF VACANCY CREATED IN OFFICE OF THE VICE PRESIDENT BY BOARD ACTION ON AGENDA ITEM II, ELECTION TO FILL UNEXPIRED TERM OF BOARD VICE PRESIDENT, PURSUANT TO LOS ANGELES CITY CHARTER SECTION 503(A) AND POSSIBLE BOARD ACTION – No action was taken on this item and it will be continued to the next Board meeting.

IV

BOARD PRESIDENT VERBAL REPORT – There was no report.

V

GENERAL MANAGER VERBAL REPORT

A. REPORT ON DEPARTMENT OPERATIONS – Neil M. Guglielmo, General Manager, advised the Board of the following items:

- Departure of Board President, Nilza Serrano
- Decommissioning of leased space at former LA Times Complex
- Front desk operations
- Women’s History Month 2023
- Retirement Services updates
- Health Benefits Administration updates
- Communications and Stakeholder Relations
- Upcoming events

B. UPCOMING AGENDA ITEMS – Neil M. Guglielmo, General Manager, advised the Board of the following items:

- Board of Administration – COLA Adjustment for July 2023

IV

RECEIVE AND FILE ITEMS

A. MONTHLY REPORT ON SEMINARS AND CONFERENCES FOR FEBRUARY 2023 – This report was received by the Board and filed.

B. COMMISSIONER JANNA SIDLEY BOARD EDUCATION EVALUATION ON COUNCIL OF INSTITUTIONAL INVESTORS SPRING CONFERENCE; WASHINGTON, D.C.; MAY 6-8, 2023 – This report was received by the Board and filed.

VII

Commissioner Wilkinson moved approval of Consent Agenda Item VII-A, seconded by Commissioner Sidley, and adopted by the following vote: Ayes, Commissioners Chao, Huynh, Sidley, Sohn, Wilkinson, Vice President Lee -6; Nays, None.

CONSENT ITEM(S)

- A. APPROVAL OF MINUTES FOR THE MEETING OF FEBRUARY 28, 2023 AND POSSIBLE BOARD ACTION

VIII

COMMITTEE REPORT(S)

- A. INVESTMENT COMMITTEE VERBAL REPORT FOR THE MEETING ON MARCH 14, 2023 – Vice President Lee stated the Committee approved the contract with Granahan Investment Management, Inc. and the Adaptive Asset Allocation Policy.
- B. BENEFITS ADMINISTRATION COMMITTEE VERBAL REPORT FOR THE MEETING ON MARCH 28, 2023 – Commissioner Wilkinson stated the Committee was presented with an overview of the Anthem Medicare Preferred (PPO) Plan Member survey and the 2024 Health Plan Contract Renewal Timeline and Strategy.

IX

BOARD/DEPARTMENT ADMINISTRATION

- A. ACTUARIAL RISK ASSESSMENT AND REVIEW OF FUNDED STATUS OF THE RETIREMENT AND HEALTH PLANS AS OF JUNE 30, 2022 – Paul Angelo, Actuary, and Andy Yeung, Actuary, with Segal Consulting, presented and discussed this item with the Board for one hour.
- B. PRELIMINARY PROPOSED BUDGET, PERSONNEL, AND ANNUAL RESOLUTIONS FOR FISCAL YEAR 2023-24 AND POSSIBLE BOARD ACTION – Neil M. Guglielmo, General Manager, provided the Board with an overview and highlights of the proposed budget. After a brief discussion, Commissioner Sohn moved approval, seconded by Commissioner Wilkinson, and adopted by the following vote: Ayes, Commissioners Chao, Huynh, Sidley, Sohn, Wilkinson, and Vice President Lee -6; Nays, None.
- C. TRIENNIAL BOARD POLICY REVIEW: SECTION 3.0 DUTIES AND RESPONSIBILITIES, SUBSECTIONS 3.1 THROUGH 3.5 AND POSSIBLE BOARD ACTION – John Koontz, Senior Management Analyst, presented this item to the Board. Commissioner Sidley moved approval, seconded by Commissioner Wilkinson, and adopted by the following vote: Ayes, Commissioners Chao, Huynh, Sidley, Sohn, Wilkinson, and Vice President Lee -6; Nays, None.

X

INVESTMENTS

A. CHIEF INVESTMENT OFFICER VERBAL REPORT INCLUDING DISCUSSION ON THE PORTFOLIO EXPOSURE TO GLOBAL EVENTS – Rod June, Chief Investment Officer, reported on the portfolio value of \$21.08 billion as of March 27, 2023. Mr. June discussed the following items:

- Volatility Index at 20.5
- Staff is evaluating the Adaptive Asset Allocation Policy at the direction of the Investment Committee
- LACERS’ public equity bank exposure is estimated at \$688 million; and of that amount, \$51 million is exposed to regional banks
- ESG update regarding President Biden’s veto of the bill that the House of Representatives tried to pass
- Future Agenda Items: Several investment manager contracts

Mr. June shared that Russian exposure for LACERS was 1.4 basis points and there were no material changes since March 24, 2023.

B. INVESTMENT MANAGER CONTRACT WITH GRANAHAN INVESTMENT MANAGEMENT, INC. REGARDING THE MANAGEMENT OF AN ACTIVE U.S. SMALL CAP GROWTH EQUITIES PORTFOLIO AND POSSIBLE BOARD ACTION – Rod June, Chief Investment Officer, presented this item to the Board. Commissioner Wilkinson moved approval of the following Resolution:

**CONTRACT RENEWAL
GRANAHAN INVESTMENT MANAGEMENT, INC.
ACTIVE U.S. SMALL CAP GROWTH EQUITIES
PORTFOLIO MANAGEMENT**

RESOLUTION 230328-B

WHEREAS, LACERS’ current three-year contract with Granahan Investment Management, Inc. (Granahan) for active U.S. small cap growth equities portfolio management expires on July 31, 2023; and,

WHEREAS, Granahan is in compliance with the LACERS Manager Monitoring Policy; and,

WHEREAS, a contract renewal with Granahan will allow the LACERS total portfolio to maintain a diversified exposure to U.S. small cap growth equities; and,

WHEREAS, on March 28, 2023, the Board approved the Investment Committee’s recommendation to approve a three-year contract renewal with Granahan.

NOW, THEREFORE, BE IT RESOLVED, that the General Manager is hereby authorized to approve and execute a contract subject to satisfactory business and legal terms and consistent with the following services and terms:

Company Name: Granahan Investment Management, Inc.

| | |
|---|---|
| <u>Service Provided:</u> | Active U.S. Small Cap Growth Equities Portfolio Management |
| <u>Effective Dates:</u> | August 1, 2023 through July 31, 2026 |
| <u>Duration:</u> | Three years |
| <u>Benchmark:</u> | Russell 2000 Growth Index |
| <u>Allocation as of January 31, 2023:</u> | \$124.2 million |

Which motion was seconded by Commissioner Sohn, and adopted by the following vote: Ayes, Commissioners Chao, Huynh, Sidley, Sohn, Wilkinson, and Vice President Lee -6; Nays, None.

- C. ADAPTIVE ASSET ALLOCATION POLICY AND STATUS REPORT AND POSSIBLE BOARD ACTION – Rod June, Chief Investment Officer, presented this item to the Board. Commissioner Sohn moved approval, seconded by Commissioner Wilkinson, and adopted by the following vote: Ayes, Commissioners Chao, Huynh, Sidley, Sohn, Wilkinson, and Vice President Lee -6; Nays, None.

XI

OTHER BUSINESS – There was no other business.

XII

NEXT MEETING: The next Regular meeting of the Board is scheduled for Tuesday, April 11, 2023, at 10:00 a.m., in the LACERS Boardroom, at 977 N. Broadway, Los Angeles, California 90012-1728.

XIII

ADJOURNMENT – There being no further business before the Board, Vice President Lee adjourned the Meeting at 12:34 p.m.

Elizabeth Lee
Vice-President

Neil M. Guglielmo
Manager-Secretary



REPORT TO BOARD OF ADMINISTRATION

From: Investment Committee
Elizabeth Lee, Chair
Thuy Huynh
Janna Sidley

MEETING: APRIL 25, 2023
ITEM: IX - B

SUBJECT: INVESTMENT MANAGER CONTRACT WITH EAM INVESTORS, LLC REGARDING THE MANAGEMENT OF AN ACTIVE U.S. SMALL CAP GROWTH EQUITIES PORTFOLIO AND POSSIBLE BOARD ACTION

ACTION: CLOSED: CONSENT: RECEIVE & FILE:

Recommendation

That the Board:

1. Approve a three-year contract renewal with EAM Investors, LLC for management of an active U.S. small cap growth equities portfolio.
2. Authorize the General Manager to approve and execute the necessary documents, subject to satisfactory business and legal terms.

Discussion

On April 11, 2023, the Committee considered the attached staff report (Attachment 1) recommending a three-year contract renewal with EAM Investors, LLC (EAM). EAM has managed an active U.S. small cap growth equities portfolio for LACERS since October 2015 and was awarded a new contract in January 2020 as a result of the 2019-2020 Active U.S. Small Cap Equities Request for Proposal process. The contract became effective on August 1, 2020 and expires on July 31, 2023. LACERS' portfolio was valued at approximately \$86 million as of February 28, 2023. EAM is in compliance with the LACERS Manager Monitoring Policy. Since inception, LACERS has paid EAM a total of \$5.7 million in investment fees.

Staff discussed the organization, investment strategy, performance, and fees. The Committee inquired about EAM's slight underperformance of -0.12%, net of fees, relative to the Russell 2000 Growth Index since inception of LACERS' account (refer to page 2 of Attachment 1). Staff explained that higher interest rates and a volatile market environment have hampered EAM's momentum-oriented strategy. Staff and NEPC have conviction that EAM can successfully manage through this current cycle of volatility based on EAM's ability to manage through such cycles in the past. Since inception of the

strategy in October 2007, EAM has generated a net of fee excess return of 0.60%. Following the discussion, the Committee concurred with the staff recommendation.

Strategic Plan Impact Statement

A contract renewal with EAM will allow the LACERS total portfolio to maintain a diversified exposure to the U.S. small cap growth equities markets, which is expected to optimize long-term risk adjusted investment returns (Goal IV). The discussion of the investment manager's profile, strategy, performance, and management fee structure is consistent with Goal V (uphold good governance practices which affirm transparency, accountability, and fiduciary duty).

Prepared By: Barbara Sandoval, Emerging Manager Program Officer and Investment Officer II,
Investment Division

NMG/RJ/BF/BS

Attachments: 1. Investment Committee Recommendation Report dated April 11, 2023
2. Proposed Resolution



LACERS
LA CITY EMPLOYEES'
RETIREMENT SYSTEM



REPORT TO INVESTMENT COMMITTEE
From: Neil M. Guglielmo, General Manager

MEETING: APRIL 11, 2023
ITEM: V

SUBJECT: INVESTMENT MANAGER CONTRACT WITH EAM INVESTORS, LLC REGARDING THE MANAGEMENT OF AN ACTIVE U.S. SMALL CAP GROWTH EQUITIES PORTFOLIO AND POSSIBLE COMMITTEE ACTION

ACTION: **CLOSED:** **CONSENT:** **RECEIVE & FILE:**

Recommendation

That the Committee recommend to the Board a three-year contract renewal with EAM Investors, LLC for management of an active U.S. small cap growth equities portfolio.

Executive Summary

EAM Investors, LLC (EAM) has managed an active U.S. small cap growth equities portfolio for LACERS since October 2015 and was awarded a new contract in January 2020 as a result of the 2019-2020 Active U.S. Small Cap Equities Request for Proposal process. LACERS' portfolio was valued at approximately \$86 million as of February 28, 2023. EAM is in compliance with the LACERS Manager Monitoring Policy. Staff and NEPC, LLC (NEPC), LACERS' General Fund Consultant, recommend a three-year contract renewal.

Discussion

Background

EAM manages an active U.S. small cap growth equities portfolio for LACERS benchmarked to the Russell 2000 Growth Index. EAM's strategy seeks to identify companies undergoing positive fundamental changes that will potentially accelerate the companies' earnings growth rates. The strategy is co-led by Travis Prentice, Chief Executive Officer and Chief Investment Officer, and Montie Weisenberger, Managing Director, both of whom have over 25 years of industry experience. LACERS' portfolio was valued at approximately \$86 million as of February 28, 2023.

EAM has managed assets for LACERS since October 2015. The Board initially hired the firm through the 2014-2015 Active U.S. Small Cap Growth Equities search. At the time of hire, EAM qualified as an Emerging Investment Manager pursuant to the LACERS Emerging Investment Manager Policy. The firm rebid for the Small Cap Growth Equities mandate through the 2019-2020 Active U.S. Small Cap Equities manager search process and was reselected by the Board on January 28, 2020 to manage the existing mandate under a new three-year contract. The contract became effective on August 1,

2020 and expires on July 31, 2023. Representatives of EAM most recently presented a portfolio review to the Investment Committee on January 10, 2023.

Organization

EAM was founded in 2007 and currently is 56% employee-owned and 44% owned by Roth Capital Partners. The firm is headquartered in Solana Beach, California, and has a total of 23 employees. As of February 28, 2023, EAM managed \$2.3 billion in assets, with \$448 million of assets in the U.S. small cap growth equities strategy.

Due Diligence

Staff conducts routine due diligence of the manager; since inception of the contract, quarterly due diligence meetings have been conducted telephonically and virtually. The most recent comprehensive onsite due diligence meeting at EAM’s headquarters was conducted in March 2023; staff and NEPC had no adverse findings as result of this meeting. Based upon these due diligence activities as well as staff’s and NEPC’s continuous monitoring, EAM’s organization, investment philosophy, strategy, and process have not changed materially over the contract period.

Performance

As of February 28, 2023, EAM outperformed its benchmark, net-of-fees, over the 5-year and 7-year time periods and underperformed its benchmark over the 3-month, 1-year, 2-year, 3-year and since inception time periods as presented in the table below.

| Annualized Performance as of 2/28/2023 (Net-of-Fees) | | | | | | | |
|---|--------------|--------------|--------------|--------------|-------------|-------------|------------------------------|
| | 3-Month | 1-Year | 2-Year | 3-Year | 5-Year | 7-Year | Since Inception ¹ |
| EAM Investors, LLC | -1.01 | -17.25 | -16.68 | 4.87 | 6.60 | 11.44 | 8.39 |
| Russell 2000 Growth Index | 1.78 | -7.92 | -12.79 | 6.51 | 5.06 | 10.29 | 8.51 |
| <i>% of Excess Return</i> | <i>-2.79</i> | <i>-9.33</i> | <i>-3.89</i> | <i>-1.64</i> | <i>1.54</i> | <i>1.15</i> | <i>-0.12</i> |

¹Performance inception date: 10/1/2015.

EAM’s momentum-based strategy is expected to underperform in periods of high market volatility, which is characteristic of the current market environment; EAM’s strategy generally requires trends to capture excess returns. The underperformance of the portfolio over the past year has been specifically driven by a sharp rally in low momentum, high beta, non-earner, and low return on equity stocks that are contained in the benchmark, but not in EAM’s portfolio. EAM’s stock selection across the Industrials, Information Technology and Materials sectors also contributed to the underperformance.

Staff analyzed EAM’s composite performance history (aggregated performance history of all EAM account managed in the small cap growth style) and found that EAM has successfully managed through several highly volatile market periods, resulting in long term net of fee excess returns of 60 basis points (0.60%) since inception of the strategy in October 2007. Staff have conviction that EAM can successfully manage the portfolio through the current cycle of high volatility. Further, EAM is currently

in compliance with the LACERS Manager Monitoring Policy. Staff and NEPC recommend renewing EAM’s contract for another three-year period and will continue to monitor the manager and strategy pursuant to the Policy.

Calendar year performance is presented in the table below as supplemental information.

| Calendar Year Performance as of 12/31/2022 (Net-of-Fees) | | | | | | | | |
|---|--------------|-------------|-------------|-------------|-------------|-------------|--------------|---------------------------|
| | 2022 | 2021 | 2020 | 2019 | 2018 | 2017 | 2016 | 10/1/2015 – 12/31/2015 |
| EAM Investors, LLC | -31.11 | 3.77 | 44.11 | 32.39 | -1.41 | 22.68 | 4.65 | 1.63 |
| Russell 2000 Growth Index | -26.36 | 2.83 | 34.63 | 28.48 | -9.31 | 22.17 | 11.32 | 4.32 |
| <i>% of Excess Return</i> | <i>-4.75</i> | <i>0.94</i> | <i>9.48</i> | <i>3.91</i> | <i>7.90</i> | <i>0.51</i> | <i>-6.67</i> | <i>-2.69</i> |

Fees

LACERS pays EAM an effective fee of 73 basis points (0.73%), which is approximately \$627,800 annually based on the value of LACERS’ assets as of February 28, 2023. This fee ranks in the 33rd percentile among its peers in the eVestment U.S. Small Cap Growth Universe (i.e., 67% of like-managers have higher fees). From contract inception on October 1, 2015 to December 31, 2022, LACERS has paid EAM a total of \$5.7 million in investment fees.

General Fund Consultant Opinion

NEPC concurs with this recommendation.

Strategic Plan Impact Statement

A contract renewal with EAM will allow the LACERS total portfolio to maintain a diversified exposure to the U.S. small cap growth equities markets, which is expected to help optimize long-term risk adjusted investment returns (Goal IV). The discussion of the investment manager’s profile, strategy, performance, and management fee structure is consistent with Goal V (uphold good governance practices which affirm transparency, accountability, and fiduciary duty).

Prepared By: Barbara Sandoval, Investment Officer II, Investment Division
Jeremiah Paras, Investment Officer I, Investment Division

NMG/RJ/BF/BS/JP:rm

Attachment: 1. Consultant Recommendation – NEPC



To: Los Angeles City Employees' Retirement System Investment Committee

From: NEPC, LLC

Date: April 11, 2023

Subject: EAM Investors - Contract Renewal

Recommendation

NEPC recommends Los Angeles City Employees' Retirement System (LACERS) renew the contract that is currently in place with EAM Investors ('EAM') for a period of three years from the date of contract expiry.

Background

EAM has been an investment manager for LACERS since October 1, 2015. As of February 28, 2023, EAM managed \$85.9 million, or 0.4% of Plan assets. The portfolio is benchmarked against the Russell 2000 Growth Index and has a performance objective of outperforming the benchmark, net of fees, annualized over a full market cycle (normally three-to-five years). The EAM portfolio is currently compliant with LACERS' manager monitoring policy.

The firm was founded by Montie Weisenberger, Travis Prentice and Joshua Moss. All three founders came from Nicholas-Applegate and started the firm in 2007. Their product lineup focuses on small and microcap names in the U.S. and outside of the U.S. The firm received venture funding by Roth Capital Partners, a boutique investment bank, in exchange for a 49% ownership stake. Today Roth owns 44% of the organization and they are a strategic, "evergreen" investor. EAM has an option to buy the firm if Roth wants to sell their interest. Approximately 60% of the firm's assets are managed across the Non-U.S. and Global product suite while 40% is managed across U.S. small and microcap strategies. The non-U.S. products were incepted in the 2011 to 2017 timeframe while the U.S. strategies have been managed since the firm began operations in 2007. All products use the same team, investment process and tools. As of December 31, 2022 the firm managed \$2.4 billion.

The firm's investment philosophy is rooted in identifying companies undergoing positive fundamental change that will accelerate their growth rate and where the implications are not yet fully appreciated by market participants. EAM's process has three broad phases which include: Discover, Analyze and Challenge. The Discover phase is where they evaluate the technical side of change relative to price screening with above average volume. They want to see at least one sign that a company is already performing. They screen in real time using the William O'Neil system and the Portfolio Manager sets the priority for what gets covered. During the Analyze phase, each analyst builds out the fundamental analysis to identify positive changes. During the Challenge phase, new names are evaluated against the existing names in the portfolio. Portfolios typically hold 150 names and position sizes are capped at 2%. Portfolio tracking error is 4%-6%.

All ten members of the portfolio management and research analyst teams function as generalists and all participate in the fundamental research of investment ideas. Travis Prentice and Montie Weisenberger are the portfolio managers responsible for all decisions with regard to the EAM Small

Cap Growth strategy. In the research effort, the product is supported by Portfolio Managers Josh Moss, John Scripp, Nick Dame and Adam Rubin, and Research Analysts Brian Chu, Zak Kavajecz, Khade Muangkroot, and Caelan Ness.

Performance

Referring to Exhibit 1, as of February 28, 2023, since the portfolio's inception date of October 1, 2015, the portfolio has underperformed its benchmark by 0.1%. Over the last seven-years ended February 28, 2023, the portfolio has outperformed its benchmark by 1.3%. Over the five-years, ended February 28, 2023 the portfolio has outperformed by 1.5%. Referring to Exhibit 1A, over longer periods of time EAM clients in the US Small Cap product have experienced outperformance. The composite outperformed by 0.6% over the last 10 years and 0.6% since inception over 15.4 years.

Referring to Exhibit 2, as of December 31, 2022, since inception the portfolio has outperformed its benchmark by 0.6% and ranked in the 85th percentile in its peer group of small cap growth managers. In the past five-years, ended December 31, 2022, the portfolio outperformed its benchmark by 2.6% and ranked in the 68th percentile in its peer group. Over the past one-year, the portfolio underperformed its benchmark by 4.7% and ranked in the 73rd percentile among peers.

Referring to Exhibit 3, since inception, the cumulative effect of the short-term underperformance over the last year has eroded the portfolio's outperformance over longer-term rolling periods since the portfolio has underperformed 0.1% since inception ended February 28, 2023. Underperformance in the portfolio over the past year has been driven by a sharp rally in low momentum, high beta, non-earners, and low return on equity stocks. More specifically, stock selection across the Industrials, Information Technology and Materials sectors contributed to underperformance in the short-run. Over the longer-run, the portfolio's emphasis on delivering the momentum risk premium has provided value to LACERS and has been driven by stock selection in the Information Technology and Healthcare economic sectors.

Fees

The portfolio has an asset-based fee of 0.73% annually. This fee ranks in the 33rd percentile among its peers in the eVestment US Small Cal Growth universe. In other words, 67% of the products included in the peer universe have a higher fee than the LACERS account.

Conclusion

EAM has slightly underperformed its benchmark index since October 1, 2015. However, longer-term underperformance has been heavily influenced by near-term challenges to their investment approach. For example, through May 31, 2022, the strategy had outperformed the Russell 2000 Growth Index by 240 basis points since inception (compared to 10 basis points of underperformance through February 28, 2023). The firm has exhibited stability in their investment process, investment team, strategy and philosophy. EAM's strategy employs a behaviorally-based, fundamentally-driven investment philosophy, focused on companies that are accelerating their potential earnings growth due to positive, fundamental change through innovation, reinvention and/or disruption. The strategy offers a number of positive traits and we believe that it can play an appropriate role in the LACERS portfolio. NEPC recommends a contract renewal for a period of three years from the period of contract expiry.

The following tables provide specific performance information, net of fees referenced above.



Exhibit 1: Performance Comparison Net of Fees as of February 28, 2023

| | 1 Month | YTD | 1 Year | 3 Years | 5 Years | 7 Years | Inception | Inception Date |
|---------------------|---------|------|--------|---------|---------|---------|-----------|----------------|
| EAM Investors | -0.9 | 3.6 | -17.2 | 4.9 | 6.6 | 11.4 | 8.4 | Oct-15 |
| Russell 2000 Growth | -1.1 | 8.8 | -7.9 | 6.5 | 5.1 | 10.3 | 8.5 | |
| Over/Under | 0.2 | -5.2 | -9.3 | -1.6 | 1.5 | 1.2 | -0.1 | |

Exhibit 1A: Performance Comparison Net of Fees EAM Separately Managed Accounts Composite as of February 28, 2023

| Product Name | YTD | 1 Year | 3 Years | 5 Years | 7 Years | 10 Years | Returns - Since Inception 15.42 Years 10/2007 - 02/2023 |
|---------------------|------|--------|---------|---------|---------|----------|---|
| EAM US Small Cap* | 3.7 | -17.3 | 5.4 | 6.9 | 11.6 | 9.9 | 8.1 |
| Russell 2000 Growth | 8.8 | -7.9 | 6.5 | 5.1 | 10.3 | 9.3 | 7.5 |
| Over/Under | -5.1 | -9.3 | -1.2 | 1.8 | 1.3 | 0.6 | 0.6 |

*Source: eVestment, EAM US Small Cap composite return net of fees separately managed accounts





Exhibit 2: Universe Performance Comparison Net of Fees Ending December 31, 2022

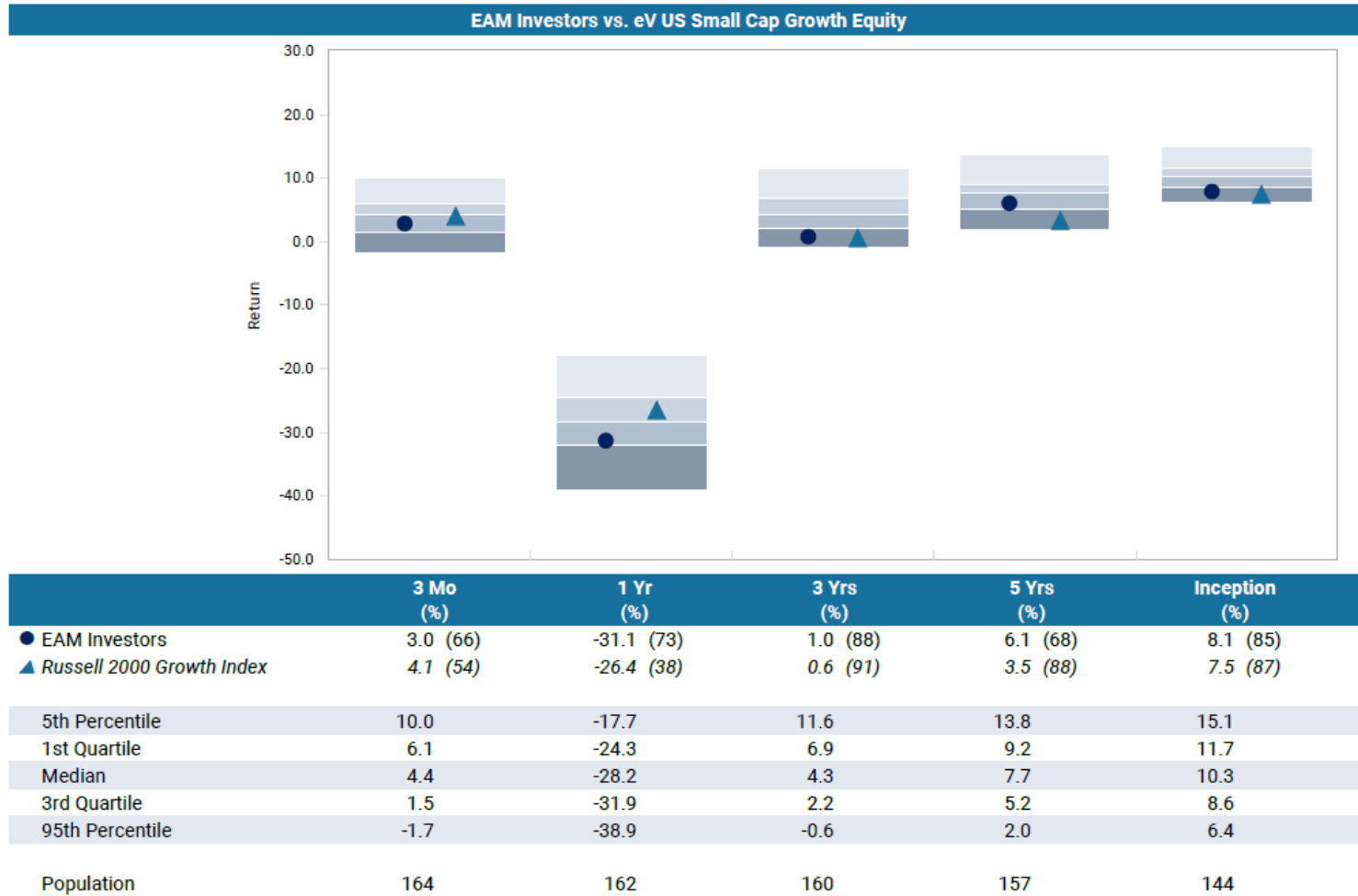
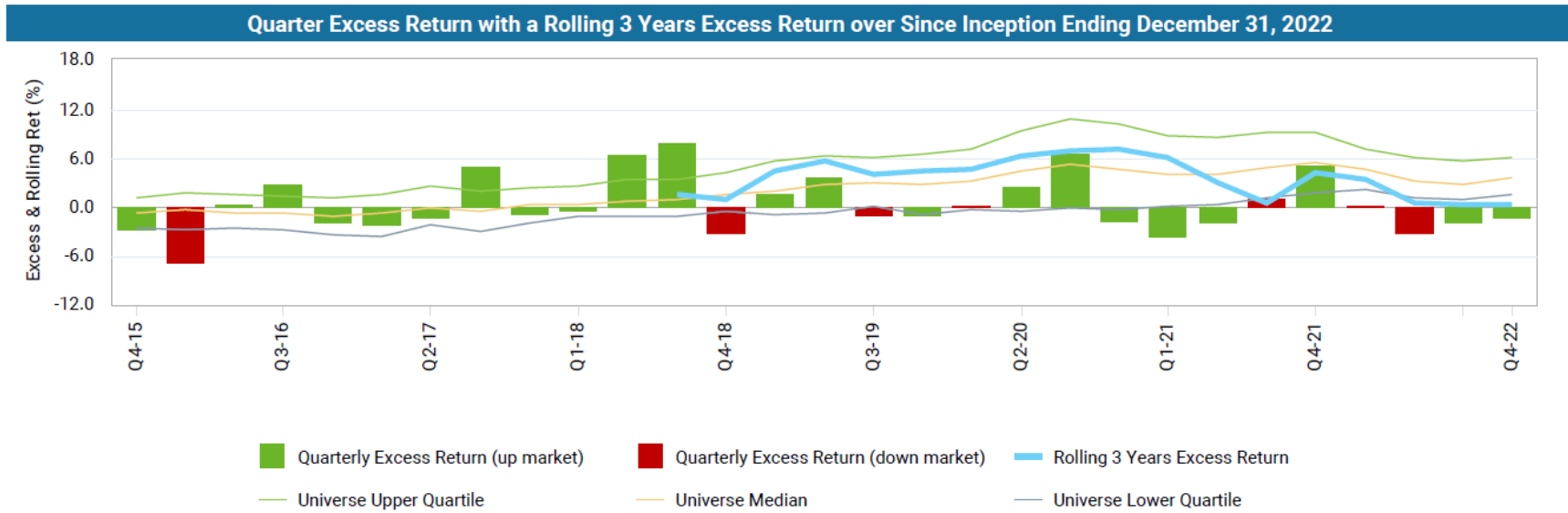


Exhibit 3: Cumulative Excess Performance Net of Fees Ending December 31, 2022



CONTRACT RENEWAL
EAM INVESTORS, LLC
ACTIVE U.S. SMALL CAP GROWTH EQUITIES
PORTFOLIO MANAGEMENT

PROPOSED RESOLUTION

WHEREAS, LACERS' current three-year contract with EAM Investors, LLC (EAM) for active U.S. small cap growth equities portfolio management expires on July 31, 2023; and,

WHEREAS, EAM is in compliance with the LACERS Manager Monitoring Policy; and,

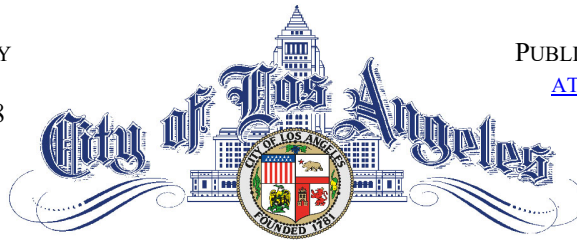
WHEREAS, a contract renewal with EAM will allow the LACERS total portfolio to maintain a diversified exposure to U.S. small cap equities; and,

WHEREAS, on April 25, 2023, the Board approved the Investment Committee's recommendation to approve a three-year contract renewal with EAM.

NOW, THEREFORE, BE IT RESOLVED, that the General Manager is hereby authorized to approve and execute a contract subject to satisfactory business and legal terms and consistent with the following services and terms:

| | |
|--|--|
| <u>Company Name:</u> | EAM Investors, LLC |
| <u>Service Provided:</u> | Active U.S. Small Cap Growth Equities Portfolio Management |
| <u>Effective Dates:</u> | August 1, 2023 through July 31, 2026 |
| <u>Duration:</u> | Three years |
| <u>Benchmark:</u> | Russell 2000 Growth Index |
| <u>Allocation as of February 28, 2023:</u> | \$86 million |

April 25, 2023



Office of the Los Angeles City Attorney
Hydee Feldstein Soto

Board Mtg: 04/25/23
Item: X-A

MEMORANDUM

To: Board of Administration
Los Angeles City Employees' Retirement System

From: Anya Freedman, Assistant City Attorney *AF*
Miguel Bahamon, Deputy City Attorney *MGB*
Gina Di Domenico, Deputy City Attorney *GD*

Date: April 25, 2023

Re: Board Education: Fiduciary Duties and Corporate Engagement

Cc: Neil Guglielmo, General Manager

The Public Pensions General Counsel Division of the City Attorney's Office, in collaboration with outside securities monitoring counsel, Cohen Milstein Sellers & Toll PLLC (Cohen Milstein), has prepared this Board education item on Fiduciary Duties and Corporate Engagement. In the fall of 2022, the U.S. Department of Labor (DOL) published the Final Rule on Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights (2022 Rule). The 2022 Rule pertains specifically to the Employee Retirement Income Security Act (ERISA), but it serves as important guidance for the LACERS Board as fiduciaries. In the 2022 Rule, the DOL clarified that "fiduciaries may consider climate change and other environmental, social and governance (ESG) factors when they make investment decisions and when they exercise shareholder rights, including voting on shareholder resolutions and board nominations." The 2022 Rule and a DOL Fact Sheet are included as attachments A and B.

In partnership with our Office, Cohen Milstein prepared a PowerPoint presentation, enclosed as attachment C, that will equip the Board with tools to continue acting as prudent investors by: (1) providing strategies to handle the 2022 Rule adjustments when making investment decisions; and (2) highlighting non-investment strategies to advance the best interests of LACERS Members, such as advocacy, proxy proposals, and derivative litigation.

We look forward to presenting this education item with Cohen Milstein on April 25, 2023, and welcome further discussion with the Board on these issues.

Encl.

AJG/MGB/GD:np

Attachment A

DEPARTMENT OF LABOR**Employee Benefits Security Administration****29 CFR Part 2550**

RIN 1210-AC03

Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights

AGENCY: Employee Benefits Security Administration, Department of Labor.

ACTION: Final rule.

SUMMARY: The Department of Labor (Department) is adopting amendments to the Investment Duties regulation under Title I of the Employee Retirement Income Security Act of 1974, as amended (ERISA). The amendments clarify the application of ERISA's fiduciary duties of prudence and loyalty to selecting investments and investment courses of action, including selecting qualified default investment alternatives, exercising shareholder rights, such as proxy voting, and the use of written proxy voting policies and guidelines. The amendments reverse and modify certain amendments to the Investment Duties regulation adopted in 2020.

DATES:

Effective date: This rule is effective on January 30, 2023.

Applicability dates: See § 2550.404a-1(g) of the final rule for compliance dates for § 2550.404a-1(d)(2)(iii) and (d)(4)(ii) of the final rule.

FOR FURTHER INFORMATION CONTACT: Fred Wong, Acting Chief of the Division of Regulations, Office of Regulations and Interpretations, Employee Benefits Security Administration, (202) 693-8500. This is not a toll-free number.

Customer Service Information: Individuals interested in obtaining information from the Department of Labor concerning ERISA and employee benefit plans may call the Employee Benefits Security Administration (EBSA) Toll-Free Hotline, at 1-866-444-EBSA (3272) or visit the Department of Labor's website (www.dol.gov/ebsa).

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I. Background*A. General*

Title I of the Employee Retirement Income Security Act of 1974 (ERISA) establishes minimum standards that govern the operation of private-sector employee benefit plans, including fiduciary responsibility rules. Section 404 of ERISA, in part, requires that plan fiduciaries act prudently and diversify plan investments so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.¹ Sections 403(c) and 404(a) also require fiduciaries to act solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan.²

To maximize employee pension and welfare benefits, section 404 of ERISA dictates that the focus of ERISA plan fiduciaries on the plan's financial returns and risk to beneficiaries must be paramount.³ And for years, the Department's non-regulatory guidance has recognized that, under the appropriate circumstances, ERISA does not preclude fiduciaries from making investment decisions that reflect environmental, social, or governance ("ESG") considerations, and choosing economically targeted investments ("ETIs") selected in part for benefits in addition to the impact those considerations could have on investment return.⁴ The Department's non-regulatory guidance has also recognized that the fiduciary act of managing employee benefit plan assets includes the management of voting rights as well as other shareholder rights connected to shares of stock, and that management of those rights, as well as shareholder engagement activities, is subject to ERISA's prudence and loyalty requirements.⁵ Subsection B of this background section provides a complete overview of the Department's prior non-regulatory guidance.

The Department's Investment Duties regulation under Title I of ERISA is codified at 29 CFR 2550.404a-1 (hereinafter "current regulation" or "Investment Duties regulation," unless otherwise stated). On June 30 and

¹ 29 U.S.C. 1104.

² 29 U.S.C. 1103(c) and 1104(a).

³ See Interpretive Bulletin 2015-01, 80 FR 65135 (Oct. 26, 2015).

⁴ See, e.g., *id.*

⁵ See, e.g., Interpretive Bulletin 2016-01, 81 FR 95879 (Dec. 29, 2016).

September 4, 2020, the Department published in the **Federal Register** proposed rules to remove prior non-regulatory guidance from the CFR and to amend the Department's Investment Duties regulation. The objective was to address perceived confusion about the implications of that non-regulatory guidance with respect to ESG considerations, ETIs, shareholder rights, and proxy voting.⁶ The preambles to the 2020 proposals expressed concern that some ERISA plan fiduciaries might be making improper investment decisions, and that plan shareholder rights were being exercised in a manner that subordinated the interests of plans and their participants and beneficiaries to unrelated objectives.⁷ Given the persistent confusion in this area due in part to varied statements the Department had made on the subject over the years in non-regulatory guidance, the Department believed that providing further clarity on these issues in the form of a notice and comment regulation would be more helpful and permanent than another iteration of non-regulatory guidance.

Less than six months later, on November 13, 2020, the Department published a final rule titled "Financial Factors in Selecting Plan Investments," which adopted amendments to the Investment Duties regulation that generally require plan fiduciaries to select investments and investment courses of action based solely on consideration of "pecuniary factors."⁸ Among these amendments was a prohibition against adding or retaining any investment fund, product, or model portfolio as a qualified default investment alternative (QDIA) as described in 29 CFR 2550.404c-5 if the fund, product, or model portfolio includes even one non-pecuniary objective in its investment objectives or principal investment strategies. On December 16, 2020, the Department published a final rule titled "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights," which also adopted amendments to the Investment Duties regulation to establish regulatory standards for the obligations of plan fiduciaries under ERISA when voting proxies and exercising other shareholder rights in connection with plan investments in shares of stock.⁹

On January 20, 2021, the President signed Executive Order 13990 (E.O. 13990), titled "Protecting Public Health

and the Environment and Restoring Science to Tackle the Climate Crisis."¹⁰ Section 1 of E.O. 13990 acknowledges the Nation's "abiding commitment to empower our workers and communities; promote and protect our public health and the environment." Section 1 also sets forth the policy of the Administration to listen to the science; improve public health and protect our environment; bolster resilience to the impacts of climate change; and prioritize both environmental justice and the creation of the well-paying union jobs necessary to deliver on these goals. Section 2 directed agencies to review all existing regulations promulgated, issued, or adopted between January 20, 2017, and January 20, 2021, that are or may be inconsistent with, or present obstacles to, the policies set forth in section 1 of E.O. 13990. Section 2 further provided that for any such actions identified by the agencies, the heads of agencies shall, as appropriate and consistent with applicable law, consider suspending, revising, or rescinding the agency actions.¹¹

On March 10, 2021, the Department announced that it had begun a reexamination of the current regulation, consistent with E.O. 13990, the Administrative Procedure Act, and ERISA's grant of regulatory authority in section 505.¹² The Department also announced that, pending its review of the current regulation, the Department will not enforce the current regulation or otherwise pursue enforcement actions against any plan fiduciary based on a failure to comply with the current regulation with respect to an investment, including a QDIA, investment course of action or an exercise of shareholder rights. In announcing the enforcement policy, the Department also stated its intention to conduct significantly more stakeholder outreach to determine how to craft rules that better recognize the role that ESG integration can play in the evaluation and management of plan investments in

ways that further fundamental fiduciary obligations.¹³

On May 20, 2021, the President signed Executive Order 14030 (E.O. 14030), titled "Executive Order on Climate-Related Financial Risk."¹⁴ The policies set forth in section 1 of E.O. 14030 include advancing acts to mitigate climate-related financial risk and actions to help safeguard the financial security of America's families, businesses, and workers from climate-related financial risk that may threaten the life savings and pensions of U.S. workers and families. Section 4 of E.O. 14030 directed the Department to consider publishing, by September 2021, for notice and comment a proposed rule to suspend, revise, or rescind "Financial Factors in Selecting Plan Investments,"¹⁵ and "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights."¹⁶

B. The Department's Prior Non-Regulatory Guidance

The Department has a longstanding position that ERISA fiduciaries may not sacrifice investment returns or assume greater investment risks as a means of promoting collateral social policy goals. These proscriptions flow directly from ERISA's stringent standards of prudence and loyalty under section 404(a) of the statute.¹⁷ The Department has a similarly longstanding position that the fiduciary act of managing plan assets that involve shares of corporate stock includes making decisions about voting proxies and exercising shareholder rights. Over the years the Department repeatedly has issued non-regulatory

¹³ See U.S. Department of Labor Statement Regarding Enforcement of its Final Rules on ESG Investments and Proxy Voting by Employee Benefit Plans (Mar. 10, 2021) Available at www.dol.gov/sites/dolgov/files/ebsa/laws-and-regulations/laws/erisa/statement-on-enforcement-of-final-rules-on-esg-investments-and-proxy-voting.pdf. Following publication of the final rules the Department heard from a wide variety of stakeholders, including asset managers, labor organizations and other plan sponsors, consumer groups, service providers and investment advisers that questioned whether the 2020 Rules properly reflect the scope of fiduciaries' duties under ERISA to act prudently and solely in the interest of plan participants and beneficiaries. The stakeholders also questioned whether the Department rushed the rulemakings unnecessarily and failed to adequately consider and address the substantial evidence submitted by public commenters on the use of environmental, social and governance considerations in improving investment value and long-term investment returns for retirement investors.

¹⁴ 86 FR 27967 (May 25, 2021). E.O. 14030 was signed 128 days after the effective date of "Financial Factors in Selecting Plan Investments," and 125 days after the effective date of "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights."

¹⁵ 85 FR 72846 (Nov. 13, 2020).

¹⁶ 85 FR 81658 (Dec. 16, 2020).

¹⁷ 29 U.S.C. 1104(a).

¹⁰ 86 FR 7037 (Jan. 25, 2021). E.O. 13990 was signed eight days after the effective date of "Financial Factors in Selecting Plan Investments," and five days after the effective date of "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights."

¹¹ A Fact Sheet issued simultaneously with E.O. 13990, specifically confirmed that the Department was directed to review the final rule on "Financial Factors in Selecting Plan Investments" Available at www.whitehouse.gov/briefing-room/statements-releases/2021/01/20/fact-sheet-list-of-agency-actions-for-review/.

¹² 29 U.S.C. 1135.

⁶ See 85 FR 39113 (June 30, 2020); 85 FR 55219 (Sept. 4, 2020).

⁷ See 85 FR 39116; 85 FR 55221.

⁸ 85 FR 72846 (Nov. 13, 2020).

⁹ 85 FR 81658 (Dec. 16, 2020).

guidance to assist plan fiduciaries in understanding their obligations under ERISA to apply these principles to ETIs and ESG.

1. ETI/ESG Investing

Interpretive Bulletin 94–1 (IB 94–1), published in 1994, addressed economically targeted investments (ETIs) selected, in part, for collateral benefits apart from the investment return to the plan investor.¹⁸ The Department's objective in issuing IB 94–1 was to state that ETIs¹⁹ are not inherently incompatible with ERISA's fiduciary obligations. The preamble to IB 94–1 explained that the requirements of sections 403 and 404 of ERISA do not prevent plan fiduciaries from investing plan assets in ETIs if the investment has an expected rate of return at least commensurate to rates of return of available alternative investments, and if the ETI is otherwise an appropriate

¹⁸ 59 FR 32606 (June 23, 1994) (appeared in Code of Federal Regulations as 29 CFR 2509.94–1). Prior to issuing IB 94–1, the Department had issued a number of letters concerning a fiduciary's ability to consider the collateral effects of an investment and granted a variety of prohibited transaction exemptions to both individual plans and pooled investment vehicles involving investments that produce collateral benefits. See Advisory Opinions 80–33A, 85–36A and 88–16A; Information Letters to Mr. George Cox, dated Jan. 16, 1981; to Mr. Theodore Groom, dated Jan. 16, 1981; to The Trustees of the Twin City Carpenters and Joiners Pension Plan, dated May 19, 1981; to Mr. William Chadwick, dated July 21, 1982; to Mr. Daniel O'Sullivan, dated Aug. 2, 1982; to Mr. Ralph Katz, dated Mar. 15, 1982; to Mr. William Ecklund, dated Dec. 18, 1985, and Jan. 16, 1986; to Mr. Reed Larson, dated July 14, 1986; to Mr. James Ray, dated July 8, 1988; to the Honorable Jack Kemp, dated Nov. 23, 1990; and to Mr. Stuart Cohen, dated May 14, 1993. The Department also issued a number of prohibited transaction exemptions that touched on these issues. See PTE 76–1, part B, concerning construction loans by multiemployer plans; PTE 84–25, issued to the Pacific Coast Roofers Pension Plan; PTE 85–58, issued to the Northwestern Ohio Building Trades and Employer Construction Industry Investment Plan; PTE 87–20, issued to the Racine Construction Industry Pension Fund; PTE 87–70, issued to the Dayton Area Building and Construction Industry Investment Plan; PTE 88–96, issued to the Real Estate for American Labor A Balcor Group Trust; PTE 89–37, issued to the Union Bank; and PTE 93–16, issued to the Toledo Roofers Local No. 134 Pension Plan and Trust, et al. In addition, one of the first directors of the Department's benefits office authored an article on this topic in 1980. See Ian D. Lanoff, *The Social Investment of Private Pension Plan Assets: May It Be Done Lawfully Under ERISA?*, 31 Labor L.J. 387, 391–92 (1980) (stating that “[t]he Labor Department has concluded that economic considerations are the only ones which can be taken into account in determining which investments are consistent with ERISA standards,” and warning that fiduciaries who exclude investment options for non-economic reasons would be “acting at their peril”).

¹⁹ IB 94–1 used the terms ETI and economically targeted investments to broadly refer to any investment or investment course of action that is selected, in part, for its expected collateral benefits, apart from the investment return to the employee benefit plan investor.

investment for the plan in terms of such factors as diversification and the investment policy of the plan. Some commentators have referred to this as the “all things being equal” test or the “tiebreaker” standard. The Department stated in the preamble to IB 94–1 that when competing investments serve the plan's economic interests equally well, plan fiduciaries can use such collateral considerations as the deciding factor for an investment decision. This was the Department's unchanged position for approximately three decades.

In 2008, the Department replaced IB 94–1 with Interpretive Bulletin 2008–01 (IB 2008–01),²⁰ and then, in 2015, the Department replaced IB 2008–01 with Interpretive Bulletin 2015–01 (IB 2015–01).²¹ Although the Interpretive Bulletins differed from each other in tone and content to some extent, each endorsed the “all things being equal” test, while also stressing that the paramount focus of plan fiduciaries must be the plan's financial returns and providing promised benefits to participants and beneficiaries. Each Interpretive Bulletin also cautioned that fiduciaries violate ERISA if they accept reduced expected returns or greater risks to secure social, environmental, or other policy goals.

Additionally, the preamble to IB 2015–01 explained that if a fiduciary prudently determines that an investment is appropriate based solely on economic considerations, including those that may derive from ESG factors, the fiduciary may make the investment without regard to any collateral benefits the investment may also promote. In Field Assistance Bulletin 2018–01 (FAB 2018–01), the Department indicated that IB 2015–01 had recognized that there could be instances when ESG issues present material business risk or opportunities to companies that company officers and directors need to manage as part of the company's business plan, and that qualified investment professionals would treat the issues as material economic considerations under generally accepted investment theories. As appropriate economic considerations, such ESG issues should be considered by a prudent fiduciary along with other relevant economic factors to evaluate the risk and return profiles of alternative investments. In other words, in these instances, the factors are not “tiebreakers,” but “risk-return” factors affecting the economic merits of the investment.

FAB 2018–01 cautioned, however, that “[t]o the extent ESG factors, in fact, involve business risks or opportunities that are properly treated as economic considerations themselves in evaluating alternative investments, the weight given to those factors should also be appropriate to the relative level of risk and return involved compared to other relevant economic factors.”²² The Department further emphasized in FAB 2018–01 that fiduciaries “must not too readily treat ESG factors as economically relevant to the particular investment choices at issue when making a decision,” as “[i]t does not ineluctably follow from the fact that an investment promotes ESG factors, or that it arguably promotes positive general market trends or industry growth, that the investment is a prudent choice for retirement or other investors.” Rather, ERISA fiduciaries must always put first the economic interests of the plan in providing retirement benefits, and “[a] fiduciary's evaluation of the economics of an investment should be focused on financial factors that have a material effect on the return and risk of an investment based on appropriate investment horizons consistent with the plan's articulated funding and investment objectives.”²³

FAB 2018–01 also explained that in the case of an investment platform that allows participants and beneficiaries an opportunity to choose from a broad range of investment alternatives, a prudently selected, well managed, and properly diversified ESG-themed investment alternative could be added to the available investment options on a 401(k) plan platform without requiring the plan to remove or forgo adding other non-ESG-themed investment options to the platform.²⁴ According to the FAB, however, the selection of an investment fund as a QDIA is not analogous to a fiduciary's decision to offer participants an additional investment alternative as part of a prudently constructed lineup of investment alternatives from which participants may choose. FAB 2018–01 expressed concern that the decision to favor the fiduciary's own policy preferences in selecting an ESG-themed investment option as a QDIA for a 401(k)-type plan without regard to possibly different or competing views of plan participants and beneficiaries would raise questions about the fiduciary's compliance with ERISA's duty of loyalty.²⁵ In addition, FAB

²² FAB 2018–01 (Apr. 23, 2018).

²³ *Id.*

²⁴ *Id.*

²⁵ FAB 2018–01.

²⁰ 73 FR 61734 (Oct. 17, 2008).

²¹ 80 FR 65135 (Oct. 26, 2015).

2018–01 stated that, even if consideration of such factors could be shown to be appropriate in the selection of a QDIA for a particular plan population, the plan’s fiduciaries would have to ensure compliance with the previous guidance in IB 2015–01. For example, the selection of an ESG-themed target date fund as a QDIA would not be prudent if the fund would provide a lower expected rate of return than available non-ESG alternative target date funds with commensurate degrees of risk, or if the fund would be riskier than non-ESG alternative available target date funds with commensurate rates of return.

2. Exercising Shareholder Rights

The Department’s past non-regulatory guidance has also consistently recognized that the fiduciary act of managing employee benefit plan assets includes the management of voting rights as well as other shareholder rights connected to shares of stock, and that management of those rights, as well as shareholder engagement activities, is subject to ERISA’s prudence and loyalty requirements.

The Department first issued non-regulatory guidance on proxy voting and the exercise of shareholder rights in the 1980s. For example, in 1988, the Department issued an opinion letter to Avon Products, Inc. (the Avon Letter), in which the Department took the position that the fiduciary act of managing plan assets that are shares of corporate stock includes the voting of proxies appurtenant to those shares, and that the named fiduciary of a plan has a duty to monitor decisions made and actions taken by investment managers with regard to proxy voting.²⁶ In 1994, the Department issued its first interpretive bulletin on proxy voting, Interpretive Bulletin 94–2 (IB 94–2).²⁷ IB 94–2 recognized that fiduciaries may engage in shareholder activities intended to monitor or influence corporate management if the responsible fiduciary concludes that, after taking into account the costs involved, there is a reasonable expectation that such shareholder activities (by the plan alone or together with other shareholders) will enhance the value of the plan’s investment in the corporation. The Department also reiterated its view that ERISA does not permit fiduciaries, in voting proxies or exercising other shareholder rights, to subordinate the

economic interests of participants and beneficiaries to unrelated objectives.

In October 2008, the Department replaced IB 94–2 with Interpretive Bulletin 2008–02 (IB 2008–02).²⁸ The Department’s intent was to update the guidance in IB 94–2 and to reflect interpretive positions issued by the Department after 1994 on shareholder engagement and socially-directed proxy voting initiatives. IB 2008–02 stated that fiduciaries’ responsibility for managing proxies includes both deciding to vote and deciding not to vote.²⁹ IB 2008–02 further stated that the fiduciary duties described at ERISA sections 404(a)(1)(A) and (B) require that, in voting proxies, the responsible fiduciary shall consider only those factors that relate to the economic value of the plan’s investment and shall not subordinate the interests of the participants and beneficiaries in their retirement income to unrelated objectives. In addition, IB 2008–02 stated that votes shall only be cast in accordance with a plan’s economic interests. IB 2008–02 explained that if the responsible fiduciary reasonably determines that the cost of voting (including the cost of research, if necessary, to determine how to vote) is likely to exceed the expected economic benefits of voting, the fiduciary has an obligation to refrain from voting.³⁰ The Department also reiterated in IB 2008–02 that any use of plan assets by a plan fiduciary to further political or social causes “that have no connection to enhancing the economic value of the plan’s investment” through proxy voting or shareholder activism is a violation of ERISA’s exclusive purpose and prudence requirements.³¹

In 2016, the Department issued Interpretive Bulletin 2016–01 (IB 2016–01), which reinstated the language of IB 94–2 with certain modifications.³² IB 2016–01 reiterated and confirmed that “in voting proxies, the responsible fiduciary [must] consider those factors that may affect the value of the plan’s investment and not subordinate the interests of the participants and beneficiaries in their retirement income to unrelated objectives.”³³ In its guidance, the Department has also stated that it rejects a construction of ERISA that would render the statute’s

tight limits on the use of plan assets illusory and that would permit plan fiduciaries to expend trust assets to promote a myriad of personal public policy preferences at the expense of participants’ economic interests, including through shareholder engagement activities, voting proxies, or other investment policies.³⁴

C. Executive Order Review of Current Regulation

In early 2021, consistent with E.O. 13990 and E.O. 14030, the Department engaged in informal outreach to hear views from interested stakeholders on how to craft regulations that better recognize the important role that climate change and other ESG factors can play in the evaluation and management of plan investments, while continuing to uphold fundamental fiduciary obligations. The Department heard from a wide variety of stakeholders, including asset managers, labor organizations and other plan sponsors, consumer groups, service providers, and investment advisers. Many of the stakeholders expressed skepticism as to whether the current regulation properly reflects the scope of fiduciaries’ duties under ERISA to act prudently and solely in the interest of plan participants and beneficiaries.

That outreach effort by the Department suggested that, rather than provide clarity, some aspects of the current regulation instead may have created further uncertainty about whether a fiduciary under ERISA may consider ESG and other factors in making investment and proxy voting decisions that the fiduciary reasonably believes will benefit the plan and its participants and beneficiaries. Many stakeholders questioned whether the Department rushed the current regulation unnecessarily and failed to adequately consider and address substantial evidence submitted by public commenters suggesting that the use of climate change and other ESG factors can improve investment value and long-term investment returns for retirement investors. The Department also heard from stakeholders that the current regulation, and investor confusion about it, including whether climate change and other ESG factors may be treated as “pecuniary” factors under the regulation, already had begun to have a chilling effect on appropriate integration of climate change and other ESG factors in investment decisions. This continued through the current non-enforcement period, including in circumstances where the current

²⁸ 73 FR 61731 (Oct. 17, 2008).

²⁹ 73 FR 61732.

³⁰ *Id.*

³¹ 73 FR 61734.

³² 81 FR 95879 (Dec. 29, 2016). In addition, the Department issued a Field Assistance Bulletin to provide guidance on IB 2016–01 on April 23, 2018. See FAB 2018–01, at www.dol.gov/sites/dolgov/files/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-01.pdf.

³³ 81 FR 95882.

³⁴ See 81 FR 95881.

²⁶ Letter to Helmuth Fandl, Chairman of the Retirement Board, Avon Products, Inc. 1988 WL 897696 (Feb. 23, 1988).

²⁷ 59 FR 38860 (July 29, 1994).

regulation may in fact allow consideration of ESG factors.

After conducting a review of the current regulation, the Department concluded there is a reasonable basis for the concerns raised by the stakeholders. A number of public comment letters had criticized the 2020 proposed regulatory text for appearing to single out ESG investing for heightened scrutiny, which they asserted was inappropriate in light of research and investment practices suggesting that climate change and other ESG factors are material economic considerations.³⁵ In response, the Department did not include explicit references to ESG in the current regulation and furthermore acknowledged in the preamble discussion to the *Financial Factors in Selecting Plan Investments* final rulemaking that there are instances where one or more ESG factors may be properly taken into account by a fiduciary.³⁶ The preamble to the *Fiduciary Duties Regarding Proxy Voting and Shareholder Rights* final rulemaking also acknowledged academic studies and investment experience surrounding the materiality of ESG considerations in investment decisionmaking.³⁷ However, other statements in the preamble appeared to express skepticism about fiduciaries' reliance on ESG considerations. For instance, the preamble to the *Financial Factors in Selecting Plan Investments* final rulemaking asserted that ESG investing raises heightened concerns under ERISA, and cautioned fiduciaries against "too hastily" concluding that ESG-themed funds may be selected based on pecuniary factors.³⁸ Similarly,

³⁵ See, e.g., Comment # 567 at www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB95/00567.pdf and Comment # 709 at www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB95/00709.pdf.

³⁶ See 85 FR 72859 (Nov. 13, 2020) ("[T]he Department believes that it would be consistent with ERISA and the final rule for a fiduciary to treat a given factor or consideration as pecuniary if it presents economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories").

³⁷ 85 FR 81662 (Dec. 16, 2020) ("This [Fiduciary Duties Regarding Proxy Voting and Shareholder Rights] rulemaking project, similar to the recently published final rule on ERISA fiduciaries' consideration of financial factors in investment decisions, recognizes, rather than ignores, the economic literature and fiduciary investment experience that show a particular 'E,' 'S,' or 'G' consideration may present issues of material business risk or opportunities to a specific company that its officers and directors need to manage as part of the company's business plan and that qualified investment professionals would treat as economic considerations under generally accepted investment theories.").

³⁸ 85 FR 72848, 72859 (Nov. 13, 2020).

the preamble to the *Fiduciary Duties Regarding Proxy Voting and Shareholder Rights* final rulemaking expressed the view that it is likely that many environmental and social shareholder proposals have little bearing on share value or other relation to plan financial interests.³⁹ Many stakeholders indicated that the current regulation has been interpreted as putting a thumb on the scale against the consideration of ESG factors, even when those factors are financially material.

The Department's review under the Executive orders caused it concern that, as stakeholders warned, uncertainty with respect to the current regulation may be deterring fiduciaries from taking steps that other marketplace investors would take in enhancing investment value and performance, or improving investment portfolio resilience against the potential financial risks and impacts associated with climate change and other ESG factors. The Department was concerned that the current regulation created a perception that fiduciaries are at risk if they include any ESG factors in the financial evaluation of plan investments, and that they would need to have special justifications for even ordinary exercises of shareholder rights.

Based on these concerns, the Department, on October 14, 2021, published a notice of proposed rulemaking (NPRM) proposing amendments to the current regulation.⁴⁰ The intent of the NPRM was to address uncertainties regarding aspects of the current regulation and its preamble discussion relating to the consideration of ESG issues, including climate-related financial risk, by fiduciaries in making investment and voting decisions, and to provide further clarity that will help safeguard the interests of participants and beneficiaries in the plan benefits.

II. Purpose of Regulatory Action and Proposed Rule

A. Purpose

Like the NPRM, the purpose of the final rule is to clarify the application of ERISA's fiduciary duties of prudence and loyalty to selecting investments and investment courses of action, including selecting QDIAs, exercising shareholder rights, such as proxy voting, and the use of written proxy voting policies and guidelines. The need for clarification comes from the chilling effect and other potential negative consequences caused by the current regulation with respect to the consideration of climate change and other ESG factors in connection with

³⁹ 85 FR 81681 (Dec. 16, 2020).

⁴⁰ 86 FR 57272 (Oct. 14, 2021).

these activities. Overall, the public comments support the clarifications provided by this final rule, although some commenters challenged the stated need. The Department disagrees with commenters who asserted that any clarifications to the current regulation are unnecessary. The Department's conclusion, supported by many public commenters, is that the current regulation creates uncertainty and is having the undesirable effect of discouraging ERISA fiduciaries' consideration of climate change and other ESG factors in investment decisions, even in cases where it is in the financial interest of plans to take such considerations into account. This uncertainty may further deter fiduciaries from taking steps that other marketplace investors take in enhancing investment value and performance or improving investment portfolio resilience against the potential financial risks and impacts associated with climate change and other ESG factors. Major comments are addressed in detail below in conjunction with specific provisions of the final rule.

B. Major Provisions of Proposed Rule

Consistent with the purpose of the overall rulemaking initiative, the NPRM proposed several key changes and clarifications to the current regulation, as follows:

- The NPRM proposed to delete the "pecuniary/non-pecuniary" terminology from the current regulation based on concerns that the terminology causes confusion and has a chilling effect on financially beneficial choices.
- The NPRM proposed the addition of regulatory text that would have made it clear that, when considering projected returns, a fiduciary's duty of prudence may often require an evaluation of the economic effects of climate change and other ESG factors on the particular investment or investment course of action.

- The NPRM proposed to add to the operative text of the rule three sets of examples of climate change and other ESG factors that, depending on the facts and circumstances, may be material to the risk-return analysis.

- The NPRM proposed to remove the special rules for QDIAs that apply under the current regulation. The NPRM would instead apply the same standards to QDIAs as apply to other investments.

- The NPRM proposed to modify the current rule's "tiebreaker" test, which permits fiduciaries to consider collateral benefits as tiebreakers in some circumstances. The current regulation imposes a requirement that the competing investments underlying a

tiebreaker situation be indistinguishable based on pecuniary factors alone before fiduciaries can turn to collateral factors to break a tie and imposes a special documentation requirement on the use of such factors. The NPRM proposed replacing those provisions with a standard that would have instead required the fiduciary to conclude prudently that competing investments, or competing investment courses of action, equally serve the financial interests of the plan over the appropriate time horizon. In such cases, the fiduciary is not prohibited from selecting the investment, or investment course of action, based on collateral benefits other than investment returns. The NPRM also proposed to remove the current regulation's special documentation requirements in favor of ERISA's generally applicable statutory duty to prudently document plan affairs.

- To the extent individual account plans use the tiebreaker test in the selection of a designated investment alternative, the NPRM proposed that plans must prominently disclose to the plans' participants the collateral considerations that were used as tiebreakers.

- The NPRM proposed to eliminate the statement in paragraph (e)(2)(ii) of the current regulation that "the fiduciary duty to manage shareholder rights appurtenant to shares of stock does not require the voting of every proxy or the exercise of every shareholder right," which the Department was concerned could be misread as suggesting that plan fiduciaries should be indifferent to the exercise of their rights as shareholders, even if the cost is minimal.

- The NPRM proposed to eliminate paragraph (e)(2)(iii) of the current regulation, which sets out specific monitoring obligations with respect to use of investment managers or proxy voting firms, and to address such monitoring obligations in another provision of the regulation that more generally covers selection and monitoring obligations. The Department was concerned that the specific monitoring provision could be read as requiring some special obligations above and beyond the statutory obligations of prudence and loyalty that generally apply to monitoring the work of service providers.

- The NPRM proposed to remove the two "safe harbor" examples for proxy voting policies permissible under paragraphs (e)(3)(i)(A) and (B) of the current regulation. One of these safe harbors permitted a policy to limit voting resources to particular proposals

that the fiduciary had prudently determined were substantially related to the issuer's business activities or were expected to have a material effect on the value of the investment. The other safe harbor permitted a policy of refraining from voting on proposals when the plan's holding in a single issuer relative to the plan's total investment assets was below a quantitative threshold. The Department was concerned that the safe harbors did not adequately safeguard the interests of plans and their participants and beneficiaries.

- The NPRM proposed to eliminate from the current regulation a specific requirement on maintaining records on proxy voting activities and other exercises of shareholder rights, which appeared to treat proxy voting and other exercises of shareholder rights differently from other fiduciary activities and risked creating a misperception that proxy voting and other exercises of shareholder rights are disfavored or carry greater fiduciary obligations than other fiduciary activities.

The Department invited interested persons to submit comments on the NPRM. In response to this invitation, the Department received more than 895 written comments and 21,469 petitions (e.g., form letters) submitted during the open comment period. These comments and petitions (hereinafter collectively referred to as "comments" unless otherwise specified) came from a variety of parties, including plan sponsors and other plan fiduciaries, individual plan participants and beneficiaries, financial services companies, academics, elected government officials, trade and industry associations, and others, both in support of and in opposition to the NPRM. These comments are available for public review on the Department's Employee Benefits Security Administration website.

III. The Final Rule

A. Executive Summary of Major Changes and Clarifications

The final rule generally tracks the NPRM but makes certain clarifications and changes in response to public comments. Before describing these changes, the Department emphasizes that the final rule does not change two longstanding principles. First, the final rule retains the core principle that the duties of prudence and loyalty require ERISA plan fiduciaries to focus on relevant risk-return factors and not subordinate the interests of participants and beneficiaries (such as by sacrificing investment returns or taking on additional investment risk) to objectives

unrelated to the provision of benefits under the plan. Second, the fiduciary duty to manage plan assets that are shares of stock includes the management of shareholder rights appurtenant to those shares, such as the right to vote proxies. As described in further detail below in subsection B of this section III, the final rule adopts the following changes to the current regulation:

- Like the NPRM, the final rule amends the current regulation to delete the "pecuniary/non-pecuniary" terminology based on concerns that the terminology causes confusion and a chilling effect to financially beneficial choices.

- Like the NPRM, the final rule amends the current regulation to make it clear that 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 and that such 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.

- Like the NPRM, the final rule amends the current regulation to remove the stricter rules for QDIAs, such that, under the final rule, the same standards apply to QDIAs as to investments generally.

- Like the NPRM, the final rule amends the current regulation's "tiebreaker" test, which permits fiduciaries to consider collateral benefits as tiebreakers in some circumstances. The current regulation imposes a requirement that competing investments be indistinguishable based on pecuniary factors alone before fiduciaries can turn to collateral factors to break a tie and imposes a special documentation requirement on the use of such factors. The final rule replaces those provisions with a standard that instead requires the fiduciary to conclude prudently that competing investments, or competing investment courses of action, equally serve the financial interests of the plan over the appropriate time horizon. In such cases, the fiduciary is not prohibited from selecting the investment, or investment course of action, based on collateral benefits other than investment returns. The final rule also removes the current regulation's special regulatory documentation requirements in favor of ERISA's generally applicable statutory duty to prudently document plan affairs.

- The final rule adds a new provision clarifying that 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. Thus, in this way, giving consideration to whether an investment option aligns with participants' preferences can be relevant to furthering the purposes of the plan.

- Like the NPRM, the final rule amends the current regulation to eliminate the statement in paragraph (e)(2)(ii) of the current regulation that "the fiduciary duty to manage shareholder rights appurtenant to shares of stock does not require the voting of every proxy or the exercise of every shareholder right." The final rule eliminates this provision because it may be misread as suggesting that plan fiduciaries should be indifferent to the exercise of their rights as shareholders, even if the cost is minimal.

- Like the NPRM, the final rule amends the current regulation to remove the two "safe harbor" examples for proxy voting policies permissible under paragraphs (e)(3)(i)(A) and (B) of the current regulation. One of these safe harbors permitted a policy to limit voting resources to types of proposals that the fiduciary has prudently determined are substantially related to the issuer's business activities or are expected to have a material effect on the value of the investment. The other safe harbor permitted a policy of refraining from voting on proposals or types of proposals when the plan's holding in a single issuer relative to the plan's total investment assets is below a quantitative threshold. Taken together, the Department believes the safe harbors encouraged abstention as the normal course and the Department does not support that position because it fails to recognize the importance that prudent management of shareholder rights can have in enhancing the value of plan assets or protecting plan assets from risk. Because of this failure, the Department believes these safe harbors do not adequately safeguard the interests of plans and their participants and beneficiaries.

- Like the NPRM, the final rule eliminates paragraph (e)(2)(iii) of the current regulation, which sets out specific monitoring obligations with respect to use of investment managers or proxy voting firms. The final rule instead addresses such monitoring obligations in another provision of the

regulation that more generally covers selection and monitoring obligations. These amendments address concerns that the specific monitoring provision could be read as requiring special obligations above and beyond the statutory obligations of prudence and loyalty that generally apply to monitoring the work of service providers.

- Like the NPRM, the final rule amends the current regulation to eliminate from paragraph (e)(2)(ii)(E) of the current regulation a specific requirement on maintaining records on proxy voting activities and other exercises of shareholder rights. The provision is removed from the current regulation because it is widely perceived as treating proxy voting and other exercises of shareholder rights differently from other fiduciary activities and, in that respect, risks creating a misperception that proxy voting and other exercises of shareholder rights are disfavored or carry greater fiduciary obligations than other fiduciary activities.

B. Detailed Discussion of Public Comments and Final Regulation

1. Section 2550.404a-1(a) and (b)—General and Investment Prudence Duties

(a) Paragraph (a)

Paragraph (a) of the final rule is unchanged from the NPRM and derives from the exclusive purpose requirements of ERISA section 404(a)(1)(A), and the prudence duty of ERISA section 404(a)(1)(B). The provision is also the same as paragraph (a) of the current regulation. The Department did not accept comments to expand the scope of the regulation to provide additional guidance on the duty of diversification under section 404(a)(1)(C) and the duty of impartiality under section 404(a)(1)(A) as interpreted in cases such as *Varity v. Howe*,⁴¹ as these other duties generally are beyond the scope of this rulemaking initiative.

(b) Paragraph (b)

Paragraph (b) of the final rule addresses the investment prudence duties of a fiduciary under ERISA. Like the NPRM, paragraph (b) of the final rule contains four subordinate paragraphs. As discussed below, the final rule includes several changes from the proposal based on public comment, mostly in paragraphs (b)(2) and (4) of the final rule.

(c) Paragraph (b)(1)

The NPRM did not propose any amendments to paragraph (b)(1) of the current regulation. Like the current regulation (and the 1979 Investment Duties regulation before it), paragraph (b)(1) of the NPRM provided that the requirements of section 404(a)(1)(B) of the Act set forth in paragraph (a) are satisfied with respect to a particular investment or investment course of action if the fiduciary meets two conditions. First, the fiduciary must give "appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment . . . including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties." And second, the fiduciary must have "acted accordingly." Except for the addition of the words "or menu" after the word "portfolio" for clarification, as explained below, paragraph (b)(1) of the final rule is unchanged from the NPRM.

(d) Paragraph (b)(2)

Paragraph (b)(2) of the NPRM addressed the "appropriate consideration" language referenced in paragraph (b)(1) of the proposal. Paragraph (b)(2) of the NPRM contained two prongs.

First, paragraph (b)(2)(i) of the NPRM provided that for purposes of paragraph (b)(1), "appropriate consideration" shall include, but is not necessarily limited to, a determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio (or, where applicable, that portion of the plan portfolio with respect to which the fiduciary has investment duties), to further the purposes of the plan. For this purpose, the plan fiduciary must take into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action compared to the opportunity for gain (or other return) associated with reasonably available alternatives with similar risks.

Second, paragraph (b)(2)(ii) of the NPRM provided that for purposes of paragraph (b)(1), "appropriate consideration" shall also include, but is not necessarily limited to, consideration of the composition of the portfolio with regard to diversification (paragraph (b)(2)(ii)(A)), the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan (paragraph (b)(2)(ii)(B)), and

⁴¹ 516 U.S. 489 (1996).

the projected return of the portfolio relative to the funding objectives of the plan, which may often require the evaluation of the economic effects of climate change and other environmental, social, or governance factors on the particular investment or investment course of action (paragraph (b)(2)(ii)(C)).

(1) Reasonably Available Alternatives

Several commenters provided views on the condition in paragraph (b)(2)(i) that a fiduciary must compare an investment or investment course of action under evaluation with reasonably available alternatives. This condition was not part of the original investment duties regulation adopted in 1979 and was added to the current regulation in 2020. The Department carried forward this condition in the 2021 NPRM and solicited comments on whether it was necessary to restate this principle of general applicability as part of this regulation.

Some commenters agreed that prudent fiduciaries should and generally do compare similar, available investments when making investment decisions. Some commenters said that because the provision is a simple restatement of a fundamental prudence tenet, its inclusion in the final rule is unnecessary. Some commenters were concerned that the term “reasonably available” is ambiguous and could make fiduciaries vulnerable to litigation challenging the reasonableness of a fiduciary’s determination of the number of investments used in making the required comparison. Commenters were also concerned that the requirement imposes burdens on fiduciaries that do not necessarily have the resources to conduct research on all reasonably available alternatives. Some commenters noted that the Department did not adopt a comparative requirement in the 1979 rule and furthermore expressed concerns that the rule could be interpreted to require all fiduciaries, regardless of factors such as plan assets, to purchase and implement extensive and expensive systems to conduct the comparative analysis. One commenter suggested adding operative text that would explicitly allow for market-based comparisons using benchmarks or other market data as alternatives to the “reasonably available investment alternatives” language. One commenter cautioned that removing the provision would imply that the Department no longer believes that the marketplace is a true forum and benchmark of the investment selection process.

The Department continues to believe the requirement to compare reasonably available alternatives is commonly understood by plan fiduciaries, is uncontroversial in nature, and reflects the ordinary practice of fiduciaries in selecting investments. The Department is unpersuaded by some commenters’ concerns regarding perceived ambiguity in the meaning of “reasonably available.” The scope of a fiduciary’s obligation to compare an investment or investment course of action is limited to those facts and circumstances that a prudent person having similar duties and familiar with such matters would consider reasonably available. Further, the term allows for the possibility that the characteristics and purposes served by a given investment or investment course of action may be sufficiently rare that a fiduciary could prudently determine that there are no other reasonably available alternatives for comparative purposes. Accordingly, the final rule continues to require in paragraph (b)(2)(i) that “appropriate consideration” shall include taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action compared to the opportunity for gain (or other return) associated with reasonably available alternatives with similar risks. The language reflects the Department’s longstanding view, articulated in Interpretive Bulletin 94–1 (and reiterated in subsequent Interpretive Bulletins) and earlier interpretive letters, that facts and circumstances relevant to an investment or investment course of action would include consideration of the expected return on alternative investments with similar risks available to the plan.⁴²

(2) Portfolio Versus Menu

The final rule adopts minor amendments to the text in paragraph (b)(2) of the current regulation in response to commenters’ requests to clarify whether and how it applies in the context of participant-directed individual account plans. Commenters observed that language in paragraph (b)(2), which was originally developed in 1979, contains certain considerations and factors that, in their view, are germane to the selection of investments

for defined benefit plans but not to the selection of investments for defined contribution plans that have a set of designated investment alternatives available for participant to choose from, often referred to as a “menu.” For instance, they noted that paragraphs (b)(2)(i) and (ii) require focusing on a “portfolio,” which they believe is confusing because a participant-directed defined contribution plan’s menu may include both funds that participants have chosen as investments as well as funds that have not been chosen. The commenters further noted that, in conventional investment parlance, the term “portfolio” refers to a collection of assets actually owned by an investor, whereas a menu of investment options for a participant-directed individual account plan consists of a range of designated investment alternatives that are available to participants. In addition, they questioned how to determine “anticipated cash flow requirements of the plan” in evaluating investment options for the menu of a participant-directed defined contribution plan. A commenter stated that, in its view, many of the appropriate consideration factors in paragraph (b)(2)(ii) of the NPRM seem largely irrelevant to participant-directed plans. These commenters suggested that clarification on the application of paragraph (b)(2)(ii) to the selection of investment options would be helpful for plan sponsors.

The Department appreciates the difficulties raised by commenters. Paragraph (b)(2)(ii) sets out a non-exclusive list of factors that functions as a minimum set of considerations for a fiduciary seeking to rely upon paragraph (b)(1). Failure to meet those minimum considerations would leave a fiduciary at risk of failing the standard even if, in the context of choosing investment options for a participant-directed plan, the responsible fiduciary has considered the relevant facts and circumstances surrounding its decision, including making a sound determination as described in paragraph (b)(2)(i). Accordingly, the Department is making changes to paragraph (b)(2) of the final rule. The changes clarify that the determination factors in paragraph (b)(2)(i) apply to menu construction and the factors in paragraph (b)(2)(ii) do not. Specifically, the Department is adding to paragraph (b)(2)(i) of the final rule references to an investment “menu,” and is adding an introductory clause to paragraph (b)(2)(ii) of the final rule limiting its application to employee benefit plans other than participant-directed individual account plans.

These changes do not affect the requirements of paragraph (b)(1)(i) of

⁴² 59 FR 32606 at 32607 (June 23, 1994); I.B. 2008–1, 73 FR 61734 (Oct. 17, 2008); I.B. 2015–1, 80 FR 65135 (Oct. 26, 2015); *see, e.g.*, Information Letter to Mr. Michael A. Feinberg, dated August 4, 1985; Information Letter to Mr. James Ray, dated July 8, 1988 (“It is the position of the Department that, to act prudently, a fiduciary must consider, among other factors, the availability, riskiness, and potential return of alternative investments.”).

the final rule, that a fiduciary must give appropriate consideration to those facts and circumstances a fiduciary knows or should know are relevant to the investment. These changes also should not be interpreted as suggesting that a fiduciary of an individual account plan is subject to a lower standard in giving appropriate consideration to the facts and circumstances surrounding a particular decision relating to an investment or investment course of action. Notwithstanding the changes to paragraph (b)(2)(ii), the Department believes that in selecting investment options for a plan menu, a fiduciary's considerations of surrounding facts and circumstances should be soundly reasoned and supported and reflect the requirements of section 404(a)(1)(B) of ERISA. The Department agrees with one commenter that, in the context of constructing a menu of investment options, the relevant analysis involves two questions: First, how does a given fund fit within the menu of funds to enable plan participants to construct an overall portfolio suitable to their circumstances? Second, how does a given fund compare to a reasonable number of alternative funds to fill the given fund's role in the overall menu?

Except for the questions described above with respect to application in the context of plan investment menus, the Department did not receive substantive comments on paragraphs (b)(2)(ii)(A) and (B) of the proposal. Those provisions are otherwise unchanged in the final rule.

(3) "May Often Require"

The Department received several comments on the language in paragraph (b)(2)(ii)(C) of the proposal which specified that consideration of the projected return of the portfolio relative to the funding objectives of the plan "may often require an evaluation of the economic effects of climate change and other environmental, social or governance factors on the particular investment or investment course of action." This new language—the "may often require" clause—was proposed by the Department to counteract any negative perception against the consideration of climate change and other ESG factors in investment decisions caused by the current regulation. The intent behind this new clause was to clarify that plan fiduciaries may, and often should depending on the investment under consideration, consider the economic effects of climate change and other ESG factors on the investment at issue. In no way did the Department consider this proposed clause to be an expression of

a novel concept. Indeed, the sentiment had been expressed in earlier non-regulatory guidance, although using different terminology.⁴³

The Department received comments supporting and opposing this new clause. On the one hand, some commenters indicated that it helped address the chilling effect on evaluating ESG issues and served as a useful reminder to fiduciaries that ESG factors often do have an impact on investments. In the main, these commenters support the regulatory text as an express acknowledgement that climate change and other ESG factors are relevant to risk and return, and as an indication that fiduciaries should not be exposed to additional perceived or actual fiduciary liability risk under ERISA if they include such factors in their evaluation of plan investments.

On the other hand, a great many commenters, including some who concurred with the need to address the chilling effect under the current regulation, expressed a variety of concerns with this provision. Some commenters were concerned that by differentiating ESG considerations from other factors in express regulatory text, the regulation goes beyond removing the chilling effect and improperly places a thumb on the scale in favor of ESG investing. Some further cautioned that fiduciaries may treat the provisions as an effective mandate that they must consider ESG factors under all circumstances. The commenters argued that, absent guidance on when such an evaluation would not be required, plan fiduciaries would feel obligated to consider climate change and other ESG factors for every investment. Several commenters criticized the Department for, in their view, essentially favoring ESG investment strategies and overriding a fiduciary's considered judgment with respect to which investment factors or strategies to consider. Multiple commenters indicated that studies and research on investment performance involving ESG strategies show mixed results, and that a regulatory bias in favor of ESG investing is not justified. In line with this comment, some commenters questioned whether the Department presented sufficient evidence to support a position on the frequency ("may often require") with which fiduciaries may be required to consider ESG factors, or argued that the market has already priced ESG factors into the price of any given investment.

⁴³ See Field Assistance Bulletin 2018–01 and Interpretive Bulletin 2015–01.

Some commenters who criticized the new language in paragraph (b)(2)(ii)(C) stated that if the regulation takes the position that evaluating the economic effects of climate change and other ESG factors "may often" be required, then ambiguity surrounding the definition of the term ESG factors must be reduced to provide regulatory certainty. Commenters noted, however, that it would be difficult to precisely define ESG factors. Commenters also expressed concern that the language may be interpreted as effectively directing fiduciaries to take on the costs and complexity of evaluating the effects of climate change and other ESG factors, even if not otherwise prudent. In this regard, a commenter argued that there are common situations when a prudent analysis of the projected return relative to the portfolio's funding objective is unlikely to require an evaluation of the economic effects of ESG factors, such as when the objective of the applicable portion of the portfolio is to track the performance of an index. Several commenters offered alternative language to reduce the likelihood of misinterpreting the provision. Other commenters opined that the "may often require" language is largely unnecessary to address the chilling effect on consideration of ESG factors under the current regulation because of the broad language in paragraph (b)(4) of the proposal relating to the consideration of "any material factor."

Based on the comments received, the Department has decided to modify paragraph (b)(2)(ii)(C) of the proposal by deleting the "which may often require" language altogether and consolidating the reference to "climate change and other environmental, social, or governance ESG factors" with language in paragraph (b)(4), as further modified below. The proposed language in paragraph (b)(2)(ii)(C) of the NPRM was not intended to create an effective or de facto regulatory mandate. Nor was the language intended to create an overarching regulatory bias in favor of ESG strategies. The Department is not persuaded that alternative language suggested by commenters to replace the "may often require" would be as effective in removing regulatory bias as the course chosen in the final rule. The modified version of the proposed language is intended to make it clear that climate change and other ESG factors may be relevant in a risk-return analysis of an investment and do not need to be treated differently than other relevant investment factors, without causing a perception that the

Department favors such factors in any or all cases.

As modified (and relocated to paragraph (b)(4) of the final regulation), the new text sets forth three clear principles. First, 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 section 402(b)(1) of ERISA. Second, 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. Third, the weight given to any factor by a fiduciary should appropriately reflect an assessment of its impact on risk and return.

In the Department's view, this principles-based approach is sufficient to address the chilling effect under the current regulation without establishing an effective mandate or explicitly favoring climate change and other ESG factors. This principles-based approach is designed to eliminate the substantial chilling effect caused by the current regulation, including its reference to "pecuniary factors." As previously discussed, numerous commenters indicated that the current regulation puts a thumb on the scale against ESG factors, and chills fiduciaries from considering any ESG factors even when they are relevant to a risk-return analysis. The undesired effect of the current regulation is to chill and discourage fiduciaries from considering relevant investment factors that prudent investors otherwise would consider. At the same time, the final rule makes unambiguous that it is not establishing a mandate that ESG factors are relevant under every circumstance, nor is it creating an incentive for a fiduciary to put a thumb on the scale in favor of ESG factors. By declining to carry forward the "may often require" clause in paragraph (b)(2)(ii)(C) of the proposal, the final rule achieves appropriate regulatory neutrality and ensures that plan fiduciaries do not misinterpret the final rule as a mandate to consider the economic effects of climate change and other ESG factors under all circumstances. Instead, the final rule makes clear that a fiduciary may exercise discretion in determining, in light of the surrounding facts and

circumstances, the relevance of any factor to a risk-return analysis of an investment. A fiduciary therefore remains free under the final rule to determine that an ESG-focused investment is *not* in fact prudent. Finally, nothing about the principles-based approach should be construed as overturning long established ERISA doctrine or displacing relevant common law prudent investor standards.

(e) Paragraph (b)(3)

Paragraph (b)(3) of the final rule is unchanged from the proposal and states that an investment manager appointed pursuant to the provisions of section 402(c)(3) of the Act to manage all or part of the assets of a plan may, for purposes of compliance with the provisions of paragraphs (b)(1) and (2) of the proposal, rely on, and act upon the basis of, information pertaining to the plan provided by or at the direction of the appointing fiduciary, if such information is provided for the stated purpose of assisting the manager in the performance of the manager's investment duties, and the manager does not know and has no reason to know that the information is incorrect. The Department did not receive substantive comment on the provision, which carries forward, without change, regulatory language dating back to the 1979 Investment duties regulation.

(f) Paragraph (b)(4)

(1) Introductory Text

The introductory text of paragraph (b)(4) of the proposal provided that "a prudent fiduciary may consider any factor in the evaluation of an investment or investment course of action that, depending on the facts and circumstances, is material to the risk return analysis[.]" This introductory text was then followed by three paragraphs of specific ESG examples. Commenters were generally supportive of this provision minus the three paragraphs describing specific ESG examples. In context, many viewed paragraph (b)(4) of the NPRM as confirming the discretionary authority of fiduciaries to consider whatever factor or factors, in the reasoned judgment of the fiduciaries, are relevant to risk and return of the investment or investment course of action, including climate change and other ESG factors. Some commenters expressed the view that this introductory text (without the three paragraphs of examples), in conjunction with the removal of the so-called "pecuniary-only" terminology from the current regulation, would make significant headway in counteracting

the negative perception of the consideration of climate change and other ESG factors caused by the current regulation. Paragraph (b)(4) of the final rule, therefore, retains the introductory text's focus on factors that are relevant to a risk and return analysis. Paragraph (b)(4) also retains its central recognition that relevant risk and return factors may, depending on the facts and circumstances, include the economic effects of climate change and other ESG factors. But, paragraph (b)(4) of the final rule otherwise contains substantial modifications discussed below.

(2) Three Paragraphs of ESG Examples

Comments on the list of examples in paragraph (b)(4) of the NPRM focused on both content and placement and were varied. Some commenters supported both the content (only ESG examples) and placement of the examples. In general, these commenters are of the view that the list of examples, even though limited to only ESG factors, is an appropriate corrective for what they view as the severe anti-ESG bias of the current regulation. In their view, adding the three paragraphs of ESG examples directly to the regulatory text will help to reassure fiduciaries that they will not be subject to litigation solely because of the use of such factors.

Many commenters, however, had concerns with the list of examples in paragraph (b)(4) of the NPRM and recommended their removal from the operative regulatory text. One frequently cited concern was that the list of examples in the proposal was too one-sided in favor of ESG factors. According to these commenters, the perceived regulatory bias would predictably trigger revisions by a future Administration with opposing views, effectively reducing the reliability and durability of the rule. This concern was raised by commenters who both supported and opposed the content of the examples.

Another frequently cited concern was that the list might have unintended consequences. For example, plan fiduciaries might erroneously conclude that the factors listed in the operative text are more prudent than non-listed factors. A different but possible unintended consequence mentioned several times was that some plan fiduciaries might perceive the list as a safe harbor, such that fiduciaries may believe they will be deemed to have made a prudent investment decision if they consider only the listed examples (and no others). Others suggested that, by singling out these particular examples to the exclusion of other examples, the regulation could be read

as implying that these factors were especially important when selecting an investment. Consequently, according to these commenters, at least some fiduciaries would feel obligated to document in writing their justification for not considering these example factors. Similarly, some commenters suggested that, in their view, listing in the operative text only a few of the potentially material factors that a prudent fiduciary might consider might unintentionally create a perception that the Department expects fiduciaries will take these specific factors into consideration, even where it might not be possible, practical, or prudent.

Another repeated concern of commenters was that the list of factors is unnecessary. According to these commenters, the general reference to material risk-return factors in paragraph (b)(4) of the NPRM would be sufficient to make clear that fiduciaries may consider any factor material to a risk-return analysis, including ESG factors. To these commenters, the concept of materiality provides for the determination of relevant factors on a case-by-case basis. In their view, such a principles-based approach better serves plans and provides greater flexibility for ERISA fiduciaries to consider the unique factors relevant to particular investment decisions.

Another frequently cited concern was that the examples would become stale over time. Several commenters opined that a list of specific examples of material factors that may be of particular importance now may be of less importance in the future. Thus, at a minimum, the regulation could require updates over time as risk management and investment strategies evolve.

Some commenters indicated that the list of ESG factors could be improved with additional examples. For instance, many commenters suggested that the list should be balanced by expanding the list to include non-ESG factors that may be material risk-return factors (*e.g.*, good products, compelling corporate strategy, tight cost controls). Some further suggested it would be helpful for the Department to add examples of when it is not prudent to consider ESG factors. A commenter noted that by including only ESG factors as examples, the Department risks creating a perception that fiduciaries may take only ESG factors into account. Another commenter criticized that some of the examples as proposed are broad and ambiguous, inherently subjective, and give too much flexibility to plan fiduciaries who may be inclined to use plan assets to further particular ESG goals. Some commenters further

characterized the proposed examples as singling out special interests and progressive ESG priorities that have little to no impact on financial returns. Multiple commenters suggested additions of factors that seemed to fall within the broad categories of examples but were not specifically listed. Commenters also suggested the addition of factors that did not appear to fall within any of those categories.

After consideration of the comments received, the Department is persuaded that paragraph (b)(4) of the final rule should not include a list of examples. The list of examples was never intended to be exclusive; nor was it intended to define “ESG” or introduce any new conditions under the prudence safe harbor. The list of examples was merely intended to reaffirm that fiduciaries may consider ESG factors that are relevant to a risk-return analysis of the investment. The examples were intended to make clear that ESG factors may be more than mere tiebreakers, but rather financially material to the investment decision. The Department believes, however, that this point is made sufficiently clear by the general language in paragraph (b)(4) of the final rule. The primary justification for removing the examples from the operative text of the final rule is that the Department is wary of creating an apparent regulatory bias in favor of particular investments or investment strategies.

Removal of the list from paragraph (b)(4) should not be viewed as limiting a fiduciary’s ability to take into account any risk and return factor that the fiduciary reasonably determines is relevant to a risk/return analysis. The Department continues to be of the view that, depending on the surrounding facts and circumstances, these may include the factors listed in paragraph (b)(4) of the proposal. Thus, depending on the surrounding circumstances, a fiduciary may reasonably conclude that climate-related factors, such as a corporation’s exposure to the real and potential economic effects of climate change including exposure to the physical and transitional risks of climate change and the positive or negative effect of Government regulations and policies to mitigate climate change, can be relevant to a risk/return analysis of an investment or investment course of action. A fiduciary also may make a similar determination with respect to governance factors, such as those involving board composition, executive compensation, and transparency and accountability in corporate decisionmaking; a corporation’s avoidance of criminal liability; compliance with labor,

employment, environmental, tax, and other applicable laws and regulations; the corporation’s progress on workforce diversity, inclusion, and other drivers of employee hiring, promotion, and retention; investment in training to develop a skilled workforce; equal employment opportunity; and labor relations and workforce practices generally.

The foregoing examples are merely illustrative, and not intended to limit a fiduciary’s discretion to identify factors that are relevant with respect to its risk/return analysis of any particular investment or investment course of action. A fiduciary may reasonably determine that a factor that seems to fall within a general category described above (*e.g.*, climate-related factors), but is not specifically identified above, nonetheless is relevant to the analysis (*e.g.*, drought). For example, depending on the facts and circumstances, relevant factors may include impact on communities in which companies operate, due diligence and practices regarding supply chain management, including environmental impact, human rights violations records, and lack of transparency or failure to meet other compliance standards. As another example, labor-relations factors, such as reduced turnover and increased productivity associated with collective bargaining, also may be relevant to a risk and return analysis.

Of course, a fiduciary’s determination of relevant factors is not limited to the general categories described above. Prudent investors commonly take into account a wide range of financial circumstances and considerations, depending on the particular circumstances, such as a corporation’s operating and financial history, capital structure, long-term business plans, debt load, capital expenditures, price-to-earnings ratios, operating margins, projections of future earnings, sales, inventories, accounts receivable, quality of goods and products, customer base, supply chains, barriers to entry, and a myriad of other financial factors, depending on the particular investment. This rule, as amended, does not supplant such considerations, but rather makes clear that there is no inconsistency between the appropriate consideration of ESG factors and ERISA section 404(a)(1)(B)’s standard of prudence, which requires that fiduciaries act with the “care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”

(3) Consolidation of Multiple Provisions Into Paragraph (b)(4) of the Final Rule

In concert with removing the list of examples from paragraph (b)(4) of the NPRM, elements of paragraphs (b)(2)(ii)(C) and (c)(2) of the NPRM are now merged into paragraph (b)(4) of the final rule. These edits address commenters' concerns that aspects of paragraph (b)(2)(ii)(C) of the NPRM could constitute an effective or de facto mandate to always consider the effects of climate change and other ESG factors on every investment or investment course of action, that the examples in paragraph (b)(4) of the NPRM interject inappropriate regulatory bias in favor of ESG factors, and that the final rule not retreat from the principle in paragraph (c)(2) of the NPRM that fiduciaries must base investment decisions only on factors that are relevant to a risk and return analysis. The essence of paragraph (c)(2) of the NPRM was not changed when merged into paragraph (b)(4) of the final rule. As mentioned below, the merger avoids the existence of redundant concepts in multiple paragraphs and reflects that the substance of paragraph (c)(2) of the NPRM is more closely connected to ERISA's duty of prudence than the duty of loyalty.

Accordingly, paragraph (b)(4) of the final rule provides that 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 section 402(b)(1) of ERISA. It further indicates that 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, and whether any particular consideration is a risk-return factor depends on the individual facts and circumstances. Finally, it provides that the weight given to any factor by a fiduciary should appropriately reflect a reasonable assessment of its impact on risk-return.

As revised, paragraph (b)(4) of the final rule subsumes core elements of paragraphs (c)(1) and (f)(3) of the current regulation. Specifically, the emphasis on risk and return factors in these two paragraphs carries forward into paragraph (b)(4) of the final rule. The current regulation's reliance on "pecuniary only" and related terminology, however, is otherwise

rescinded. The framework in paragraph (b)(4) of the final rule continues to adhere to the principle, underpinning paragraphs (c)(1) and (f)(3) of the current regulation, that when selecting an investment or investment course of action plan fiduciaries must focus on relevant risk and return factors, but the Department no longer supports the current regulation's framework and terminology for advancing this principle. The Department, instead, agrees with the commenters who found the current regulation's framework and terminology confusing and susceptible to inferences of bias against the treatment of climate change and other ESG factors as potentially relevant risk and return factors. The Department intends with these edits to dispel the perception caused by the current regulation that climate change and other ESG factors are somehow presumptively suspect or unlikely to be relevant to the risk and return of an investment or investment course of action. Paragraph (b)(4) of the final recognizes that, as with other factors, climate change and other ESG factors sometimes may be relevant to a risk and return analysis and sometimes not—and when relevant, they may be weighted and factored into investment decisions alongside other relevant factors, as deemed appropriate by the plan fiduciary.

(4) Conforming Terminology—"Relevance" Versus "Material"

In addition, paragraph (b)(4) of the final rule contains a change in terminology to establish consistency with the terminology in paragraph (b)(1) of the final rule. Several commenters noted that paragraph (b)(1) of the NPRM refers to "relevant" factors but that paragraph (b)(4) of the NPRM refers to "material" factors. Noting a body of decisional and regulatory law underpinning "materiality" under Federal securities laws and accounting conventions, many of these commenters considered the NPRM's use of these different terms a source of confusion. In conjunction with proposed paragraph (b)(4)'s focus on risk and return factors, many commenters were concerned that paragraph (b)(4)'s use of "material" might be construed as circumscribing the role or authority of plan fiduciaries under ERISA's prudence standard as reflected in the use of "relevance" in paragraph (b)(1) of the NPRM.

In discussing these concerns, commenters mentioned many factors that, in their view, are relevant factors routinely considered by plan fiduciaries when selecting investments, such as brand name or reputation of the fund or fund manager, lifetime income options,

style of fund (*e.g.*, growth versus value), style of fund management (passive versus active), an investment's regulatory regime, participants' understanding of the investment, participants' preferences, and other investment-related operational considerations. These commenters expressed concern that such factors may not always perfectly align with securities law or accounting concepts of materiality or directly affect the risk and return of an investment in clear or obvious ways.

In response to some of these concerns, paragraph (b)(4) of the final rule uses the word "relevant" instead of "material."⁴⁴ The Department stresses, however, that under paragraph (b)(4) of the final rule, the fiduciary's investment determination must ultimately rest on factors relevant to a risk and return analysis. The Department does not undertake in this document to address specific risk and return factors, but it notes that it has previously concluded that plan contributions do not constitute a "return" on investment.

2. Section 2550.404a-1(c) Investment Loyalty Duties

(a) Removal of Pecuniary-Only Requirement—Paragraph (c)(2) of the Proposal

Paragraph (c)(2) of the NPRM modified the requirement in paragraph (c)(1) of the current regulation that a fiduciary's evaluation of an investment or investment course of action must be based "only on pecuniary factors," which is defined at paragraph (f)(3) of the current regulation as a factor that a fiduciary prudently determines is expected to have a material effect on the risk and/or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives and the funding policy. The Department used the phrase "pecuniary factors" for the first time in the 2020 regulations, and although the Department defined it in those regulations, the phrase is not found in ERISA and has no longstanding meaning in employee benefits law. The NPRM proposed to remove the "pecuniary only" formulation of the requirement and to integrate the concept of "risk/return" factors directly into paragraph (c)(2) of the NPRM. This approach was intended to address stakeholder concerns about ambiguity in the meaning and application of the

⁴⁴ A similar change was made in paragraph (d)(2)(ii)(D) of the final regulation to appropriately align terminology in similar contexts across different paragraphs of the final regulation.

“pecuniary only” terminology of the current regulation.

A significant number of commenters supported the NPRM’s proposed removal of the pecuniary-only test and related terminology. Many commenters on this issue were of the view that, rather than providing clarity, the current regulation’s pecuniary-only terminology created confusion by layering an additional standard or test onto the existing fiduciary framework. That framework already unambiguously required fiduciaries to base plan investment decisions on financially relevant factors. In line with that concern, many commenters asserted that this pecuniary-only terminology chills plan fiduciaries from considering climate change and other ESG factors even where they have a material effect on the bottom line of an investment, merely because such factors also may have the effect of supporting non-financial objectives. In such “dual purpose” circumstances, the position of these commenters was that just because an investment factor or strategy may simultaneously have economic and non-economic dimensions, the non-economic dimensions do not lessen the factor or strategy’s economic significance. These commenters stated that the NPRM’s proposed elimination of the pecuniary-only and related terminology would make clear to fiduciaries that they are free to consider the full range of potential material risk-return factors without undue fear of regulatory second-guessing or litigation. According to these commenters, the elimination would encourage fiduciaries to take the same steps that other marketplace investors take in enhancing investment value and performance or improving investment portfolio resilience against the potential financial risks and impacts associated with climate change and other ESG factors.

Some commenters opposed the NPRM’s proposed changes; they emphasized the importance of basing investment decisions on only pecuniary considerations and urged the Department to retain the pecuniary factors and related terminology. These commenters generally were of the view that ERISA requires that plan fiduciaries focus solely on the economics of an investment and state that climate change and other ESG factors rarely can be harmonized with this requirement. Given that belief, these commenters were concerned that participants’ retirement security will suffer as plan fiduciaries and money managers pursue agendas unrelated to the exclusive purpose of providing financial benefits to retirement plan participants and

beneficiaries. In line with this concern, one commenter asserted that the insertion of non-pecuniary investment criteria in the management of pension and other such funds imposes a substantial penalty over time in terms of realized returns. One commenter questioned the consistency of permitting the consideration of non-pecuniary goals with the Supreme Court’s opinion in *Fifth Third Bancorp v. Dudenhoeffer*, which stressed the fiduciary’s obligation to focus on retirement plan participants’ financial interests.⁴⁵

The Department is not persuaded to retain the current regulation’s use of and reliance on the novel pecuniary-only formulation and its related terminology. The pecuniary-only requirement and related terminology unfortunately caused a great deal of confusion, and it accounts for a substantial amount of the chilling effect this rulemaking project set out to redress. These facts are manifest in the many comment letters on the NPRM. Many view the “pecuniary-only” terminology as ambiguous or decidedly prohibitive on the question of whether climate change and other ESG factors may be considered when those factors are relevant to the risk-and-return analysis. Indeed, as indicated by commenters, the current rule actually has a chilling effect that discourages fiduciaries from prudently considering climate change and other ESG factors that may be relevant to the risk-return analysis. Some commenters, in particular, asked questions about considering factors that have both economic and noneconomic components, suggesting apprehension that this would fall outside the current regulation’s pecuniary-only requirement. In light of the foregoing, the Department no longer supports the use of this terminology. Rather, the Department thinks, and many commenters agree, that paragraph (c)(2) of the NPRM, subject to certain modifications discussed elsewhere in this preamble, is a more understandable formulation of ERISA’s requirement that a fiduciary’s evaluation of an investment or investment course of action must focus on factors that the fiduciary reasonably determines are relevant to a risk and return analysis. Removing the “based only on pecuniary factors” language (and related terminology throughout) from the current regulation will help re-establish the Department’s position reflected in non-regulatory guidance as early as 2015 that climate change and other ESG

factors that may be relevant in a risk-return analysis of an investment do not need to be treated differently than other relevant investment factors, even though they may possess the “dual purpose” dimensions mentioned by some commenters. Put differently, removing this novel terminology is removing the current regulation’s thumb from the scale so as not to discourage fiduciaries from considering climate change and other ESG factors where relevant to the risk-return analysis.

Finally, the Department finds no merit to the argument that the final rule, either in general or in not carrying forward the pecuniary/non-pecuniary terminology, permits or requires behavior contrary to the holding in *Dudenhoeffer*. On the contrary, the central premise behind the final rule’s rescission of the pecuniary/non-pecuniary distinction is that the current regulation is being perceived by plan fiduciaries and others as undermining the fundamental principle *Dudenhoeffer* expressed: fiduciaries must protect the financial benefits of plan participants and beneficiaries. In this way, the pecuniary-only requirement would effectively prohibit or encumber plan fiduciaries from managing against or taking advantage of climate change and other ESG risk factors in selecting investments, even when it is financially prudent to do so. Thus, the final rule’s amendments to the current regulation, which are aimed solely at counteracting that perception, are entirely consistent with the principle articulated in *Dudenhoeffer*.

Notwithstanding the foregoing, paragraph (c)(2) of the proposal has been incorporated into paragraph (b)(4) of the final rule for clarity and to avoid potentially redundant and confusing requirements. This consolidation reflects that the essence of the requirement of paragraph (c)(2) of the proposal that fiduciaries make investment decisions based on factors relevant to a risk and return analysis is inherently prudential in nature, rather than a loyalty obligation, and therefore overlaps with the requirements of paragraph (b)(4) of the proposed rule. Although including such a requirement in the regulation’s loyalty provisions may help establish regulatory guideposts for fiduciaries,⁴⁶ that same function is fulfilled by incorporating it into the final regulation’s prudence provisions at paragraph (b)(4) of the final rule.

⁴⁵ *Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409 (2014).

⁴⁶ See 85 FR 72854.

(b) Paragraph (c)(1)

Paragraph (c)(1) of the proposal restated the Department's longstanding expression of ERISA's duty of loyalty in the context of investment decisions, as also expressed in Interpretive Bulletins and associated preamble discussions. It provided that a fiduciary may not subordinate the interests of participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives and may not sacrifice investment return or take on additional investment risk to promote goals unrelated to the plan and its participants and beneficiaries. Similar language is contained in paragraph (c)(2) of the current regulation. The Department did not receive substantive comments on paragraph (c)(1) of the proposal, and it is being adopted in the final rule without change. As in the proposal and current regulation, the final rule's paragraph (c)(1) is a legal requirement and not a safe harbor.

(c) Paragraph (c)(2)—Tie Breaker Test and Tie Breaker Standard

Paragraph (c)(3) of the proposal directly rescinded the "tiebreaker" standard in paragraph (c)(2) of the current regulation and replaced it with a standard intended to align more closely with the Department's original non-regulatory guidance from nearly three decades ago, IB 94-1, which first advanced the "tiebreaker" concept. In explaining the standard in the preamble to IB 94-1, the Department stated that "a plan fiduciary may consider collateral benefits in choosing between investments that have comparable risks and rates of return."⁴⁷ In contrast, the current regulation narrowly focused on whether competing investments are "indistinguishable" based on pecuniary factors alone. Under such circumstances, the current regulation permits a plan fiduciary to use a non-pecuniary factor as a deciding factor in making its investment decision, but only if the fiduciary also complies with a specific documentation requirement.

A number of commenters supported both the rescission of the current tiebreaker standard and the proposal's replacement standard—*i.e.*, that competing investments "equally serve" the financial interests of the plan. In their view, the proposed formulation represented a significant improvement over the current regulation, which they argued set out an unrealistically difficult and prohibitively stringent standard. Some further suggested that the standard in the current regulation is

so stringent that it effectively eliminated the Department's historical tiebreaker test. For instance, according to one commenter, the current regulation's tiebreaker standard improperly limits its application, because it would only apply when a fiduciary is unable to distinguish two or more investments based on pecuniary factors alone—an occurrence that is rare and unreasonably difficult to identify, according to this commenter. In actual practice, the commenter states, a prudent fiduciary process often produces a variety of investments that are consistent with, and in the fiduciary's judgment, equally promote, the financial interests of participants and beneficiaries. According to a different commenter, the current regulation's "economically indistinguishable" standard is in practice impossible for fiduciaries to surmount, given that differences exist even among very similar investments. As put by yet another commenter, the requirement that investments be "economically indistinguishable" before a fiduciary can consider collateral factors (such as ESG factors when not relevant to risk and return) effectively subverts the fiduciary's best judgment in favor of a standard that is virtually impossible to meet. Overall, these commenters viewed the proposal's standard as tracking the Department's prior guidance more closely, and more accurately reflecting the realities of fiduciary decisionmaking. They supported adoption of the NPRM's standard without change.

Other commenters supported the proposal's rescission of the current tiebreaker standard, but raised concerns with the proposal's "equally serve" formulation. Commenters indicated that the proposal was not clear as to how to determine when investments meet the "equally serve" standard and requested further guidance. Questions presented included whether the equally-serve analysis is based on how similar investments are, or based on the potential financial effects of the investments on the plan's portfolio. One commenter suggested that the Department should recognize that investments may vary from each other but still serve the same plan purpose. Another commenter asked how small deviations in the financial effects of two investments would affect the equally serve analysis. These commenters did not believe the tiebreaker standard should require investments to be identical, and suggested clarifying language, such as a standard based on investments that serve the financial

interests of the plan comparably well, or equally well.

Other commenters indicated that the "equally serve" standard appeared to imply an investment process under which a fiduciary selection process involves evaluating a group of potential investments, paring the group down to a few competing investments, and then moving on to the tiebreaker test and the selection of a single investment. Commenters opined that such a mechanical process of elimination should not be necessary if a fiduciary has already prudently determined that each investment is consistent with the plan's objectives and is reasonably designed to further the purposes of the plan. Some commenters asserted that the tiebreaker test should focus on whether investments are the result of a prudent fiduciary process rather than on an analysis of their equivalence, and suggested formulations based on "equally prudent" investments, or investments identified through a prudent process.

Some commenters supported the tiebreaker standard in the current regulation and objected to the rescission of the current standard. These commenters viewed the proposal's standard as far too lenient, and the current regulation's indistinguishability based on pecuniary factors only standard as appropriate in light of ERISA's high standard of fiduciary responsibilities. They asserted that the current regulation's provisions are a valuable curb against behavior that could otherwise lead to subordinating the interests of participants and beneficiaries in their retirement income. These commenters expressed concern that the proposal, with changes to the tiebreaker standard and related documentation provisions, would invite abuse and open the door to using pension plan assets for policy agendas, or encourage fiduciaries to advance personal policies and agendas at the expense of interests of trust beneficiaries in a secure retirement.

A number of commenters did not support inclusion of any tiebreaker provision in the regulation. Some commenters believe the tiebreaker test cannot be reconciled with ERISA's duty of loyalty, which requires that fiduciaries discharge their duties for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan. Commenters also cautioned that the tiebreaker provision weakens the focus on the best financial outcome for plan participants and beneficiaries by encouraging consideration of collateral factors. In

⁴⁷ 59 FR 32607 (June 23, 1994).

their view, fiduciaries desiring to seek third-party benefits may, deliberately or inadvertently, be encouraged to declare ties to free themselves from the duty of loyalty. Several of these commenters did not believe a tiebreaker is necessary regardless of formulation because, in their view, ties generally do not exist, particularly in liquid financial markets. Furthermore, they argued that the purpose of an investment manager is to exploit differences among investments and to select a winner (or buy both for increased diversification in the case of ties). In their view, fiduciaries are accustomed to deliberating on such matters, including close calls, and if they are doing their job and creating an appropriate record, there should be no need for tiebreaker guidance in the rule.

Some commenters also believed that a tiebreaker test may potentially cause harm or detriment to plans. For instance, some suggested that a tiebreaker test may reduce accountability and promote complacency by allowing investment decisionmakers to adopt a “close enough” attitude and point to some reason other than financial merit to justify their decisions. In contrast, others suggested that the tiebreaker test promotes a misconception that there is a single “best” investment for a plan. Still others cautioned that the mere existence of a tiebreaker test could unintentionally signal that ESG factors cannot, on their own, be considered material to a risk-return analysis. Some also suggested that there is a chance the tiebreaker test may be overused unnecessarily in cases where the fiduciary has little doubt about the financial merits of the investment in question but where the fiduciary perceives the tiebreaker route as providing a level of protection from future allegations of disloyalty. Such overuse may lead to substantial burdens on recordkeepers in connection with the proposal’s related collateral benefit disclosure requirement.

The Department is not persuaded that the tiebreaker provision should be removed from the final rule. The Department does not agree with commenters who asserted that the tiebreaker test is unnecessary or inconsistent with ERISA. Although there has been some mostly semantic variation in what constituted ties under the Department’s prior non-regulatory guidance, some version of the tiebreaker test has appeared in the CFR since 1994. Consequently, since at least that time, the Department has recognized that fiduciaries may use collateral benefits to break ties between various investments. The tiebreaker test thus aligns the final

rule with the settled expectations of fiduciaries and others involved in the investment of assets of employee benefits plans under ERISA, especially in the multiemployer plan context. Although some fiduciaries, by the nature of their arrangements with plans, may apply investment strategies that never require them to choose between alternatives that equally serve the plan’s needs, other fiduciaries, such as those making investments outside liquid financial markets, may find the tiebreaker test useful for circumstances in which there are equally strong cases for competing investments under a risk-return analysis. In addition, although some commenters question the need for a tiebreaker test and whether ties exist, other commenters acknowledge the utility of the tiebreaker standard. For instance, some commenters argued that in the event of a tie between two investment options, the fiduciary should increase diversification by investing in both investment options. They acknowledge, however, that in not all circumstances is this appropriate, and thus, the tie will need to be broken. Under the commenter’s approach, for example, the tiebreaker test provides plan fiduciaries with a solution in cases when investing in two (or more) alternatives that equally serve the financial interests of the plan, rather than one, entails additional costs (such as transactional or monitoring costs) that offset the benefits of investing in two (or more) investments rather than one.

More generally, those questioning the need for a tiebreaker test are reminded that ERISA does not specifically address a fiduciary’s investment choice in circumstances where multiple investment alternatives equally serve the financial interests of the plan and thus the economic interests of the plan’s participants and beneficiaries are protected by choosing either alternative. The Department is choosing to leave that decision in the hands of fiduciaries, who are charged with choosing among investment alternatives that equally serve the financial interests of the plan. Fiduciaries without a need to break a tie while selecting investments need not use the provision. This may be the case, for example, with respect to participant-directed individual account plans where adding additional investment options is not necessarily a zero-sum game, such that the fiduciary may choose only one option. Moreover, when there is a need to break a tie, there is nothing in the regulation that requires fiduciaries to look to climate change or other ESG factors to break the tie.

With respect to concerns that the tiebreaker provision might be subject to abuse or not be part of a prudent fiduciary process, we note that fiduciaries utilizing the tiebreaker provision remain subject to ERISA’s prudence requirements. In addition, they also remain subject to the explicit prohibition against accepting expected reduced returns or greater risks to secure such additional benefits. The Department is of the view that these provisions, coupled with the safeguards added by ERISA’s statutory prohibited transaction provisions, discussed below, sufficiently protect participants’ and beneficiaries’ retirement benefits in this context.

As to commenters who suggested that the existence of a tiebreaker provision implies that ESG factors are non-economic, the potential economic relevance of ESG factors is reflected in paragraph (b)(4) of the final rule, as discussed above. When such factors are relevant to a risk and return analysis, the tiebreaker test is not at issue. Put differently, as with other types of investment factors, climate change and other ESG factors sometimes may be relevant to a risk and return analysis and sometimes not—and when relevant, they may be factored into investment decisions alongside other relevant factors, as deemed appropriate by the plan fiduciary under paragraph (b)(4) of the final rule. However, when such factors are not relevant to a risk and return analysis, such factors may nevertheless be the decisive factor under the tiebreaker test, provided that the other conditions of the tiebreaker test are satisfied. The Department believes that rescission of the current regulation’s tiebreaker standard and replacement with a standard more closely aligned with prior non-regulatory guidance is appropriate. The current regulation’s tiebreaker standard, “unable to distinguish on the basis of pecuniary factors alone,” in practice, has meant indistinguishable in all respects, or identical. This standard is causing a great deal of confusion, given that no two investments are the same in each and every respect. The imposition of a standard that effectively requires investments to be precisely identical therefore is both impractical and unworkable. Investments can and do differ in a wide range of attributes, but when considered in their totality, may serve the financial interests of the plan equally well. This problem was noted by the Department in 2020 when making the current regulation’s tiebreaker standard, but as shown by the comments discussed above, the current

regulation has not effectively resolved this problem.⁴⁸ The Department believes the final rule's "equally serve" standard comports with the realities of fiduciary decisionmaking and firmly protects participant retirement benefits, since it strictly forbids the subordination of plans' and participants' financial interests to any other objective.

In response to comments requesting further guidance on the determination of whether investments equally serve the financial purposes of the plan, the Department has not made changes to the proposed standard. In the Department's view, as explained in the preamble to the proposal, investments may differ on a wide range of attributes, but when considered in their totality, serve the financial interests of the plan equally well.⁴⁹ Given the wide range of attributes associated with different investments, the uncertainties inherent in investing, and the practical limitations on the availability and processing of relevant data, the Department does not agree with those commenters who suggested that fiduciaries can never conclude that competing alternatives serve the financial purposes of the plan equally well. Under the final rule, investments do not need to be identical in order to equally serve the financial interests of a plan. Whether, in any particular circumstances, the tiebreaker standard is met is an inherently factual question.

Like the NPRM, the final rule's tiebreaker provision does not define or explicitly limit the concept of "collateral benefits." On this topic, the preamble to the NPRM specifically provided that the proposal did not place parameters on the collateral benefits that may be considered by a fiduciary to break the tie. The preamble to the NPRM explained that this position is consistent with prior nonregulatory guidance, but the preamble nevertheless solicited comments on whether more specificity should be provided in the provision. For instance, the preamble asked if the final rule should require that any collateral benefit relied upon as a tiebreaker be based upon an assessment of the shared interests or views of the participants, above and beyond their financial interests as plan participants, such as the investment's likely impact on participants' jobs or plan contribution rates. This scenario was just an example.

Some commenters opposed such limitations, both as a general idea and specifically the scenario mentioned in

the preamble of the NPRM, *i.e.*, placing additional constraints in the form of requiring an assessment of the shared interests or views of the participants. Commenters stated that the Department's longstanding position prior to the 2020 amendments, going back at least to 1994, never defined or limited the concept of "collateral benefits" and that there is no history justifying a change now. Focusing on the specific scenario in the preamble to the NPRM, one commenter stated that it is not clear how a fiduciary would use information on participant views, collect such information, or even what issues should be included in such an assessment. A different commenter also focusing on this scenario stated the concern that making decisions based on a survey or estimation of participants' views unrelated to plan returns is in tension with ERISA's command that fiduciaries operate "for the exclusive purpose" of providing benefits and defraying reasonable expenses. One commenter argued that a regulatory definition is not necessary because the tiebreaker test already ensures that the investment must be prudent and serve the best interests of the participants and beneficiaries regardless of whether a collateral benefit is used. Requiring further assessment would increase costs and complexity, according to this commenter.

Other commenters had different views on this question. One commenter stated that, in its view, the tiebreaker provision is unlawful, but that if some version of it is retained in the final rule, the retained version should require that any collateral benefit relied upon as a tiebreaker be based upon an assessment of the shared interests or views of the participants, along with the consent of each participant to pursue collateral benefits with funds in their account and a delineation of the causes they support. One commenter raised the concern that, because the NPRM did not place any parameters on the collateral benefits that fiduciaries may consider, fiduciaries could be left guessing which factors would be appropriate for consideration, with the possibility that the Department's views could shift over the years.

The final rule takes the same approach as the NPRM. Some form of the tiebreaker test permitting fiduciaries to consider collateral benefits has existed for more than four decades, and the Department is not aware of plan fiduciaries struggling with the concept of permissible collateral benefits. In the Department's experience, collateral benefits have routinely involved criteria or considerations other than factors that

are relevant to a risk and return analysis of the investment, such as stimulating union jobs and investing in the geographic region where participants live and work, as just a few examples. In response to requests from several commenters, the Department confirms that an investment that stimulates or maintains employment that, in turn, results in continued or increased contributions to a multiemployer plan is an example of "collateral benefits other than investment returns" under paragraph (c)(2) of the final rule. In response to the concern that, without a definition, plan fiduciaries will be forced to guess as to what constitutes a legitimate "collateral benefit" versus an impermissible collateral benefit, the Department reminds that plan fiduciaries are not required to consider collateral benefits in choosing between investments that have comparable risks and rates of return. Moreover, the statement that the final rule does not contain explicit parameters on the collateral benefits that may be considered by a fiduciary to break a tie directly responds to and addresses commenters' concerns about exceeding such parameters. Finally, while the final rule itself adds no explicit parameters on collateral benefits, ERISA's prohibited transaction provisions in section 406 remain and generally forbid collateral benefits to the extent any such benefit involves a transaction that violates those provisions.⁵⁰

(d) Paragraph (c)(2) Tiebreaker Test—Documentation

Paragraph (c)(3) of the NPRM also rescinded the current regulation's novel documentation requirement applicable to any instance of use of the tiebreaker test; instead, the proposal included a requirement that if a plan fiduciary uses the tiebreaker to select a designated investment alternative for a participant-directed individual account plan based on collateral benefits other than investment returns, "the plan fiduciary must ensure that the collateral-benefit characteristic of the fund, product, or model portfolio is prominently displayed in disclosure materials provided to participants and beneficiaries."

A number of commenters objected to the removal of the current regulation's

⁵⁰ See, e.g., AO 85-36A (Oct. 23, 1985) (certain investment arrangements may involve a use of plan assets for the benefit of a party in interest in violation of ERISA section 406(a)(1)(D)); Information Letter to Katz (Mar. 15, 1982) (purchase by a plan of an insurance policy pursuant to an arrangement under which it is expected that the insurance company will make a loan to a party in interest is a prohibited transaction).

⁴⁸ 85 FR 72846, 62.

⁴⁹ 86 FR 57278.

documentation provision, under which a fiduciary using the tiebreaker test is required to document, among other things, its analysis in those cases where the fiduciary has concluded that pecuniary factors alone were insufficient to be the deciding factor.⁵¹ The requirement was intended to “provide a safeguard against the risk that plan fiduciaries will improperly find economic equivalence and make decisions based on non-pecuniary factors without a proper analysis and evaluation.”⁵² Some of these commenters are of the view that the tiebreaker test may be inconsistent with ERISA, as discussed above, and that a stringent documentation requirement is perhaps the best way for plan fiduciaries to contemporaneously document their decisionmaking with respect to tiebreakers and mitigate the effects of their reliance on factors that do not materially affect risk-return or directly promote retirement income.

Other commenters supported removal of the current regulation’s documentation requirement, arguing that the disclosure was formulaic, singled out one investment category, could chill fiduciaries from properly considering ESG factors, and was largely unnecessary given ERISA’s general obligations. For instance, one commenter indicated that the documentation requirement has a chilling effect and is seen as suggesting that ESG investing entails extraordinary risks. Other commenters also viewed the documentation requirement as creating a stigma around considering ESG factors in investment decisions. Commenters also believed that the regulation’s documentation provision is unnecessary because fiduciaries commonly document and maintain records about their investment decisions as part of their general prudence obligation. Others believed that removal of the documentation provision brings the tiebreaker standard more in line with prior non-regulatory guidance and may provide additional cost savings, which would ultimately benefit plan participants and beneficiaries. A commenter noted that some fiduciaries, even before the 2020 amendments, may have viewed tiebreaker situations as perhaps requiring enhanced documentation. This commenter requested that the Department provide further clarification regarding prudent recordkeeping if the final rule removes the current regulation’s documentation requirement.

The Department is not persuaded that the current regulation’s brand new documentation requirement should be retained in the tiebreaker provision. Commenters confirmed the Department’s initial concern that the documentation provision in the current regulation is very likely to chill and discourage plan fiduciaries from using the tiebreaker test generally, including in cases involving the appropriate consideration of ESG factors (when such factors are not otherwise relevant to a risk and return analysis). The tiebreaker test, by its terms, applies only where competing investments equally serve the financial interests of the plan. It disallows the investment selection from sacrificing the plan’s economic interests or from exposing plans to additional risk. In light of these guardrails, the Department sees no reason for a regulatory provision imposing further burdens on its use. Since the tiebreaker test only applies in cases where the competing investments equally serve the financial interests of the plan, the Department is of the view that use of the tiebreaker test should not be discouraged with additional burdens, because neither of the competing investments sacrifices the economic interests of the plan, but one of them promotes collateral benefits the other does not. In addition, the elaborateness of the current regulation’s tiebreaker-specific documentation provision likely will be viewed by fiduciaries as suggesting that the Department sees tiebreakers as occurring infrequently, and the Department did not have in 2020 and does not now have sufficient information to make a judgement as to the frequency of ties. The documentation requirement also may be viewed by fiduciaries as a self-reported “red flag” that uniquely directs potential litigants’ attention to tiebreaker decisions as inherently problematic, even though there is no necessary or presumed inconsistency between their use and the requirements of ERISA. The Department is wary that the potential for litigation may cause fiduciaries to consciously or unconsciously skew their investment analyses to avoid open acknowledgment of a “tie” and the requirement of specifically prescribed documentation, while still favoring investments that provide collateral benefits. The Department believes this potentially creates incentives that discourage, rather than promote, proper fiduciary activity and transparency, and further reduces the likelihood that the benefits associated with the additional

documentation obligation would outweigh the associated costs.

The Department also agrees with commenters that the current regulation’s prescribed documentation provisions are unnecessary given the general obligations of prudence under ERISA. The Department finds it noteworthy that no commenter provided contrary evidence demonstrating that ERISA’s general obligations of prudence are deficient in protecting the interests of plan participants and beneficiaries in this context. The Department emphasizes that removal of the documentation provision from the regulation does not suggest that ERISA fiduciaries are excused from complying with ERISA’s prudence obligations, or subject to a lower standard of care, with regard to documentation or otherwise. Fiduciary documentation of their investment activities already is a common practice. As explained in the preamble to the NPRM, the Department’s concern with the current regulation’s document provision rests on its formulaic and rigid nature. The Department believes ERISA section 404’s prudence obligation sufficiently protects participants’ and beneficiaries’ financial interests in their plans in this regard. That obligation, which fiduciaries had prior to the 2020 amendments and will continue to have, provides that the nature and degree of the fiduciary’s duty to document an investment decision depends upon the facts and circumstances particular to that decision, regardless of whether the decision is under the tiebreaker test or the type of collateral benefit at issue.⁵³ Thus, the Department believes the current regulation’s specific documentation provision is not necessary and can lead to conduct contrary to the plan’s interests. This includes the risk that fiduciaries will over-document or under-document their investment decisions.⁵⁴ Over-documentation would result in increased transaction costs for no particular benefit to plan participants.

⁵³ The preamble to Interpretive Bulletin 2015–01, in relevant part, stated that, “the Department does not construe consideration of ETIs or ESG criteria as presumptively requiring additional documentation or evaluation beyond that required by fiduciary standards applicable to plan investments generally. As a general matter, the Department believes that fiduciaries responsible for investing plan assets should maintain records sufficient to demonstrate compliance with ERISA’s fiduciary provisions. As with any other investments, the appropriate level of documentation would depend on the facts and circumstances.”

⁵⁴ 86 FR 57272 at 57279.

⁵¹ 29 CFR 2550.404a–1(c)(2) (2021).

⁵² 85 FR 72862.

(e) Paragraph (c)(2) Tiebreaker Test—
Collateral Benefit Disclosure

The NPRM contained a disclosure requirement within the tiebreaker test limited to participant-directed individual account plans. Specifically, paragraph (c)(3) of the NPRM, in relevant part, provided that if a plan fiduciary selects an investment, or investment course of action, based on collateral benefits other than investment returns, “the plan fiduciary must ensure that the collateral-benefit characteristic of the fund, product, or model portfolio is prominently displayed in disclosure materials provided to participants and beneficiaries.” This would have been a new disclosure requirement under ERISA.

The preamble to the NPRM explained the policy intent behind this proposed requirement. In relevant part, the NPRM explained that the “essential purpose of this proposed disclosure requirement is to ensure that plan participants are given sufficient information to be aware of the collateral factor or factors that tipped the scale in favor of adding the investment option to the plan menu, as opposed to its economically equivalent peers that were not.”⁵⁵ The Department thought the disclosure of this information would have been of potential benefit to plan participants and beneficiaries because of the possibility that “a particular plan participant or a population of plan participants does not share the same preference for a given collateral purpose as the plan fiduciary that selected the designated investment alternative for placement on the menu among the plan’s other options.”

The preamble to the NPRM also provided an example of an application of this proposed requirement. The example, in relevant part, provided that “if the tiebreaking characteristic of a particular designated investment alternative were that it better aligns with the corporate ethos of the plan sponsor or that it improves the esprit de corps of the workforce, . . . then such feature or features prompting the selection of the investment must be prominently disclosed by the plan fiduciary. . . .” The NPRM believed this information “will be useful to participants and beneficiaries in deciding how to invest their plan accounts.”⁵⁶

The preamble to the NPRM also clarified that, in terms of compliance, the Department’s intent was to provide flexibility in how plan fiduciaries would fulfill this requirement given the

unknown spectrum of collateral benefits that might influence a plan fiduciary’s selection. The preamble to the NPRM explained that one likely way to comply “is that the plan fiduciary could simply use the required disclosure under 29 CFR 2550.404a–5.”⁵⁷ That regulation, adopted in 2012, already entitles participants in participant-directed individual account plans to receive sufficient information regarding designated investment alternatives to make informed decisions about the management of their individual accounts. The information required by the 2012 rule includes information regarding the alternative’s objectives or goals and the alternative’s principal strategies (including a general description of the types of assets held by the investment) and principal risks. The NPRM, therefore, assumed these existing disclosures, perhaps with minor modifications or clarifications, would have been sufficient to satisfy the disclosure element of the tiebreaker provision in paragraph (c)(3) of the proposal.

As is evident from the foregoing discussion, the NPRM assumed appreciable benefits to plan participants and beneficiaries and relatively small compliance costs resulting from this proposed disclosure requirement.⁵⁸ The NPRM solicited comments on the overall utility of this disclosure provision, including ideas on how best to operationalize the provision considering its intended purpose balanced against costs of implementation and compliance.

(1) Support for Disclosure Requirement

The public record reflects limited support for the proposed disclosure requirement. One commenter stated that plan participants and beneficiaries should have information about collateral benefits because such information may impact participant behavior, such as whether to participate, savings rates, and asset allocations. One commenter registered its support for better disclosure to plan participants and of investment policies more generally, inclusive of sustainable investment policies and collateral benefit factors. One commenter believed the proposed requirement would protect participants and beneficiaries by

ensuring that plan sponsors fully considered collateral benefits alongside financial performance. One commenter supported the proposed disclosure requirement as “reasonable,” but recommended that the Department provide plan fiduciaries with a model notice to assist compliance with this disclosure requirement. Finally, one commenter conditionally supported the proposed disclosure requirement because the commenter believed it would give plan participants needed transparency in the tiebreaking context. However, this commenter recommended that the proposed requirement, if retained, be improved with additional content requirements, including a requirement that the fiduciary disclose what specific alternative investments were considered in breaking the tie and more analysis behind the fiduciary’s decisionmaking process.

(2) Concerns With Disclosure Requirement

The public record also reflects substantial concerns with the proposed disclosure requirement. In summary, these concerns are as follows. Some commenters found the content requirements of proposed disclosure requirement to be inherently ambiguous. Some found the proposed disclosure requirement to be unnecessary and the required content of the disclosure to be of no economic significance. Other commenters were concerned that the proposed disclosure requirement may undermine the purposes of other disclosure regulations promulgated by the Department aimed at helping plan participants and beneficiaries make informed investment decisions. Certain commenters expressed concerns that the proposed disclosure requirement would single out certain factors and strategies over other factors and strategies, contrary to the principle of neutrality they believe is embedded in ERISA. Other commenters were concerned that the proposed disclosure requirement could have a chilling effect on the proper use of climate change and other ESG factors. Several commenters were concerned that the proposed disclosure provision would result in unnecessary litigation. Each of these concerns is explained in detail below.

(a) Ambiguity

Some commenters found the content requirements of the proposed disclosure requirement to be inherently ambiguous. According to them, the NPRM was unclear on what “collateral-benefit characteristics” a fiduciary would be required to disclose. They

⁵⁷ *Id.*⁵⁸ 86 FR 57272 at 57300 (“The Department estimates that it will take a legal professional twenty minutes on average per year to update existing disclosures for each of the 46,551 small individual account plans with participant direction that are anticipated to utilize this provision. This results in a per-plan cost of \$46.14 annually relative to the pre-2020 final rule baseline.”).⁵⁵ 86 FR 57272, 80.⁵⁶ *Id.*

contrasted regulatory language requiring the disclosure of the collateral benefit characteristics “of the fund” with preamble language focused on the “features prompting the selection” by the fiduciary and other language referencing “improved employee morale” as the factor that “tipped the scale.” Commenters requested clarification of whether the proposed disclosure requirement was focused on an objective characteristic of the fund or the subjective reason the fiduciary selected the fund. According to the commenters, these are not necessarily the same things. Commenters said the subjective collateral benefit perceived by the plan fiduciary may be wholly different from the characteristic of the fund that would be expected to provide the collateral benefit. For example, assume that the plan sponsor is an organization whose primary mission is to tackle climate change. The plan fiduciary may decide to use the tiebreaker test to select a fund that uses ESG criteria with an environmental focus to improve the morale of its employees. In this example, the commenters stated that the regulatory text and preamble were unclear on what must be disclosed under the proposal—would it be the environmental focus of the fund’s strategy or improved employee morale? Most commenters on this issue requested confirmation that the former is what the Department intended, and they asserted flaws with the NPRM’s cost-benefit analysis if the latter.

(b) Unnecessary

Some commenters were of the view that the proposed disclosure requirement is unnecessary, and the required content of the disclosure is of no economic significance. The commenters stated that the Department and the Securities and Exchange Commission already have regulations in place to ensure that participants and investors have ready access to necessary investment-related information, such as principal strategies and risks, performance information, benchmarks, and fees. Commenters alleged that the content requirements of the proposed disclosure, by contrast, contained no information about the economics of the investment in question, but instead focused on information that was collateral to the economics of the investment and therefore would have no economic relevance to participant investors. Whether a participant shares the fiduciary’s preference for the collateral benefit or purpose that “tipped the scale” is of no relevance to whether the investment option is

economically prudent and makes economic sense to a participant. The only thing that should matter to participants, in the view of these commenters, is whether the selected investment was prudently chosen. In their view, disclosures focused on the policy or social preferences of the selecting fiduciaries will not advance intelligent investment behavior and therefore are unnecessary.

(c) Interference With Existing Disclosure Regulations

Some commenters were concerned the proposed disclosure requirement would undermine the purposes of other disclosure regulations promulgated by the Department aimed at helping plan participants and beneficiaries make informed investment decisions. These commenters pointed to existing disclosures under 29 CFR 2550.404a–5, 2550.404c–1, and 2550.404c–5 as being sufficient to enable plan participants and beneficiaries to make informed investment decisions.⁵⁹ These disclosures, according to the commenters, focus on what the Department has determined, through multiple notice-and-comment rulemaking projects, is the relevant investment-related information that plan participants and beneficiaries need, as investors. The proposed collateral benefit disclosure requirement, by contrast, focused on non-investment information, *i.e.*, the collateral purpose that tipped the scale—information that, by definition, is not material to risk and return. These commenters argued that not only is the proposed collateral benefit disclosure of no economic relevance, but the disclosure risks distracting participants and beneficiaries from basic and important information required under the existing regulations mentioned above. Put differently, one commenter stated that it opposes the proposed disclosure requirement because it would

⁵⁹ The disclosure requirements to which these commenters refer include: 29 CFR 2550.404a–5 (requiring disclosure of certain plan administrative and investment-related information, including fee and expense information, to participants and beneficiaries in participant-directed individual account plans (*e.g.*, 401(k) plans)); 29 CFR 2550.404c–1 (requiring that participants and beneficiaries in participant-directed individual account plans are furnished specified information about the plan’s investment alternatives and incidents of ownership appurtenant to such investment alternatives); and 29 CFR 2550.404c–5 (requiring that participants and beneficiaries whose plan assets may be invested, by default, into a plan’s QDIA by a plan fiduciary are furnished specified investment-related information about the QDIA, the circumstances in which plan assets will be invested in a QDIA, and their ability to direct their assets to plan investment alternatives other than a QDIA).

disproportionately emphasize one part of the fiduciary decisionmaking process over other more relevant factors in a way that could mislead participants and impact participant choices in ways that are unintended by the Department.

(d) Lack of Neutrality & Chilling Effect

Commenters expressed concerns that the proposed disclosure requirement singles out certain factors over other factors, contrary to the principle of neutrality, while other commenters are concerned that the proposed disclosure requirement might have a chilling effect on the proper use of climate change and other ESG factors. Certain commenters expressed opposition to the idea of singling out any class of investment factor, including collateral benefit factors, as needing additional or stricter requirements. These commenters asserted that ERISA is, and should be, factor neutral, including with respect to collateral purposes or factors. By imposing special disclosure requirements on collateral benefits, the proposed disclosure is contrary to this principle, according to these commenters.

In line with this concern, other commenters were concerned that the proposed disclosure provision could inadvertently have a chilling effect on the proper use of climate change and other ESG factors. These commenters posited that investment strategies often simultaneously integrate multiple ESG factors into the analysis, some of which are relevant to a risk and return assessment while others are not. In these circumstances, commenters asserted that fiduciaries may avoid the investment based on ambiguity over whether it is subject to the disclosure requirement, or over disclose even when the options were selected solely for financial reasons.

(e) Litigation

Multiple commenters raised concerns that the proposed disclosure requirement would effectively act as an invitation to litigation. The very purpose of the disclosure, according to the commenters, is to draw the reader’s attention to the non-financial motives of the plan fiduciary. Considering this purpose, commenters said the disclosures themselves unintendedly would serve as a signal of potential wrongdoing and as a roadmap to litigation. To altogether avoid the litigation risk, some plan sponsors and fiduciaries simply would not use the tiebreaker test even in cases when they otherwise might have been willing to use it to promote collateral purposes,

such as addressing climate change, according to commenters.

(f) Per Se Disloyalty

Other commenters raised concerns with the idea that a disclosure violation would constitute a *per se* breach of ERISA's duty of loyalty, which the commenters saw as the necessary consequence of embedding a disclosure requirement within the portion of a regulation defining ERISA's duty of loyalty. They argued that a disclosure failure does not (and should not), by itself, prove disloyalty. But as structured, that seems to be the result under the NPRM regardless of how prudent and loyal the fiduciary is when selecting the investment, the commenters asserted. These commenters observed the unconventionality of the idea that ERISA commands that if fiduciaries fail in whole or in part to disclose their motivations to participants and beneficiaries, those fiduciaries are *per se* disloyal as a result of the failure, regardless of how loyal the fiduciaries were, in fact, when selecting the investment. These commenters assert that it is a non sequitur to say that a failure to disclose the scale-tipping attributes of an investment is dispositive evidence of disloyalty, especially when the investment is prudent and serves the financial interests of the plan equally as well as a reasonable number of alternatives. To this point, the commenters note that some version of the tiebreaker test has existed for approximately forty years without a related disclosure requirement, embedded in loyalty or otherwise—and nothing in the marketplace has changed in a way that supports the new disclosure requirement. The commenters question whether the many plan fiduciaries that used the tiebreaker test in the past would now be considered disloyal because they likely never disclosed to participants the collateral benefits that broke the tie.

(g) Other Technical Concerns

In addition to the foregoing concerns, commenters raised the following technical issues with the proposed disclosure requirement. First, commenters stated that although the NPRM is clear that a collateral benefit disclosure is required only if the fiduciary uses the tiebreaker provision to select a fund, nowhere does the NPRM offer concrete guidance on when or how often the plan fiduciary must furnish this information to participants. For example, commenters requested guidance and clarification on whether a disclosure would be required only when

the fund is added to the lineup, only when a participant joins the plan, annually, any time the plan or its service providers furnish any disclosure materials pertaining to the fund, or at some other interval determined solely in the judgment of the plan fiduciary based on facts and circumstances.

Second, the NPRM specifies that the collateral benefit disclosure must be “prominently” displayed in disclosure materials provided to participants. But neither the regulation nor the preamble defines the meaning of prominence for this purpose. Several commenters therefore requested guidance on how to satisfy this standard. One concern is that this standard is being construed as requiring that collateral benefit information receive more attention or prominence than other information that likely will accompany the collateral benefit information, such as investment performance, fees, strategies, risk, etc. The commenters are of the view that collateral benefit information should not be more prominent than relevant investment-related information. These commenters assert that investment success generally turns on an intelligent evaluation of performance, fees, strategies, and risk, and that mandating the elevation of collateral information undermines the chances of an investor's success. According to the commenters, this is particularly important, in part, because the concept of “prominence” is inherently subjective, and in part, because violations of the proposed disclosure rule are *per se* acts of disloyalty.

(3) Decision

Based on the foregoing concerns, and reasons similar to those underlying the decision to remove the documentation requirements from the current regulation, the final rule does not adopt the proposed collateral benefit disclosure requirement at this time. The Department is aware that the Securities and Exchange Commission (SEC) is conducting rulemaking on investment company names, addressing, among other things, “certain broad categories of investment company names that are likely to mislead investors about an investment company's investments and risks.”⁶⁰ The SEC also is conducting rulemaking on disclosures by mutual funds, other SEC-regulated investment companies, and SEC-regulated investment advisers designed to provide consistent standards for ESG disclosures, allowing investors to make more informed decisions, including as

they compare various ESG investments.⁶¹ The Department will monitor those rulemaking projects and may revisit the need for collateral benefit reporting or disclosure depending on the findings of that agency. The Department emphasizes that the decision against adopting a collateral benefit disclosure requirement in the final rule has no impact on a fiduciary's duty to prudently document the tiebreaking decisions in accordance with section 404 of ERISA.

(f) Paragraph (c)(3)—Participant Preferences

Several commenters requested clarification on whether a plan fiduciary may consider participants' policy, social, or value preferences (*i.e.*, non-financial preferences) in connection with constructing menus for defined contribution plans that permit participants to direct their own investments. Some commenters stated that, in their view, the NPRM is ambiguous on this question. Many other commenters expressed concern that the NPRM appears not to permit plan fiduciaries to consider participants' preferences or to consider them only under the tiebreaker test.

Several of these commenters stressed their view of the importance of accommodating participants' preferences in a voluntary retirement system heavily dependent on elective deferrals. These commenters, including institutional asset managers and asset custodians, assert that both increased participation and increased deferral rates follow from accommodating such preferences. They argue that participants may not use their voluntary participant-directed savings plans to save for retirement, or will leave those plans earlier, if they cannot get access to investment choices they find attractive. Consistent with this argument, many individual commenters claim they would roll their savings out of ERISA-protected plans if the plans cannot satisfactorily accommodate their preferences.

Several commenters alleged that plan fiduciaries should not have to rely solely on the tiebreaker test to consider participants' preferences. These commenters are of the view that the NPRM's tiebreaker test may be ill-suited to some methods of constructing menus for defined contribution plans because adding additional options is not necessarily a zero-sum game under these methods. To these commenters, therefore, if plan fiduciaries are unable to use the tiebreaker test because it does

⁶⁰ 87 FR 36594 (June 17, 2022).

⁶¹ 87 FR 36654 (June 17, 2022).

not comport with how they construct defined contribution menus, they effectively have no ability under their reading of the NPRM to consider participants' preferences.

A few commenters believe that participants' preferences deserve equal treatment with risk and return factors; they believe fiduciaries should be allowed to consider and weigh participants' preferences alongside risk and return factors in a prudence analysis, giving participant's preferences such weight as the fiduciary deems appropriate, even if such preferences are not directly tied to risk or return. By contrast, a few commenters asserted that ERISA requires plan fiduciaries to focus on only pecuniary factors when selecting and retaining investments. They view participants' preferences as essentially irrelevant to menu construction.

In response to these comments, paragraph (c)(3) of the final rule provides clarification on this issue. Specifically, paragraph (c)(3) of the final rule provides that the plan fiduciary of a participant-directed individual account plan does not violate the duty of loyalty set forth in paragraph (c)(1) of the final rule solely because the fiduciary takes into account participants' preferences consistent with requirements of paragraph (b) of this section.

If accommodating participants' preferences will lead to greater participation and higher deferral rates, then it could lead to greater retirement security, as suggested by the commenters. Thus, in this way, giving consideration to whether an investment option aligns with participants' preferences can be relevant to furthering the purposes of the plan within the meaning of paragraph (b)(1) of the final rule. At the same time, however, plan fiduciaries may not add imprudent investment options to menus just because participants request or would prefer them.⁶²

The clarification in paragraph (c)(3) of the final rule does not speak to the duty of prudence. Rather, paragraph (c)(3) provides only that a fiduciary does not violate the duty of loyalty as set forth in paragraph (c)(1) of the final rule solely because the fiduciary considers participants' preferences in a manner

that is consistent with paragraph (b) of the final rule. The reference to paragraph (b) in paragraph (c)(3) clarifies that the duty of prudence is independent and, as such, prudence determinations must be made consistent with paragraph (b) of the final rule. As paragraph (b)(4) of the final rule makes clear, the selection of investment options must be grounded in the fiduciary's prudent risk and return analysis.

The clarification in paragraph (c)(3) of the final rule is not novel or a change in Departmental position. The preamble to the current regulation being amended by this final rule articulated this position when explaining the meaning and mechanics of paragraph (d)(2) of that rule (entitled "Investment Alternatives for Participant-Directed Individual Account Plans"). In relevant part, that preamble stated: "Nothing in the final rule precludes a fiduciary from looking into certain types of investment alternatives in light of participant demand for those types of investments. But in deciding whether to include such investment options on a 401(k)-style menu, the fiduciary must weigh only pecuniary . . . factors."⁶³ The relevant portion of paragraph (d)(2) of that rule, however, was incorporated into paragraphs (b) and (c)(1) of the final rule (minus the pecuniary factor terminology). The final rule restates the position as regulatory text in paragraph (c)(3), rather than as a preamble statement, to provide enhanced clarity, accessibility, and prominence, as requested by commenters.

The final rule declines to mandate that fiduciaries factor participants' preferences into their evaluation, selection, and retention of designated investment alternatives, and declines to mandate a uniform methodology for determining such preferences, as requested by a few commenters. Some commenters had concerns that a mandate to consider and act on participants' preferences would raise complex questions, such as how plan fiduciaries should properly solicit, weigh, implement, and monitor participants' preferences, and how plan fiduciaries should reconcile conflicting preferences of their participants (e.g., some participants may oppose so-called "sin stocks" and other participants in the same plan may favor them). No commenter had persuasive answers or recommendations on these questions, and the NPRM did not propose such a mandate or suggest how to resolve such competing preferences. In addition, as some commenters noted, ERISA's

fiduciary obligations could compel plan fiduciaries to disregard participants' preferences to the extent they are imprudent. Accordingly, the final rule declines to mandate that fiduciaries factor participants' preferences into their evaluation, selection, and retention of designated investment alternatives, and declines to mandate a uniform methodology for determining such preferences; the final rule, instead, leaves these questions to be decided by plan fiduciaries considering the facts and circumstances of their plan and participant population.

3. Investment Alternatives in Participant-Directed Individual Account Plans Including Qualified Default Investment Alternatives

Paragraph (d) of the current regulation contains additional rules that specifically govern fiduciaries' selection and retention of investment alternatives for participant-directed individual account plans, including qualified default investment alternatives (QDIAs). The NPRM proposes to directly rescind this paragraph. The NPRM's justification for the rescission has two dimensions. First, proposed amendments to other provisions in the section effectively merged the substance of what was paragraph (d) into these other provisions. Second, the Department no longer supports the current regulation's provisions specific to QDIAs. As structured, paragraph (d)(2)(ii) of the current regulation disallows a fund to serve as a QDIA if it, or any of its component funds in a fund-of-fund structure, has investment objectives, goals, or principal investment strategies that include, consider, or indicate the use of one or more non-pecuniary factors in its investment objectives, even if the fund is objectively economically prudent from a risk-return perspective or even best in class.

Commenters overwhelmingly supported the NPRM. A few commenters raised technical concerns regarding compliance problems and costs with paragraph (d) of the current regulation. But more globally, and fundamentally, most commenters on this issue were of the view that the provisions in paragraph (d) of the current regulation are unnecessary. This view is based, in part, on the strongly held belief, shared among a broad spectrum of commenters from various backgrounds and industries, that the legal standards under ERISA's prudence and loyalty rules should be the same for all plans, including plans with QDIAs, with respect to the selection and retention of investment alternatives.

⁶² See *Hughes v. Northwestern Univ.*, 142 S. Ct. 737 (2022) ("In *Tibble*, this Court explained that, even in a defined-contribution plan where participants choose their investments, plan fiduciaries are required to conduct their own independent evaluation to determine which investments may be prudently included in the plan's menu of options." (citing *Tibble v. Edison Int'l*, 575 U.S. 523 (2015)).

⁶³ 85 FR 72846 at 72863.

How these standards apply to a given set of facts may, of course, differ, according to the commenters, but the base standards of prudence and loyalty should be no different for these plans, absent a statutory underpinning for a difference. Yet the current regulation, according to these commenters, unnecessarily singles out individual account plans for what the commenters view as different, special, and stricter treatment (*e.g.*, some higher level of fiduciary oversight). This special treatment is especially extreme with respect to QDIAs, according to the commenters, with some commenters equating the provisions in paragraph (d)(2)(ii) of the current regulation to an effective ban on selecting investments that consider or integrate climate change and other ESG factors, regardless of the economic merits and prudence of the investment. Many commenters disagreed that QDIAs need heightened protections beyond those specifically contained in the Department's Qualified Default Investment Alternative regulation.⁶⁴ Overall, these commenters agree that the provisions of paragraph (d) of the current regulation create a perception that fiduciaries of individual account plans, including plans with QDIAs, are subject to different and heightened—but unclear—standards of prudence and loyalty as compared to fiduciaries of other plans. And the primary consequence of this perception, according to the commenters, was a concern that funds may be excluded from selection as QDIAs solely because they expressly considered climate change or other ESG factors, even though the funds are prudent based on a consideration of their financial attributes alone.

Some commenters opposed the NPRM's proposed changes to paragraph (d) of the current regulation. In the main, these commenters oppose all aspects of the NPRM, not just the NPRM's proposed deletion of paragraph (d) of the current regulation, but their expressed concerns with the proposed elimination of paragraph (d) are mainly limited to QDIAs. One of these commenters, for instance, stated that, because the proposal would allow a QDIA that states, as one of its investment objectives, a goal other than financial return, this part of the proposal, in the view of this commenter, is a *per se* violation of ERISA's exclusive purpose rule as interpreted by the Supreme Court in *Dudenhoeffer*.⁶⁵ A different commenter, noting that

individual account plans shift the risk of investment loss to participants, asserted that this shift in risk justifies enhanced—not reduced—protections for participants that are defaulted into QDIAs. This risk is compounded, according to this commenter, by the fact that defaulted employees are an increasingly larger percentage of the universe, and they tend not to opt out of the default investment. In line with the concerns of this commenter, two other commenters asserted that, to the extent ESG investing is acceptable at all, it should never be allowed in the case of QDIAs. Even if active investors are given the prerogative to align their investments with their beliefs, inattentive defaulted investors should never, according to these commenters, be forced to accept the social investment preferences of their plan fiduciaries or burdened with the obligation of having to actively recognize that the default option is misaligned with the investors' desires for higher returns (or contrary social values) and opt out.

The Department was not persuaded by these objections and the final regulation retains this aspect of the NPRM, meaning that the final regulation does not contain the set of special rules for participant-directed individual account plans, including plans with QDIAs, codified in paragraph (d) of the current regulation. The first part of paragraph (d) of the current regulation (paragraphs (d)(1) and (d)(2)(i)) was eliminated because the essential principles of this part were merged into paragraphs (b) and (c) of the final rule.

As to the second part of paragraph (d) of the current regulation, *i.e.*, the part containing special provisions for QDIAs (paragraph (d)(2)(ii) of the current), the Department generally is of the view that QDIAs warrant special treatment because plan participants have not affirmatively directed the investment of their assets into the QDIA but are nevertheless dependent on the investments for long-run financial security. Although the Department continues to believe as a general matter that special protections may be needed in some contexts for plans containing these investments, the Department no longer supports the specific restrictions in paragraph (d)(2)(ii) of the current regulation. As structured, paragraph (d)(2)(ii) of the current regulation disallows a fund to serve as a QDIA if it, or any of its component funds in a fund-of-fund structure, has investment objectives, goals, or principal investment strategies that include, consider, or indicate the use of non-pecuniary factors in its investment objectives, even if the fund is

objectively economically prudent from a risk-return perspective or even best in class.

The Department agrees with the many commenters asserting that, rather than protecting the interests of plan participants, paragraph (d)(2)(ii) of the current regulation will only serve to harm participants. It would, as the commenters notice, effectively preclude fiduciaries from considering QDIAs that include ESG strategies, even where they were otherwise prudent or economically superior to competing options. The Department sees no reason to deprive participants of such options. Consequently, the final rule directly rescinds paragraph (d)(2)(ii) of the current regulation. The rescission of this provision, however, does not leave participants and beneficiaries in plans with QDIAs without protections. QDIAs would continue to be subject to the same legal standards under the final rule as all other investments, including the prohibition against subordinating the interests of participants and beneficiaries in their retirement income to other objectives. QDIAs also would continue to be subject to the separate protections of the QDIA regulation.⁶⁶ The Department finds no merit to the argument that the final rule, either in general or in not carrying forward paragraph (d) of the current regulation in specific, sanctions behavior contrary to the holding in *Dudenhoeffer*. On the contrary, as already stated, the central premise behind the final rule's amendments to the current regulation is that the current regulation is being perceived by plan fiduciaries and others as an impediment to protecting the financial benefits of plan participants and beneficiaries by prohibiting or encumbering plan fiduciaries from managing against or taking advantage of climate change and other ESG risk factors in selecting investments. Thus, in this way, the final rule's rescission of the special provision for QDIAs is entirely consistent with the principle articulated in *Dudenhoeffer*.

4. Section 2550.404a-1(d)—Proxy Voting and Exercise of Shareholder Rights

Paragraph (d) of the final rule addresses the application of the duties of prudence and loyalty under ERISA section 404(a) to the exercise of shareholder rights, including proxy voting. As discussed below, the final rule includes several minor changes from the proposal based on public comment.

⁶⁴ 29 CFR 2550.404c-5.

⁶⁵ *Fifth Third Bancorp v. Dudenhoeffer*, 573 U.S. 409 (2014).

⁶⁶ 29 CFR 2550.404c-5.

(a) Paragraph (d)(1)

Paragraph (d)(1) of the final rule is unchanged from the proposal and provides that the fiduciary duty to manage plan assets that are shares of stock includes the management of shareholder rights appurtenant to those shares, such as the right to vote proxies. A commenter requested that the Department limit paragraph (d) to only proxy voting. The commenter noted that while the provisions cover both proxy voting and the exercise of shareholder rights, most of the substantive provisions relate only to proxy voting. The commenter further opined that other shareholder rights do not necessarily share the same objectives as those of proxy voting in connection with stock ownership. Moreover, according to the commenter, decisions on corporate actions like stock splits, tender offers, exchange offers on bond issues, and mergers and acquisitions are generally not governed by proxy voting policies or undertaken with advice from proxy advisors. For these reasons, the commenter expressed the view that exercise of shareholder rights should not be coupled with proxy voting in the regulation. The Department is not persuaded to make the suggested change. The exercise of shareholder rights has been part of the Department's prior guidance since at least the first Interpretive Bulletin in 1994. The Department believes that the exercise of shareholder rights to monitor or influence management, which may occur in lieu of, or in connection with, formal proxy proposals is no less important to fiduciary management of the investment asset as proxy voting and accordingly should be covered by the final rule.

(b) Paragraph (d)(2)

(1) Paragraph (d)(2)(i)

Paragraph (d)(2)(i) of the proposal provided that when deciding whether to exercise shareholder rights and when exercising such rights, including the voting of proxies, fiduciaries must carry out their duties prudently and solely in the interests of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and beneficiaries and defraying the reasonable expenses of administering the plan. Paragraph (d)(2)(i) was proposed without modification from paragraph (e)(2)(i) of the current regulation and is adopted without change.

(2) Paragraph (d)(2)(ii)

Paragraph (d)(2)(ii) of the proposal set forth specific standards for fiduciaries to

meet when deciding whether to exercise shareholder rights and when exercising shareholder rights. It provided that a fiduciary must act solely in accordance with the economic interest of the plan and its participants and beneficiaries (paragraph (d)(2)(ii)(A)) and consider any costs involved (paragraph (d)(2)(ii)(B)). Paragraph (d)(2)(ii) further required that a fiduciary must not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to any other objective, or promote benefits or goals unrelated to the financial interests of the plan's participants and beneficiaries (paragraph (d)(2)(ii)(C)). The proposal additionally provided that a fiduciary must evaluate material facts that form the basis for any particular proxy vote or other exercise of shareholder rights (paragraph (d)(2)(ii)(D)). Finally, paragraph (d)(2)(ii)(E) of the proposal provided that a fiduciary must exercise 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.

Paragraph (d)(2)(ii) of the proposal was based on paragraph (e)(2)(ii) of the current regulation but proposed three significant changes. First, paragraph (d)(2)(ii) of the proposal directly rescinded the statement in paragraph (e)(2)(ii) of the current regulation that "the fiduciary duty to manage shareholder rights appurtenant to shares of stock does not require the voting of every proxy or the exercise of every shareholder right." Second, proposed paragraph (d)(2)(ii) did not carry forward the current regulation's specific requirement at paragraph (e)(2)(ii)(E) that, when deciding whether to exercise shareholder rights and when exercising shareholder rights, plan fiduciaries must maintain records on proxy voting activities and other exercises of shareholder rights. Third, paragraph (d)(2)(ii)(E) of the proposal broadened the corresponding provision in the current regulation (paragraph (e)(2)(ii)(F)) in connection with a proposed streamlining of fiduciary selection and monitoring obligations under the current regulation. Specifically, paragraphs (e)(2)(ii)(F) and (e)(2)(iii) of the current regulation both address fiduciary monitoring obligations, with paragraph (e)(2)(ii)(F) covering selection and monitoring of

persons selected to advise or otherwise assist with the exercise of shareholder rights, and paragraph (e)(2)(iii) sets out specific monitoring obligations where the authority to vote proxies or exercise shareholder rights has been delegated to an investment manager or a proxy voting firm. The NPRM proposed streamlining this approach by eliminating paragraph (e)(2)(iii) and covering selection and monitoring obligations in a single more general provision (paragraph (d)(2)(ii)(E) of the proposal). Although based on paragraph (e)(2)(ii)(F) of the current regulation, paragraph (d)(2)(ii)(E) of the proposal was broader, and covered obligations related to monitoring service providers such as investment managers and proxy advisory firms that are addressed in paragraph (e)(2)(iii) of the current regulation.

(a) Rescission of "Does Not Require Voting Every Proxy" Language From Paragraph (e)(2)(ii) of the Current Regulation

The Department proposed to rescind the statement in paragraph (e)(2)(ii) of the current regulation that "the fiduciary duty to manage shareholder rights appurtenant to shares of stock does not require the voting of every proxy or the exercise of every shareholder right" out of a concern that the statement could be misread as suggesting that plan fiduciaries should be indifferent to the exercise of their rights as shareholders, particularly in circumstances where the cost is minimal as is typical of voting proxies. Such indifference could leave plan investments unprotected, as the exercise of shareholder rights is important to ensuring management accountability to the shareholders that own the company. Furthermore, abstaining from a vote is not a neutral act that has no bearing on the outcome of a particular matter put to shareholders for vote; rather, depending on the relevant voting standard under state law and the company's governing documents, abstention could determine whether a particular matter or proposal is approved.

Commenters expressed a range of views with respect to the rescission of the "does not require voting every proxy" language. Multiple commenters supported the rescission, and agreed with the Department's concerns that the language promotes indifference in managing proxy voting rights. A commenter furthermore cautioned that the language misleadingly signaled to fiduciaries that proxy voting is costly and unimportant. Some commenters expressed the view that the exercise of

shareholder rights is key to management accountability and paying attention to governance is as important as financial performance. Other commenters similarly supported rescission based on the view that exercise of shareholder rights, including through proxy voting, is an important tool for managing risk. Some commenters also indicated that the “does not require voting every proxy” language is not necessary in the current regulation because fiduciaries have never believed that ERISA required them to vote all proxies. In particular, commenters pointed to prior non-regulatory guidance which clearly indicated, in the context of foreign stock, that ERISA does not require fiduciaries to vote all proxies.⁶⁷

Some commenters did not indicate support or opposition to rescission of the “not required to vote every proxy” language, but they cautioned that removal of the language could be misread as indicating that the Department believes that ERISA requires fiduciaries to vote every proxy. These commenters requested confirmation of the Department’s view.

Other commenters opposed the rescission and viewed the NPRM as creating a presumption that all proxies should be voted. A commenter stated that many small plans abstain from proxy votes because performing the required due diligence would be inordinately expensive. Several commenters criticized that a presumption that all proxies should be voted will lead fiduciaries to further rely on proxy advisory firms, which they view as potentially harmful to plans because, according to these commenters, proxy advisory firms have conflicts of interest and base their votes on noneconomic ESG policy-driven goals. Some commenters also opposed the rescission because they believe language in the regulation was necessary because some fund managers believed they were obliged to vote proxies on all matters, which resulted either in the fund managers employing significant assets to explore the issues implicated in the matters, or in their relying on proxy advisory services to decide for them how to vote.

After considering the comments, the Department has decided to rescind the “not required to vote every proxy” language as proposed. The Department’s longstanding view of ERISA is that proxies should be voted as part of the process of managing the plan’s investment in company stock unless a responsible plan fiduciary determines

voting proxies may not be in the plan’s best interest (e.g., in cases when voting proxies may involve exceptional costs or unusual requirements, such as in the case of voting proxies on shares of certain foreign corporations).⁶⁸ This position recognizes the importance that prudent management of shareholder rights can have in enhancing the value of plan assets or protecting plan assets from risk. However, as explained in the preamble to the NPRM, the removal of the language is not meant to indicate that fiduciaries must always vote proxies or engage in shareholder activism.⁶⁹ Prudent fiduciaries should take steps to ensure that the cost and effort associated with voting a proxy is commensurate with the significance of an issue to the plan’s financial interests. The solution to proxy-voting costs is not abstention, but is, instead, for the fiduciary to be prudent in incurring expenses to make proxy decisions and, wherever possible, to rely on efficient structures (e.g., proxy voting guidelines, proxy advisors/managers that act on behalf of large aggregates of investors, etc.). With regard to commenters’ concerns about fiduciaries’ reliance on proxy advisory firms, the Department notes that, as discussed below, the final rule retains requirements relating to the prudent selection and monitoring of services providers to advise or assist with the exercise of shareholder rights. In order to satisfy that provision, fiduciaries would be expected to assess the qualifications of the provider, the quality of services offered, and the reasonableness of fees charged in light of the services provided. A fiduciary’s process also should be designed to

⁶⁸ 81 FR 95879, 81 (“The essential point of IB 94–2, however, was to articulate a general principle that a fiduciary’s obligation to manage plan assets prudently extends to proxy voting. As such, IB 94–2 properly read was meant to express the view that proxies should be voted as part of the process of managing the plan’s investment in company stock unless a responsible plan fiduciary determined that the time and costs associated with voting proxies with respect to certain types of proposals or issuers may not be in the plan’s best interest.”). See also IB 94–2, 59 FR 38861, 63 (July 29, 1994) (“The fiduciary obligations of prudence and loyalty to plan participants and beneficiaries require the responsible fiduciary to vote proxies on Issues that may affect the value of the plan’s investment. Although the same principles apply for proxies appurtenant to shares of foreign corporations, the Department recognizes that in voting such proxies, plans may, in some cases, incur additional costs. Thus, a fiduciary should consider whether the plan’s vote, either by itself or together with the votes of other shareholders, is expected to have an effect on the value of the plan’s investment that will outweigh the cost of voting. Moreover, a fiduciary, in deciding whether to purchase shares of a foreign corporation, should consider whether the difficulty and expense in voting the shares is reflected in their market price.”).

⁶⁹ 86 FR 57281.

avoid self-dealing, conflicts of interest or other improper influence.⁷⁰ Fiduciaries additionally should take steps to ensure they are fully informed of potential conflicts of proxy advisory firms and the steps such firms have taken to address them.⁷¹ To the extent relevant, fiduciaries should review the proxy voting policies and proxy voting guidelines and the implementing activities of the person being selected. If a fiduciary determines that the recommendations and other activities of such person are not being carried out in a manner consistent with those policies and/or guidelines, then the fiduciary should take appropriate action in response. The Department further notes that in 2020, the U.S. Securities and Exchange Commission adopted final rules that were intended to help ensure that investors who use proxy voting advice receive more transparent, accurate, and complete information on which to make their voting decisions.⁷² Information required to be provided pursuant to those final rules also may be useful to responsible plan fiduciaries relying on recommendations from proxy advisory firms.

(b) Removal of Specific Recordkeeping Requirement From Paragraph (e)(2)(ii)(E) of the Current Regulation

The Department proposed to eliminate the requirement in paragraph (e)(2)(ii)(E) of the current regulation that, when deciding whether to exercise shareholder rights and when exercising shareholder rights, plan fiduciaries must maintain records on proxy voting activities and other exercises of shareholder rights. The Department was concerned that the provision appeared to treat proxy voting and other exercises of shareholder rights differently from other fiduciary activities and might create a misperception that proxy voting and other exercises of shareholder rights are disfavored or carry greater fiduciary obligations, and therefore greater potential liability, than other fiduciary activities. Such a misperception could be harmful to plans, as it could potentially chill plan fiduciaries from exercising their right or result in

⁷⁰ See 85 FR 81669; see also Department of Labor Information Letter to Diana Orantes Ceresi (Feb. 19, 1998).

⁷¹ See “Selecting and Monitoring Pension Consultants—Tips for Plan Fiduciaries” <https://www.dol.gov/sites/dolgov/files/EBSA/about-ehsa/our-activities/resource-center/fact-sheets/selecting-and-monitoring-pension-consultants.pdf>.

⁷² See Exemptions from the Proxy Rules for Proxy Voting Advice, Release No. 34–89372 (July 22, 2020), 85 FR 55082 (Sept. 3, 2020). In July 2022, the SEC amended these final rules. See 87 FR 43168 (July 19, 2022).

⁶⁷ IB 94–2, 59 FR 38864; IB 2016–01, 81 FR 95882.

excessive expenditures as fiduciaries over-document their efforts.

Some commenters supported removal of the recordkeeping provision, echoing the Department's concerns stated in the preamble to the NPRM. Several commenters believed there was no need to single out proxy voting for special recordkeeping requirements. Some commenters criticized the recordkeeping requirement as creating a misperception that exercising shareholder rights carry a greater fiduciary obligation than other fiduciary activities and a heightened burden when exercised, which might cause fiduciaries to shy away from exercising shareholder rights or incur unnecessary compliance expenses when doing so. A commenter criticized the specific recordkeeping requirement as creating a new barrier and extra expense, without justification. Several commenters were of the view that the general framework of ERISA is sufficient to govern the recordkeeping requirements for proxy voting.

Other commenters opposed removal of the documentation requirement and suggested that it be retained in the regulation. A commenter indicated that removing the documentation provision deprives participants and beneficiaries of information they may use to evaluate whether fiduciaries are acting in their best interest for their exclusive benefit. Another commenter similarly suggested that eliminating the requirement impedes the ability of participants to monitor plan fiduciaries. Another commenter further opined that enhanced documentation would help to ensure that ERISA plan proxies are being voted only in a manner that is in the articulable financial interest of plan beneficiaries.

The Department is not persuaded by commenters to retain the specific recordkeeping provision. The Department does not disagree with the need for proper documentation of fiduciary activity. To the contrary, in previous guidance on proxy voting, the Department indicated that section 404(a)(1)(B) requires proper documentation both of the activities of the investment manager and of the named fiduciary of the plan in monitoring the activities of the investment manager.⁷³ Specifically,

⁷³ See Letter to Helmuth Fandl, Chairman of the Retirement Board, Avon Products, Inc. 1988 WL 897696 (Feb. 23, 1988) (“[I]t is the opinion of the Department that section 404(a)(1)(B) requires proper documentation of the activities of the investment manager and of the named fiduciary of the plan in monitoring the activities of the investment manager. Specifically, with respect to proxy voting, this would require the investment manager or other

with respect to proxy voting, this would require the investment manager or other responsible fiduciary to keep accurate records as to the voting of proxies. It is the Department's view that in order for the named fiduciary to carry out the fiduciary's responsibilities under ERISA section 404(a), the fiduciary must be able to review periodically not only the voting procedure pursuant to which the investment manager votes the proxies appurtenant to plan-owned stock, but also the actions taken in individual situations so that a determination can be made whether the investment manager is fulfilling their fiduciary obligations in a manner which justifies the continuation of the management appointment. In context, however, the Department takes note of, and to a large extent agrees with, the commenters' concern that the current regulation could be viewed by some as treating proxy voting and other exercises of shareholder rights differently from other fiduciary activities and may create a misperception that proxy voting and other exercises of shareholder rights are disfavored or carry greater fiduciary obligations, and therefore greater potential liability, than other fiduciary activities. Because this misperception could be harmful to plans, as it could potentially chill plan fiduciaries from exercising their rights or result in excessive expenditures as fiduciaries over-document their efforts, the Department has concluded it is appropriate to rescind this provision in the current regulation.

(c) Removal of Specific Monitoring Requirement From Paragraph (e)(2)(iii) of the Current Regulation

As discussed above, the Department proposed to eliminate paragraph (e)(2)(iii) of the current regulation, which set out specific monitoring obligations where the authority to vote proxies or exercise shareholder rights has been delegated to an investment manager or proxy voting firm and

responsible fiduciary to keep accurate records as to the voting of proxies.”); *see also* Interpretive Bulletin IB 94-2 (July 29, 1994) 59 FR 38860, 63 (“It is the view of the Department that compliance with the duty to monitor necessitates proper documentation of the activities that are subject to monitoring. Thus, the investment manager or other responsible fiduciary would be required to maintain accurate records as to proxy voting. Moreover, if the named fiduciary is to be able to carry out its responsibilities under ERISA § 404(a) in determining whether the investment manager is fulfilling its fiduciary obligations in investing plans assets in a manner that justifies the continuation of the management appointment, the proxy voting records must enable the named fiduciary to review not only the investment manager's voting procedure with respect to plan-owned stock, but also to review the actions taken in individual proxy voting situations.”).

proposed to broaden another provision of the regulation that more generally covers selection and monitoring obligations (paragraph (d)(2)(ii)(E) of the proposal). The Department was concerned that the more specific provision relating to providers of certain proxy-related services could be read as creating special monitoring obligations above and beyond the statutory obligations of prudence and loyalty that generally apply to monitoring service providers. In this regard, the Department noted that it had previously indicated in Interpretive Bulletin 2016-01 that the general prudence and loyalty duties under ERISA section 404(a)(1) require a fiduciary to monitor decisions made and actions taken by an investment manager with regard to proxy voting decisions. In addition, the Department had previously indicated that in adopting paragraph (e)(2)(iii) of the current regulation it did not intend to create a higher standard for a fiduciary's monitoring of an investment manager's proxy voting activities than would ordinarily apply under ERISA with respect to the monitoring of any other fiduciary or fiduciary activity.⁷⁴

Some commenters agreed with the Department's proposed elimination of paragraph (e)(2)(iii) of the current regulation. One commenter opined that the specific monitoring requirement in that provision largely duplicated the general obligation in current paragraph (e)(2)(ii)(F), which the commenter viewed as redundant and suggestive that monitoring proxy-related services demand more rigor than required to monitor other service providers. Other commenters similarly observed that the current regulation's specific monitoring requirement may have created an impression that there are special obligations above and beyond the statutory obligations of prudence and loyalty that generally apply to monitoring service providers with respect to proxy voting. Some commenters noted that ERISA's general prudence and loyalty duties already impose a monitoring requirement on fiduciaries, and further expressed the view that monitoring service providers with respect to proxy voting is no different from other fiduciary obligations and should be subject to the

⁷⁴ 85 FR 81670 (“The Department did not intend to create a higher standard for a fiduciary's monitoring of an investment manager's proxy voting activities than would ordinarily apply under ERISA with respect to the monitoring of any other fiduciary or fiduciary activity. Thus, the Department has revised the provision in the final rule to eliminate the requirement for documentation of the rationale for proxy voting decisions, and instead replaced it with a more general monitoring obligation.”).

same standards. A commenter asserted that there is no basis for heightened monitoring responsibilities when a fiduciary uses the services of a proxy advisory firm, and specifically disagreed with assertions contained in the preamble to the 2020 rule that proxy advisors are prone to factual and/or analytic errors.

Other commenters opposed the elimination of the specific monitoring requirement. A commenter viewed it as reasonable and justified to single out delegated voting authority as particularly deserving of due diligence and prudent monitoring. This commenter believed it appropriate for the regulation to remind fiduciaries of their obligations. Another commenter suggested that the specific monitoring requirement was necessary to protect plan participants. According to the commenter, proxy advisory firms are insufficiently staffed and otherwise ill-suited to conduct the sort of research required under fiduciary law, and demonstrate a history of advising on self-interested and politically motivated grounds instead of on purely financial interests. In this commenter's view, when fund managers rely on the recommendations of these firms, they may commit a violation of their duty of care. Another commenter cautioned that removal of the specific monitoring requirement may create confusion because it would remove the detailed standards fiduciaries must follow when monitoring the proxy voting of investment managers and proxy advisory firms.

The Department is not persuaded by the public comments to retain the specific monitoring provision in paragraph (e)(2)(iii) of the current regulation. Despite the Department's explicit indication, described above, that paragraph (e)(2)(iii) of the current regulation was not intended to create a higher standard in monitoring proxy voting activities of parties delegated such responsibilities, commenters continue to express concerns that paragraph (e)(2)(iii) of the current regulation suggests such heightened obligations. The Department believes it appropriate to resolve lingering doubts by eliminating paragraph (e)(2)(iii) of the current regulation, and broadening paragraph (d)(2)(ii)(E) of the final rule, which sets forth general selection and monitoring obligations, to additionally cover selection and monitoring of any person selected to exercise shareholder rights. The Department believes paragraph (d)(2)(ii)(E) is sufficient to remind fiduciaries of their responsibilities in selecting and monitoring persons selected to exercise

shareholder rights, and is sufficient to protect the interests of plan participants and beneficiaries. With respect to concerns that removal of paragraph (e)(2)(iii) of the current regulation would eliminate detailed standards that fiduciaries must follow in monitoring the proxy voting of investment managers and proxy advisory firms, the Department notes that paragraph (e)(2)(iii) of the current regulation merely references monitoring activities relating to shareholder rights for consistency with the regulation. In the Department's view, a fiduciary's obligations with respect to monitoring a service provider would include measures to ascertain the service provider's compliance with ERISA and the terms of the plan.

(d) Provisions of Paragraph (d)(2)(ii) of the Final Rule

Paragraph (d)(2)(ii) of the final rule, like the NPRM and the current regulation, sets forth specific standards for fiduciaries to meet when deciding whether to exercise shareholder rights and when exercising shareholder rights. The requirements in paragraphs (d)(2)(ii)(A) through (E) of the final rule are intended to confirm and restate what the prudence and loyalty obligations of ERISA section 404(a)(1)(A) and (B) would require in this context. Paragraph (d)(2)(ii)(A) of the final rule is the same as proposed except for a change in cross-reference to paragraph (b)(4). It provides that a fiduciary must act solely in accordance with the economic interest of the plan and its participants and beneficiaries, in a manner consistent with paragraph (b)(4) of the final rule. A commenter requested confirmation of statements in prior non-regulatory guidance that in deciding whether to vote a proxy the fiduciary should determine whether "the plan's vote, either by itself or together with the votes of other shareholders, is expected to have an effect on the value of the plan's investment that warrants the additional cost of voting."⁷⁵ In the commenter's view, without such confirmation, the "solely in the interest" requirement of paragraph (d)(2)(ii)(A) may limit plan voting where a plan holds a relatively small investment that, on its own, might not affect the outcome of a vote. In response, the Department confirms that in making decisions regarding the exercise of a plan's shareholder rights, a fiduciary's analysis may include consideration of the effects of the plan's exercise, either by itself or together with

the exercise of rights of other shareholders.

Paragraph (d)(2)(ii)(B) of the final rule is adopted as proposed. It requires that when deciding whether to exercise shareholder rights and when exercising shareholder rights, a fiduciary must consider any costs involved. The Department received no comments on this provision.

Paragraph (d)(2)(ii)(C) of the proposal provided that a fiduciary must not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to any other objective, or promote benefits or goals unrelated to those financial interests of the plan's participants and beneficiaries. A commenter suggested deleting the clause "or promote benefits or goals unrelated to those of financial interests of the plan's participants and beneficiaries" from paragraph (d)(2)(ii)(C). The commenter reasoned that where a particular exercise of a shareholder right would not directly affect shareholder value, the language could be read to prohibit such exercise. Another commenter with the same request explained that the deletion would clarify that fiduciaries are not required to undertake a burdensome economic analysis before voting proxies. This commenter opined that in some cases, it may be even less expensive to cast the vote than speculate whether the vote in question "promotes" benefits or goals unrelated to those financial interests of the plan's participants and beneficiaries. Both commenters opined that voting under these circumstances would be allowed under a tiebreaker standard. Other commenters raised concerns regarding increased potential for litigation more generally and requested that the Department factor that potential into all decisions under the final regulation; in this context, that concern might present as a dispute over whether and the extent to which any particular vote was an affirmative "promotion" of an impermissible goal as opposed to a vote on a matter the outcome of which might confer an ancillary benefit on a stakeholder other than the plan.

The Department was persuaded by the commenters' suggestion to remove the clause from paragraph (d)(2)(ii)(C). On review, the Department has concluded that the clause at issue serves no independent function, in terms of adding protections to plan participants, that is not already served by paragraph (d)(2)(ii)(A) (requirement to act "solely in accordance with the economic interests of the plan") and the first clause of paragraph (d)(2)(ii)(C)

⁷⁵ Interpretive Bulletin 2016-01, 81 FR 95882 at 95883.

(requirement “not to subordinate the interests of participant and beneficiaries in their retirement income or financial benefits under the plan to any other objectives”) of the final rule. In addition to being unnecessary, as pointed out by the commenters, the clause is easily misconstrued as suggesting or implying an affirmative duty on plan fiduciaries, above and beyond those duties contained in the other two paragraphs already mentioned, that requires the fiduciaries to do something further to investigate and ensure that their votes or other exercises do not promote objectives or goals unrelated to the financial interests of the plan, or perform an analysis of each vote’s benefit. The Department sees no reason to impose such additional duties, with their attendant costs and potential for litigation, when the other two provisions mentioned are fully adequate to protect the interests of plan participants.

The purpose of the clause was to ensure that a fiduciary does not exercise proxy voting and other shareholder rights with the goal of advancing nonpecuniary goals unrelated to the financial interests of the plan’s participants and beneficiaries so long as it does not result in increased costs to the plan or a decrease in value of the investment.⁷⁶ This clause thus dovetailed with a longstanding position of the Department that ERISA prohibits plan fiduciaries from expending trust assets to promote myriad public policy preferences.⁷⁷ The final rule’s removal of the clause at issue does not constitute a rejection of this principle. However, with respect to the concern that the fiduciary must determine that an exercise of shareholder rights *would directly* affect shareholder value, the Department’s historical view has been that ERISA’s fiduciary obligations of prudence and loyalty require the responsible fiduciary to vote proxies on issues that *may* affect the value of the plan’s investment.⁷⁸ With respect to the commenters referring to the tiebreaker test, although that test is not applicable in this context, the Department further notes that when a plan fiduciary

exercises voting authority, a violation of paragraph (d)(2)(ii)(C) of the final rule would not occur merely because stakeholders other than the plan would potentially benefit along with the investing plan.

Paragraph (d)(2)(ii)(D) of the final rule requires that when deciding whether to exercise shareholder rights and when exercising shareholder rights, a fiduciary must evaluate relevant facts that form the basis for any particular proxy vote or other exercise of shareholder rights. The provision is the same as proposed, except that the Department has substituted the term “relevant” for “material” for purposes of consistency throughout the regulation, as discussed above.

Paragraph (d)(2)(ii)(E) of the final rule is being adopted as proposed, and requires that a fiduciary must exercise prudence and diligence in the selection and monitoring of persons, if any, chosen to exercise shareholder rights or otherwise to 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. As discussed above, this provision covered obligations that were set forth in paragraphs (e)(2)(ii)(F) and (e)(2)(iii) of the current regulation. The provision is essentially a restatement of the general fiduciary obligations that apply to the selection and monitoring of plan service providers, articulated in the context of fiduciary and other service providers that exercise shareholder rights, or advise or assist with exercises of shareholder rights.

A commenter requested that the Department delete the list of services—“research and analysis, recommendations regarding proxy votes, administrative services with voting proxies, and recordkeeping and reporting services”—from the provision. The commenter was concerned that codifying an itemized list of duties that, according to the commenter, fiduciaries routinely delegate to investment managers and proxy voting firms may cause confusion or uncertainty over regulatory expectations regarding any delegation of these fiduciary responsibilities to a third party. The Department has not accepted this comment, and notes that this paragraph is focused on fiduciary duties of prudence and loyalty under ERISA section 404(a)(1)(A) and (B) in the selection and monitoring of particular service providers, and is not attempting to limit in any way the types of services that a plan or plan fiduciary may utilize

in connection with exercising shareholder rights.

Another commenter requested that the Department clarify that fiduciaries are not required to monitor every proxy vote or second-guess other fiduciaries’ specific proxy voting decisions, unless the fiduciary knows or should know the designated fiduciary is violating ERISA with their proxy voting procedures. Whether a fiduciary has complied with its obligations under paragraph (d)(2)(ii)(E) depends on the surrounding circumstances. The Department does not believe that a fiduciary would generally be required to monitor each vote or second-guess other fiduciaries’ decisions. To the extent applicable, a fiduciary would be expected to review the proxy voting policies and/or proxy voting guidelines and the implementing activities of the person being selected to exercise votes. If a fiduciary determines that the activities of such person are not being carried out in a manner consistent with those policies and/or guidelines, then the fiduciary will be expected to take appropriate action in response.⁷⁹

(3) Paragraph (d)(2)(iii)

Paragraph (d)(2)(iii) of the proposal stated that a fiduciary may not adopt a practice of following the recommendations of a proxy advisory firm or other service provider without a determination that such firm or service provider’s proxy voting guidelines are consistent with the fiduciary’s obligations described in provisions of the regulation. This provision was based on paragraph (e)(2)(iv) of the current regulation, which was intended to address specific concerns involving fiduciaries’ use of proxy advisory firms and similar service providers, including use of automatic voting mechanisms relying on proxy advisory firms.

Some commenters viewed paragraph (d)(2)(iii) as largely unnecessary because, in their view, a fiduciary’s review of a service provider’s proxy voting guidelines would already be required as part of the fiduciary’s compliance with ERISA’s prudence and loyalty requirements in the selection of a service provider. Some commenters moreover cautioned that paragraph (d)(2)(iii) could be construed as suggesting that monitoring proxy-related services demands more rigor than required to monitor other service providers. A commenter noted that the provision requires a specific determination when a fiduciary “adopts a practice of following the recommendations of a proxy advisory firm or other service provider,” and thus

⁷⁶ 85 FR 816658, 67 (Dec. 16, 2020).

⁷⁷ 81 FR 95879, 81 (Dec. 29, 2016) (preamble to IB 2016–01) (“The Department has rejected a construction of ERISA that would render ERISA’s tight limits on the use of plan assets illusory and that would permit plan fiduciaries to expend trust assets to promote myriad public policy preferences. Rather, plan fiduciaries may not increase expenses, sacrifice investment returns, or reduce the security of plan benefits in order to promote collateral goals.”); Advisory Opinion Nos. 2008–05A (June 27, 2008) and 2007–07A (Dec. 21, 2007).

⁷⁸ See Interpretive Bulletin 94–2, 59 FR 38860; Interpretive Bulletin 2016–01, 81 FR 95879.

⁷⁹ See 85 FR 81669.

would establish an additional vague and heightened burden that is unnecessary and a potential deterrent to informed, responsible shareholder engagement.

Other commenters viewed the provisions as necessary. One commenter opined that it is crucial that ERISA fiduciaries have a full understanding of the proxy advisory firm's guidelines and recommendations before relying on their advice. In this commenter's view, robo-voting presents clear risks to participants given proxy advisory firms' one-size-fits-all policies. Another commenter expressed the view that evaluation of climate risks is extremely difficult, and criticizes proxy advisors as not being particularly well-suited to perform climate analysis. Furthermore, as described above, a number of other commenters expressed concerns about proxy advisory firms' conflicts and quality of services.

In proposing paragraph (d)(2)(iii), the Department did not propose to make any changes to requirements contained in the corresponding provision of the current regulation, paragraph (e)(2)(iii). The Department is not persuaded that any of the requirements should be eliminated or otherwise modified. We note that paragraph (d)(2)(iii) deals with a fiduciary's process for making proxy voting decisions (*i.e.*, the reliance on recommendations or advice from a service provider) and does not touch on the fiduciary's obligations with regard to the selection and monitoring of the service providers used. The provision relates to oversight obligations of fiduciaries that essentially automatically rely on a service provider in carrying out the fiduciary's own obligations.⁸⁰ We do not believe that potential misunderstandings as to fiduciary monitoring obligations with respect to providers of proxy-related services, which is addressed in paragraph (d)(2)(ii)(E) of the final rule, is sufficient to justify modification or elimination of paragraph (d)(2)(iii). As a result, paragraph (d)(2)(iii) is being adopted without change.

(c) Paragraph (d)(3)

In recognition of the appropriateness of ERISA fiduciaries' adoption of proxy voting policies to help them more cost effectively comply with their obligations under ERISA and the regulation, paragraph (d)(3) of the proposal carried forward from the current regulation general provisions relating to the adoption of proxy voting policies. The proposal did not, however, carry forward from the current regulation two "safe harbor" policies that could be

used for satisfying the fiduciary responsibilities under ERISA with respect to decisions whether to vote. The first permitted a policy of limiting voting resources to particular types of proposals that the fiduciary has prudently determined are substantially related to the issuer's business activities or are expected to have a material effect on the value of the investment. The second permitted a policy of not voting on proposals or particular types of proposals when the plan's holding in a single issuer relative to the plan's total investment assets is below a quantitative threshold that the fiduciary prudently determines, considering its percentage ownership of the issuer and other relevant factors, is sufficiently small that the matter being voted upon is not expected to have a material effect on the investment performance of the plan's portfolio. The Department proposed rescinding these safe harbors because it lacked confidence that they were necessary or helpful in safeguarding the interests of plan participants and beneficiaries. The Department also was concerned that, in conjunction with other provisions in the current regulation, the safe harbors could be construed as regulatory permission for plans to broadly abstain from proxy voting without properly considering their interests as shareholders.

(1) Rescission of Safe Harbors From Paragraphs (e)(3)(i)(A) and (B) of the Current Regulation

The Department received a range of comments on the proposed rescission of the safe harbor policies. Some commenters agree with the Department's general concern that, by their nature safe harbors can invite adoption, which makes it important that the safe harbors be in participants' best interest. In this regard, some commenters generally asserted that the safe harbors may encourage fiduciaries to limit their proxy voting in ways that harm participants and beneficiaries. Also, without identifying a particular safe harbor, some commenters asserted that the proxy voting rule adopted in 2020 provided no justification as to how the safe harbors were consistent with ERISA's duties of loyalty and prudence. Another commenter opined that because a decision by an ERISA plan to not vote effectively cedes voting power to other shareholders, it should only be permitted on a case-by-case basis rather than pursuant to a general safe harbor to refrain from voting. One commenter opined that neither safe harbor was particularly helpful, and there is little evidence that a material number of

fiduciaries are currently relying on them. Another commenter cautioned that the safe harbor provisions could be interpreted as best-practice and encourage shareholders to follow those examples, instead of their established practices in line with stated investment policies and obligations under ERISA.

Commenters also raised specific concerns on the safe harbors. With respect to the first safe harbor, a commenter expressed the view that a policy to vote only particular types of proposals, depending on the scope of the policy, may be too limited to capture all relevant proposals. Another commenter criticized the first safe harbor as being based on an unsupported premise that certain types of proxy votes are not substantially related to the issuer's business activities or are expected to have a material effect on the value of the investment. The commenter noted that many of the topics that corporate law permits shareholders to have a say on—*e.g.*, election of directors or ratification of auditors—play an important risk mitigation role, and asserted that these types of issues are often prophylactic and do not readily lend themselves to an analysis of whether they will lead to a material effect on the value of a plan investment. The commenter cautioned that the first safe harbor encouraged fiduciaries to pass on these and other proxy matters, and thus created a genuine risk to plan participants' long-term interests.

With respect to the second safe harbor, a commenter expressed concern that a policy to refrain from voting unless the plan holds a concentrated position in a company suggests that diversified investors, such as plan fiduciaries, should not have a voice in corporate decisions. Another commenter asserted that the second safe harbor was never fully explained or substantiated, and viewed it as being premised on the notion that not voting at most, or perhaps all, meetings a plan would be entitled to vote at would be in the best interest of participants.

Other commenters neither supported nor opposed elimination of the safe harbors, but emphasized that proxy voting policies in general are useful to fiduciaries in making proxy voting decisions. One commenter requested confirmation from the Department that removal of the safe harbors from the regulation would not preclude, and should not be interpreted as discouraging, the adoption of such policies in appropriate circumstances. The commenter indicated that for many types of investment strategies, limiting voting resources, for example, to those

⁸⁰ 85 FR 81671.

matters that are expected to have a material effect on the value of the investment is the prudent course of action. According to the commenter, in other cases adopting a policy to refrain from voting on proposals, or particular types of proposals, based on a prudently determined quantitative threshold could be in the best interest of plan participants and beneficiaries.

Other commenters opposed rescission of the safe harbors. A commenter stated that the safe harbors appropriately recognized instances in which proxy voting would not be expected to have economic effect. The commenter cautioned that without the safe harbors, fiduciaries find the path of least resistance in hiring proxy advisory firm to vote all proxies, which would result in promoting ESG policies and raising a variety of concerns regarding proxy advisory firms, as discussed above.

After considering the public comments, the Department is not persuaded to retain the safe harbors. Taken together, they encourage abstention as the normal course. Regulatory safe harbors tend to be widely adopted and the Department no longer believes it should be promoting abstention with these safe harbors. The Department has never taken the position that ERISA requires fiduciaries to cast a proxy vote on every ballot item. Thus, it follows that abstention or not voting on a matter or matters may be appropriate and not a violation of ERISA, from the Department's perspective. Voting rights, however, are a type of plan asset and, in the Department's view, an important tool to protect the plan's investment. The Department's longstanding view of ERISA is that proxies should be voted as part of the process of managing the plan's investment in company stock unless a responsible plan fiduciary determines voting proxies may not be in the plan's best interest (*e.g.*, in cases when voting proxies may involve out of the ordinary costs or unusual requirements, such as in the case of voting proxies on shares of certain foreign corporations).⁸¹ This position recognizes the importance that prudent management of shareholder rights can have in enhancing the value of plan assets or protecting plan assets from risk. Finally, as to commenters' concerns about reliance on proxy advisory firms and quality of their services, the final rule also retains requirements relating to the prudent selection and monitoring of service

providers to advise or assist with the exercise of shareholder rights.

(2) Provisions of Paragraph (d)(3) of the Final Rule

Paragraph (d)(3)(i) of the proposal provided that in deciding whether to vote a proxy pursuant to paragraphs (d)(2)(i) and (ii) of the proposal, fiduciaries may adopt proxy voting policies providing that the authority to vote a proxy shall be exercised pursuant to specific parameters prudently designed to serve the plan's interest in providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan. Proposed paragraph (d)(3)(i) was based on paragraph (e)(3)(i) of the current regulation, but as discussed above did not retain the current regulation's two safe harbor proxy voting policies. Several commenters expressed general support for the Department's recognition of the usefulness of proxy voting policies to fiduciaries. However, the Department did not receive substantive comment on this provision of the proposal, and it is being adopted without substantive modification.⁸²

Paragraphs (d)(3)(ii) of the proposal required plan fiduciaries to periodically review proxy voting policies adopted pursuant to the regulation. The Department received no comments on this provision of the proposal, and it is being adopted without modification.

Paragraph (d)(3)(iii) of the proposal related to the effect of proxy voting policies adopted pursuant to the regulation, and provided that no proxy voting policies adopted pursuant to paragraph (d)(3)(i) shall preclude submitting a proxy vote when the fiduciary prudently determines that the matter being voted upon is expected to have a material effect on the value of the investment or the investment

⁸² Paragraph (d)(3)(iii) of the final rule uses the term "significant effect on the value of the investment" rather than "material" effect. No substantive change is intended by the revision as the Department believes that "significant" is generally the same as the adjective "material" in this context. The Department recognized this similarity in the preamble to the current regulation, but erroneously concluded then that the term "material" would be more familiar and helpful to ERISA plan fiduciaries. 85 FR 81658, 72 (December 16, 2020). However, as discussed above at section B1.(f) (4) of this preamble, commenters on the NPRM did not agree that the word "material" is a helpful term in this regulatory section because of its varied uses and meanings under accounting conventions, Federal securities laws, and other regulatory regimes. Compare note 44 (in other contexts, the final regulation substitutes "material" with "relevant," but that adjective does not work well here where the focus is on the size of the impact of one thing on another thing as opposed to the closeness of connection between two things).

performance of the plan's portfolio (or investment performance of assets under management in the case of an investment manager) after taking into account the costs involved, or refraining from voting when the fiduciary prudently determines that the matter being voted upon is not expected to have such a material effect after taking into account the costs involved. This provision recognized that, depending on the circumstances, a fiduciary may conclude that the best interests of the plan and its participant and beneficiaries would not be served by following the plan's proxy voting policies in a particular case. In such cases, paragraph (d)(3)(iii) of the proposal ensured that a fiduciary have the needed flexibility to deviate from those policies and take a different approach. The Department received no substantive comments on this provision of the proposal, and it is being adopted without modification. One commenter requested clarification that fiduciaries are not required by this provision to conduct an analysis of each proxy vote to determine whether a fiduciary needs to deviate from the proxy voting policies. The commenter misapprehends the nature of the provision. The provision does not speak, directly or indirectly, to voting frequency or establish obligations with respect to the question of whether or how often plan fiduciaries should be voting proxies. The provision seeks to ensure that plan fiduciaries may safely deviate from the generally governing written instruments as may be needed from time-to-time in circumstances when doing so is in the best economic interest of plan participants. In this way, the provision shields a fiduciary from liability to the extent that a fiduciary deviates from written policies based on the fiduciary's conclusion that a different approach in a particular case is in the economic interests of the plan considering the facts and circumstances.

(d) Paragraph (d)(4)

Paragraphs (d)(4)(i) and (ii) of the proposal, like paragraphs (e)(4)(i) and (ii) of the current regulation, reflect longstanding positions expressed in the Department's prior Interpretive Bulletins.

(1) Paragraph (d)(4)(i)

Paragraph (d)(4)(i)(A) of the proposal stated that the responsibility for exercising shareholder rights lies exclusively with the plan trustee except to the extent that either the trustee is subject to the directions of a named fiduciary pursuant to ERISA section 403(a)(1), or the power to manage,

⁸¹ 81 FR 95879, 81.

acquire, or dispose of the relevant assets has been delegated by a named fiduciary to one or more investment managers pursuant to ERISA section 403(a)(2). Paragraph (d)(4)(i)(B) of the proposal stated that where the authority to manage plan assets has been delegated to an investment manager pursuant to ERISA section 403(a)(2), the investment manager has exclusive authority to vote proxies or exercise other shareholder rights appurtenant to such plan assets in accordance with this section, except to the extent the plan, trust document, or investment management agreement expressly provides that the responsible named fiduciary has reserved to itself (or to another named fiduciary so authorized by the plan document) the right to direct a plan trustee regarding the exercise or management of some or all of such shareholder rights.

A commenter indicated that an increasing number of ERISA plan fiduciaries may choose to retain the ability to instruct the plan's trustee or investment manager to implement a proxy voting policy chosen by the plan fiduciary. The commenter requested that the Department add to paragraph (d)(4)(i)(B) language stating that a named fiduciary may direct an investment manager regarding the exercise or management of shareholder rights. The Department declines to adopt this commenter's request. In the Avon Letter, discussed above, the Department cautioned that ERISA contains no provision that would relieve an investment manager of fiduciary liability for any decision it made at the direction of another person. The commenter did not indicate whether it was requesting a reconsideration of this aspect of the Avon Letter, or guidance on different issues or arrangements than considered in the Avon Letter. In any event, an evaluation of issues related to the direction of a fiduciary investment manager by another person implicates provisions of ERISA, including sections 402, 403, and 405, that are beyond the scope of this rulemaking.

(2) Paragraph (d)(4)(ii)

Paragraph (d)(4)(ii) of the proposal described obligations of an investment manager of a pooled investment vehicle that holds assets of more than one employee benefit plan. The provision provides that an investment manager of such a pooled investment vehicle may be subject to an investment policy statement that conflicts with the policy of another plan. Furthermore, it provided that compliance with ERISA section 404(a)(1)(D) requires the investment manager to reconcile, insofar as possible, the conflicting policies

(assuming compliance with each policy would be consistent with ERISA section 404(a)(1)(D)).⁸³ The provision further stated that, in the case of proxy voting, to the extent permitted by applicable law, the investment manager must vote (or abstain from voting) the relevant proxies to reflect such policies in proportion to each plan's economic interest in the pooled investment vehicle. The provision further provided that such an investment manager may, however, develop an investment policy statement consistent with Title I of ERISA and the regulation, and require participating plans to accept the investment manager's investment policy statement, including any proxy voting policy, before they are allowed to invest. In such cases, a fiduciary must assess whether the investment manager's investment policy statement and proxy voting policy are consistent with Title I of ERISA and the regulation before deciding to retain the investment manager.

The Department received a number of comments indicating generally that investment managers of pooled funds would face operational challenges in reconciling conflicting proxy voting policies of investing plans and voting in a proportional manner, as described in the beginning of proposed paragraph (d)(4)(ii). Commenters indicated that because of these challenges, most investment managers of pooled investments require investing plans to accept the investment manager's policy, which is also contemplated in the latter portions of proposed paragraph (d)(4)(ii). Some commenters suggested that paragraph (d)(4)(ii) could be improved by placing more emphasis on the current common practices that do not require proportional voting (*i.e.*, where investment managers require plans' acceptance of the managers' proxy voting policies prior to investment), and less emphasis on arrangements that require proportional voting, which these commenters believe is rare.

Some commenters requested that the Department broaden proposed paragraph (d)(4)(ii). One commenter requested modification to address the possibility that the responsible named fiduciary may choose to retain the authority to vote proxies or to direct an

⁸³ Section 404(a)(1)(D) of ERISA provides that a fiduciary must discharge its duties with respect to the plan in accordance with the documents and instruments governing the plan insofar as such documents are consistent with the provisions of title I and title IV of ERISA. Under section 404(a)(1)(D), a fiduciary to whom an investment policy applies would be required to comply with such policy unless, for example, it would be imprudent to do so in a given instance.

investment manager regarding the voting of proxies appurtenant to those plan assets that are invested in a pooled investment vehicle. Other commenters requested that the Department extend the provision to separately-managed accounts that are managed by investment managers. This suggestion appears to be based on the common practice of investment managers in single-plan separate account arrangements requiring that plans accept the managers' proxy voting policy prior to investing.

Some commenters requested that the final rule address circumstances where investment managers have not obtained consent from participating plans accepting the manager's investment policy and proxy voting policy prior to initial investment. Commenters requested that the Department allow an investment manager to rely on a "negative consent" procedure, such as by sending a written notice stating that plans will be deemed to have accepted the investment manager's investment policy and proxy voting policy if they continue investing with the investment manager after receiving the notice.

Another commenter suggested that the Department eliminate proposed paragraph (d)(4)(ii) in its entirety and revise proposed paragraph (d)(4)(i)(B) to explicitly cover investment managers for pooled investment vehicles that hold plan assets. According to the commenter, proposed paragraph (d)(4)(ii) could result in conflicting or misinterpreted regulatory expectations. Similar to commenters discussed above, this commenter explained that paragraph (d)(4)(ii) does not reflect current industry standard practice followed by investment managers for collective investment funds and other pooled investment vehicles that hold ERISA plan assets. In particular, it stated that it was not aware of any collective investment fund or other pooled investment vehicles that did not have their own investment objectives, guidelines, and/or policies that must be accepted as a condition for investment. The commenter further suggested that if a national bank trustee of a collective investment fund, in managing the fund's portfolio, attempts "to reconcile, insofar as possible, the conflicting [investment] policies [of plans]," this may inevitably favor some plans over others. The commenter raised the question as to whether this may be inconsistent with Office of the Comptroller of the Currency expectations regarding that bank's treatment of participants in a pooled investment fund.

The Department is not persuaded to remove paragraph (d)(4)(ii) from the

final rule or make the language changes requested by commenters. Paragraph (d)(4)(ii) of the proposal is identical to paragraph (e)(4)(ii) of the current regulation, and also is similar to guidance relating to pooled investment vehicles that has been consistently part of the Department's prior Interpretive Bulletins since 1994. A number of the issues raised with respect to paragraph (d)(4)(ii) of the proposal, particularly relating to difficulties with proportional voting and industry common practices to avoid being subject to proportional voting, were also raised by commenters with respect to paragraph (e)(4)(ii) of the current regulation but not accepted by the Department. As with the current regulation, the Department declines to reorder the provisions within paragraph (d)(4)(ii) of the final rule solely to put more emphasis on the exception to the proportional voting provision. The Department does not interpret the public comments as saying that paragraph (d)(4)(ii) of the NPRM is unworkable, but rather that the popularity of the exception justifies a reorganization of the constituent parts of the paragraph to elevate the prominence of the exception to match common industry practice. The organizational structure of paragraph (d)(4)(ii) of the final rule intentionally begins with the general requirement and is followed by the exception to that requirement—a structure which has been in place for approximately four decades. The Department believes this structure to be sound and logical notwithstanding the current popularity of the exception. In addition, with respect to the commenters' more fundamental suggestions including eliminating paragraph (d)(4)(ii) in its entirety, the NPRM narrowly solicited comments on whether the provision in question should be revised to conform more closely to the Department's prior guidance.⁸⁴ These more fundamental suggestions are well beyond the scope of the solicitation in the NPRM because, if adopted, they would cause paragraph (d)(4)(ii) of the final to diverge substantially from the prior guidance. Also, as discussed above, issues relating to a named fiduciary's direction of an investment manager with respect to voting decisions implicate provisions of ERISA beyond the scope of this rulemaking. Although the Department declines to extend paragraph (d)(4)(ii) of the final rule to include managers of separately managed accounts, we note that there is nothing in ERISA that precludes an investment manager from requiring a plan fiduciary to accept the

investment manager's proxy voting policies before agreeing to become a plan investment manager. With regard to requests for approval of "negative consent" procedure for adoption of proxy policies by plans with current investments in a pooled investment vehicle, the Department believes the later applicability date of paragraph (d)(4)(ii) should alleviate commenters' concerns.

(e) Paragraph (d)(5)

Paragraph (d)(5) of the NPRM provided that the regulation does not apply to voting, tender, and similar rights with respect to shares of stock that, pursuant to the terms of an individual account plan, are passed through to participants and beneficiaries with accounts holding such shares. The Department did not receive comments on this provision, which is being adopted as proposed. Despite this exclusion, participants and beneficiaries are not without ERISA's protections. The Department stresses that plan trustees and other fiduciaries must comply with ERISA's general statutory duties of prudence and loyalty provisions with respect to the pass through of votes to plan participants and beneficiaries. In doing so, however, plan fiduciaries may continue to rely on the Department's prior guidance with respect to such participant-directed voting, including 29 CFR 2550.404c-1 (implementing ERISA section 404(c)(1) to participant-directed pass-through voting) and interpretive letters.⁸⁵

5. Section 2550.404a-1(e)—Definitions

Paragraph (e) of the final rule provides definitions and is unchanged from the proposal and current regulation. Under paragraph (e)(1) of the final rule, "investment duties" means any duties imposed upon, or assumed or undertaken by, a person in connection with the investment of plan assets which make or will make such person a fiduciary of an employee benefit plan or which are performed by such person as a fiduciary of an employee benefit plan as defined in section 3(21)(A)(i) or (ii) of ERISA. Paragraph (e)(2) defines the term "investment course of action" as any series or program of investments or actions related to a fiduciary's performance of the fiduciary's investment duties and includes the selection of an investment fund as a plan investment, or in the case of an individual account plan, a designated

investment alternative under the plan. Paragraph (e)(3) defines "plan" to mean an employee benefit plan to which Title I of ERISA applies. Finally, under paragraph (e)(4) of the final rule, the term "designated investment alternative" means any investment alternative designated by the plan into which participants and beneficiaries may direct the investment of assets held in, or contributed to, their individual accounts. The provision further provides that the term "designated investment alternative" shall not include "brokerage windows," "self-directed brokerage accounts," or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan.

6. Section 2550.404a-1(f)—Severability

Paragraph (f) of the final rule, like paragraph (f) of the proposal and paragraph (h) of the current regulation, provides that should a court of competent jurisdiction hold any provision of the rule invalid, such action will not affect any other provision. Including a severability clause describes the Department's intent that any legal infirmity found with part of the final rule should not affect any other part of the rule.

7. Section 2550.404a-1(g)—Applicability Date

The proposed rule did not include an applicability date provision. Some commenters requested that the Department provide a prospective applicability date for all recent changes to the regulation (including both changes made in 2020 as well as amendments to the current regulation made today by the final rule) that is no earlier than the date that would be one year after the Department's publication of this final rule in the **Federal Register**. The commenters indicated that plan sponsors, investment managers, proxy advisory firms, and other fiduciaries need adequate time to, as necessary, review and modify their policies, procedures, and practices to conform to the final rule's requirements.

Some commenters also specifically suggested a need for transition relief or a delayed applicability date with respect to the proxy voting provisions. One commenter requested that the Department retain and extend the delayed applicability date of certain requirements of the regulation as set forth in paragraph (g)(3) of the current regulation. In general, that provision delayed until January 31, 2022, the applicability of the requirements of paragraphs (e)(2)(ii)(D) (evaluation of

⁸⁵ See, e.g., Letter from Deputy Assistant Secretary Lebowitz to Thobin Elrod (Feb. 23, 1989); Letter from Assistant Secretary Berg to Ian Lanoff (Sept. 28, 1995).

material facts that form the basis of a vote), (e)(2)(ii)(E) (maintenance of proxy voting records), (e)(2)(iv) (prohibition against adopting practice of following proxy advisory firm recommendations without determination that firm's voting guidelines consistent with requirements of regulation), and (e)(4)(ii) (responsibilities of investment managers to pooled investment vehicles holding plan assets) of the current regulation.⁸⁶ The commenter noted that investment managers to pooled investment vehicles may have delayed their implementation efforts due to the announcement in March 2021 of the Department's enforcement policy. Others pointed to difficulties faced by investment managers in assuring that investing plans had adequately adopted manager's proxy voting policies as required under paragraph (d)(4)(ii).

After consideration of the comments, the Department has decided to provide a general applicability date of 60 days after publication in the **Federal Register**, but to delay applicability of certain provisions of the final rule's proxy voting provisions until 1 year after the date of publication. The Department is persuaded that a delayed applicability of paragraph (d)(4)(ii) of the final rule is appropriate as it gives fiduciaries of plans invested in pooled investment vehicles additional time for reviewing any proxy voting policies of the investment vehicle's investment manager; and also provides investment managers additional time to determine whether investing plans have adequately adopted their proxy voting policies, as well as assessing and reconciling, insofar as possible, any conflicting policies. The Department also believes it appropriate to delay application of paragraph (d)(2)(iii) to give additional time to plan fiduciaries to review proxy voting guidelines of proxy advisory firms and make any necessary changes in their arrangements with such firms. The Department is providing for a delay of one year as requested by commenters. The Department's March 10, 2021, enforcement statement continues to apply with respect to paragraphs (d)(2)(iii) and (d)(4)(ii) until the delayed applicability date.

Thus, paragraph (g)(1) provides that except for paragraphs (d)(2)(iii) and (d)(4)(ii), the final rule will apply in its entirety to all investments made and investment courses of action taken after January 30, 2023. Paragraph (g)(2)

provides that paragraphs (d)(2)(iii) and (d)(4)(ii) of the final rule will apply on December 1, 2023.

8. Miscellaneous

(a) Constitutional Concerns

A few commenters argue that the proposed rule violates the U.S. Constitution. These commenters contend that the proposal is unconstitutional because permitting fiduciaries to base their investment decisions on any non-pecuniary factors cannot be consistent with ERISA and thus rewrites the statute, which is the sole responsibility of Congress. As a result, they argue that the Department violates the separation of powers imposed by the Constitution.

The Department does not agree that the final rule rewrites ERISA or violates the Constitution. Congress has given the Secretary of Labor authority to promulgate regulations that interpret and fill up the details in the fiduciary duties under ERISA section 404, including the duties of prudence and loyalty.⁸⁷ The Department here interprets those duties to protect plan participants' financial benefits and strictly prohibits any other goal from subordinating their interests in those benefits. Nothing in the final rule permits a fiduciary, outside of a tiebreaker situation, to base investment decisions on factors irrelevant to a risk and return analysis. The Secretary has maintained these fundamental interpretive principles in its guidance, referenced earlier in this preamble, since 1980 and its first comprehensive guidance in 1994. Moreover, the principles stated in the proposed and final rule, including the tiebreaker, were fundamental aspects of that guidance.

(b) Administrative Procedure Act

In addition, some commenters asserted that the proposed rule was arbitrary and capricious and thus violated the Administrative Procedure Act (APA). The Department is of the view that the final rule comports with the APA.

Several commenters claimed that the NPRM did not engage in reasoned decision-making, did not look at all aspects of the problem, and did not properly consider the costs to participants and beneficiaries. These commenters, for instance, characterized the NPRM as arbitrarily and capriciously focused on clarifying that ERISA permits ESG considerations in

plan investments at the expense of protecting participants from ESG investing "run amok" or violations of ERISA's duty of loyalty. One commenter contended that the NPRM was more a political action taken because of the popularity of ESG investing rather than a reflection of the current administration's concern about a problem to be addressed. Another commenter espoused that the Department's real agenda was to encourage ESG investing. Yet another asserted that the only reason this rule was being promulgated was because of an Executive order.⁸⁸ And another commenter contended that it could not give input on the Department's view of how its rule promotes retiree welfare, because, the commenter states, the agency gives no reasoning on this point.

The Department disagrees with these contentions. The final rule repeatedly emphasizes that the Department's purpose is to remedy the chilling effect of certain aspects of the 2020 rule and preamble on the consideration of ESG factors. As stated above, the final rule allows such factors to influence investment decisions *only* when relevant to a risk and return analysis or when used as a tiebreaker. By tying the final rule to the statutory language and to the fact that ESG factors may, in some circumstances, affect both returns and risk, the Department has engaged in the essence of reasoned decisionmaking. Moreover, the fact that ESG investing has increased in popularity is another reason why fiduciaries need a clarifying rule and why the Department is promulgating one. This would be the case even if the President had never issued Executive Orders 13990 and 14030. The final rule also emphatically addresses potential loyalty breaches by forbidding subordination of participants' financial benefits under the plan to ESG or any other goal and, likewise, by prohibiting fiduciaries from sacrificing investment return or taking on additional investment risk to promote benefits or goals unrelated to interests of participants and beneficiaries in their retirement or financial benefits under the plan.

A few commenters stated that the NPRM effectively placed a "heavy thumb" on the scale in favor of ESG factors and ignored other options, such as a policy statement or interpretive guidance. At least one commenter also claimed that the NPRM was trying to address a problem that does not exist. The Department has explained its reasons for amending the current regulation, including the chilling effect

⁸⁶ Fiduciaries that are investment advisers registered with the SEC were not able to take advantage of the delayed applicability of paragraphs (e)(2)(ii)(D) and (E). See 85 FR 81676.

⁸⁷ See 29 U.S.C. 1135 (providing that "the Secretary may prescribe such regulations as he finds necessary or appropriate to carry out the provisions of this subchapter").

⁸⁸ E.O. 14030, 86 FR 27967 (May 25, 2021).

caused by, for example, its explicit documentation requirements for investors and the exercising of shareholder rights, and its restrictions on QDIAs, as discussed earlier in this preamble. The Department determined and received confirmation in public comments that features such as these, combined with the overall chilling tone of the current regulation (including its preamble) as it relates to financially beneficial ESG considerations, rendered interpretive guidance under the current regulation insufficient. Rather than placing a thumb on the scale, the final rule removes the current regulation's thumb against ESG strategies. It does this by simply clarifying that ESG factors may be relevant to a risk and return analysis to the same extent as any other relevant factor.

Many commenters expressed concerns that the NPRM language, as one put it, "imposes a de facto mandate" on retirement plan fiduciaries to consider ESG factors and declares that such a presumption would be arbitrary and capricious. The commenters referenced paragraph (b)(2)(ii)(C) of the NPRM stating that the consideration of the projected return of the portfolio relative to the plan's funding objectives "may often require" an evaluation of the economic effects of climate change and other ESG factors. As explained earlier in this preamble, in response to these comments, the Department recognizes that the language as drafted created a misimpression of its intent and has modified the provision to eliminate the "may often require" language altogether.

At least three commenters took issue with the NPRM's use of the term "ESG". They contended that the NPRM failed to define "ESG" factors and that the term "ESG" was too imprecise to serve as a basis for a regulatory standard. Commenters, citing to the November 2020 preamble statement that the term "was not a clear or helpful lexicon for a regulatory standard," claimed the Department changed its position without acknowledging it. One commenter contended that a more precise definition was especially important given the perceived "de facto mandate" in the NPRM. Use of the term ESG in the NPRM was not intended to create a regulatory mandate or standard for compliance, and as stated above, the "may often require" provision has been removed in the final rule. Rather, it was the Department's intent to clarify that ESG factors are no different than other non-ESG relevant risk-return factors. Consequently, the final rule does not define ESG because the precision of terminology is less important than the

Department's fundamental premise that fiduciaries may consider ESG factors—irrespective of the definition of the term "ESG"—when they are relevant to a risk-return analysis to the same extent as any other relevant factor.

One commenter expressed an opinion about the Department's position on negative screening which the commenter defines as excluding certain types of investments from a portfolio based on non-economic or non-pecuniary reasons. The commenter states that the NPRM, if adopted, would change a Departmental position against negative screening, without considering a serious reliance interest on the prior position. The commenter is correct that when promulgating a change in policy, the Department must consider serious reliance interests in a prior policy. The Department never has posited, however, that ERISA imposes a blanket bar against all forms of exclusionary investments. The two Department of Labor (DOL) letters the commenter cites comport. They state that the exclusionary investment first required "an economic analysis of economic consequences" of the exclusion,⁸⁹ or put another way, a "consideration of the economic and financial merit."⁹⁰ Both the NPRM and the final rule are fully consistent and in fact reinforce the position in these letters. Further, as stated in the preamble of the NPRM, the Department long has acknowledged, since the publication of those letters, the potential risk and return attributes of ESG criteria in fiduciary investment decisionmaking and portfolio construction. Thus, there is no change of position in this regard and no reliance interest on any former position to address.

Another commenter stated that the Department has not acknowledged or considered the cost of the risk of "channeling" plan assets into ESG investments given the concerns of misrepresentation highlighted by staff of Division of Examinations of the SEC in its April 2021 Risk Alert on ESG investing. The commenter concluded that the Department's NPRM, if adopted, would be arbitrary and capricious, in part, because of its failure to acknowledge the profound effect of the risk of misrepresentation. This final rule is not intended to channel assets into any particular type of investment. Rather, the intent of the final rule is simply to remove barriers to the

fiduciary's consideration of all financially relevant factors, which may include ESG, as part of a prudent and loyal process of investment decisionmaking. The Department anticipates that fiduciaries will give careful consideration in a meaningful comparison and selection process of ESG investments just as they do with any other type of investment.

The Department also disagrees with the comment that it prejudged the outcome of this rule. Offering a proposed solution to a problem is the foundation of notice and comment rulemaking. Under the APA, policymakers are required to solicit comments on the problem and its proposed solution and to adequately review those comments in the development of the final rule. The changes made to the NPRM in this final rule demonstrate that the Department has not prejudged the rule's outcome. Substantive changes in response to public comments include the elimination of the language that the evaluation of investments "may often require" consideration of ESG factors, the elimination of the list of ESG examples from the regulatory text, and removal of the collateral benefit disclosure requirement.

Some commenters added that the Department failed to identify which investors the 2020 rule confused and did not produce data showing that consideration of ESG factors will sustain or increase plan returns—returns one commenter called "phantom benefits." As amply explained in both the NPRM preamble and here, and as reflected by the Department's longstanding Investment Duties regulation, ensuring that determinations are based on relevant risk and return factors, which may include the economic effects of climate change and other ESG factors, will serve the retirement participants and beneficiaries' financial interests. The Department believes, and many commenters confirmed, the current regulation causes an unwanted chilling effect on the use of climate change and other ESG factors, and therefore is a barrier to that consideration. The Department is not required to produce a record of extensive and detailed data showing the extent to which ESG considerations will grow retirement accounts. The final rule does not require fiduciaries to consider ESG factors to a different extent than any other factors that the fiduciary reasonably determines are relevant to a risk and return analysis. Nor does the APA require the Department to specifically identify investors who were confused by or chilled by the current regulation. As

⁸⁹ Letter to the Honorable Howard M. Metzenbaum from Assistant Secretary Dennis Kass (May 27, 1986).

⁹⁰ Letter to Daniel O'Sullivan from Jeffrey Clayton (Aug. 2, 1982).

previously stated, many commenters—whose identity is public—indicated this concern.

Multiple commenters also questioned the quantitative support for the Department's position. For instance, some commenters contended that the Department's claims about climate change were unsubstantiated. The Department believes it has made reasonable efforts to quantify all aspects of the final rule, and their potential effects, for which data is available. The Department also notes that efforts have been made to qualitatively address those areas where the Department is unable to adequately derive quantitative assessments. Further, the preamble to this final rule (as well as the proposed rule) adequately cites to research supporting the Department's views. Responses to these and related additional comments are discussed later in the Regulatory Impact Analysis (RIA) section of this preamble.

Finally, one commenter asserts *Chevron* deference does not apply to the NPRM because, if adopted, it would be a "major question" in the sense that it would constitute a "decision of vast political and economic significance" and "in the realm of climate." The final rule does not represent one of the rare "extraordinary cases" for which the major questions doctrine compels a "different approach" to analyzing agency authority.⁹¹ Indeed, far from representing a "transformative expansion in [the agency's] regulatory authority,"⁹² the Department has for decades issued guidance addressing how fiduciaries, compliant with ERISA's prudence and loyalty duties, may or may not incorporate various factors into investment and shareholder rights decisions. And even if the major questions doctrine did apply, Congress has provided clear authorization to issue the final rule, including by authorizing the Secretary to "prescribe such regulations as he finds necessary or appropriate to carry out the provisions of" the subchapter encompassing fiduciary responsibilities.⁹³

Finally, as stated in the NPRM, this final rule does not undermine serious reliance interests on the part of fiduciaries selecting investments and investment courses of action or exercising shareholder rights.⁹⁴ This final rule does not upend longstanding

standards governing the selection of investments and investment courses of action or the exercise of shareholder rights. Instead, it addresses new policies included in a recently promulgated regulation. Further, the Department stayed its enforcement of the current regulation shortly after its effective date and before all portions were applicable. Consequently, the Department concludes any serious reliance interest in the changes introduced by the current regulation in 2020 is unlikely and does not outweigh the Department's good reasons for change.

IV. Regulatory Impact Analysis

This section of the preamble analyzes the regulatory impact of the final rule in 29 CFR 2550.404a–1. As explained earlier in this preamble, the final rule clarifies the legal standard imposed by sections 404(a)(1)(A) and 404(a)(1)(B) of ERISA with respect to the selection of a plan investment or, in the case of an ERISA section 404(c) plan or other individual account plan, a designated investment alternative under the plan, and with respect to the exercise of shareholder rights, including proxy voting.

The primary benefit of the final rule is to clarify legal standards and prevent confusion among stakeholders. The Department has heard from stakeholders that the current regulation, and investor confusion related to the regulation, has had a chilling effect on appropriate use of climate change and other ESG factors in investment decisions, even in circumstances allowed by the current regulation. Based on stakeholder feedback, the Department has determined that aspects of the current regulation could deter plan fiduciaries from: (a) taking into account climate change and other ESG factors when they are relevant to a risk and return analysis, and (b) engaging in proxy voting and other exercises of shareholder rights when doing so is in the plan's best interest. If these concerns with the current regulation were left unaddressed, the regulation would have (a) a negative impact on plans' financial performance as they avoid using climate change and other ESG considerations in investment analysis even when directly relevant to the financial merits of the investment, and (b) a negative impact on plans' financial performance as they shy away from proxy votes and shareholder engagement activities that are economically relevant. The final rule's clarification of the relevant legal standards is intended to address these negative impacts.

The final rule provides cost savings by eliminating the current regulation's

special documentation provisions pertaining to the tiebreaker and eliminating its proxy voting safe harbors. In the impact analysis for the current regulation, the Department had estimated that these provisions would impose a regulatory burden. Other benefits include clarifying the tiebreaker standard and clarifying the standards governing QDIAs. All benefits of the amendments are discussed below in section IV.D. As discussed in section IV.E, the final rule will impose costs; however, the costs are expected to be relatively small. Overall, the Department anticipates that the final rule's benefits justify its costs.

The Department has examined the effects of this final rule as required by Executive Order 12866,⁹⁵ Executive Order 13563,⁹⁶ the Congressional Review Act,⁹⁷ the Paperwork Reduction Act of 1995,⁹⁸ the Regulatory Flexibility Act,⁹⁹ section 202 of the Unfunded Mandates Reform Act of 1995,¹⁰⁰ and Executive Order 13132.¹⁰¹

A. Executive Orders 12866 and 13563

Executive Orders 12866 and 13563 direct agencies to assess all costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health, and safety effects; distributive impacts; and equity). Executive Order 13563 emphasizes the importance of quantifying costs and benefits, reducing costs, harmonizing rules, and promoting flexibility.

Under Executive Order 12866, "significant" regulatory actions are subject to review by the Office of Management and Budget (OMB). Section 3(f) of the Executive order defines a "significant regulatory action" as an action that is likely to result in a rule (1) having an annual effect on the economy of \$100 million or more, or adversely and materially affecting a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or state, local, or tribal governments or communities (also referred to as "economically significant"); (2) creating a serious inconsistency or otherwise interfering with an action taken or planned by

⁹⁵ Regulatory Planning and Review, 58 FR 51735 (Oct. 4, 1993).

⁹⁶ Improving Regulation and Regulatory Review, 76 FR 3821 (Jan. 21, 2011).

⁹⁷ 5 U.S.C. 804(2) (1996).

⁹⁸ 44 U.S.C. 3506(c)(2)(A) (1995).

⁹⁹ 5 U.S.C. 601 *et seq.* (1980).

¹⁰⁰ 2 U.S.C. 1501 *et seq.* (1995).

¹⁰¹ Federalism, 64 FR 43255 (Aug. 10, 1999).

⁹¹ *West Virginia v. EPA*, 142 S. Ct. 2587, 2608 (2022) (quoting *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 159 (2000)).

⁹² *Id.* (quoting *Utility Air Regul. Grp. v. EPA*, 573 U.S. 302, 324 (2014)).

⁹³ 29 U.S.C. 1135.

⁹⁴ 85 FR 57272, 57283 (Oct. 14, 2021).

another agency; (3) materially altering the budgetary impacts of entitlement grants, user fees, or loan programs or the rights and obligations of recipients thereof; or (4) raising novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in the Executive order. OMB has determined that this final rule is economically significant within the meaning of section 3(f)(1) of Executive Order 12866. Given the large scale of investments held by covered plans, approximately \$12.0 trillion, changes in investment decisions and/or plan performance may result in changes in returns in excess of \$100 million in a given year.¹⁰² Therefore, below the Department provides an assessment of the potential costs, benefits, and transfers associated with the final rule.

B. Introduction and Need for Regulation

In late 2020, the Department published two final rules dealing with the selection of plan investments and the exercise of shareholder rights, including proxy voting. The Department intended to provide clarity and certainty to plan fiduciaries regarding their legal duties under ERISA section 404 in connection with making plan investments and for exercising shareholder rights. The Department was also concerned that some investment products may be marketed to ERISA fiduciaries based on purported benefits and goals unrelated to financial performance.

Before issuing the 2020 regulation, the Department had periodically issued guidance pertaining to the application of ERISA's fiduciary rules to plan investment decisions that are based, in whole or part, on factors unrelated to financial performance. This nonregulatory guidance consisted of varied statements that led to confusion. Accordingly, the 2020 regulation was intended to provide clarity and certainty regarding the scope of fiduciary duties surrounding such issues.

Responses to the 2020 rules, however, suggest that they may have inadvertently caused more confusion than clarity. Many stakeholders told the Department that the terms and tone of the final rules and preambles increased concerns and uncertainty about the extent to which plan fiduciaries may consider climate change and other ESG

¹⁰² EBSA projected ERISA covered pension, welfare, and total assets based on the 2020 Form 5500 filings with the U.S. Department of Labor (DOL), reported SIMPLE assets from the Investment Company Institute (ICI) Report: The U.S. Retirement Market, Second Quarter 2022, and the Federal Reserve Board's Financial Accounts of the United States Z1 September 9, 2022.

factors in their investment decisions, and that the 2020 rules had chilling effects that would tend to deter consideration of ESG factors and that were contrary to the interests of participants and beneficiaries. Consequently, on March 10, 2021, the Department announced that it would stay enforcement of the 2020 rules pending a complete review of the matter. Subsequently, on May 20, 2021, the President issued Executive Order 14030, entitled "Executive Order on Climate-Related Financial Risk." Section 4 of the Executive order directs the Department to consider suspending, revising, or rescinding any rules from the prior administration that would have barred plan fiduciaries (and their investment-firm service providers) from considering climate change and other ESG factors in their investment decisions related to workers' pensions.¹⁰³ In light of the foregoing confusion among stakeholders, the Department concluded that additional notice and comment rulemaking was necessary to safeguard the interests of participants and beneficiaries in their retirement and welfare plan benefits.

The baseline for purposes of the analysis is a future in which the current regulations are implemented. The baseline does not take into account the fact that the Department stayed enforcement of the current regulations pursuant to the March 10, 2021, enforcement policy, which was after their effective date in January 2021 but before their full applicability date.¹⁰⁴

C. Affected Entities

The clarifications in the final rule will affect subsets of ERISA-covered plans and their participants and beneficiaries. The subset of plans affected by the proposed modifications of paragraphs (b) and (c) of § 2550.404a-1 include those plans whose fiduciaries consider or will begin considering climate change and other ESG factors when selecting investments and the participants in

¹⁰³ See White House Fact Sheet titled *FACT SHEET: President Biden Directs Agencies to Analyze and Mitigate the Risk Climate Change Poses to Homeowners and Consumers, Businesses and Workers, and the Financial System and Federal Government Itself* (May 20, 2021) (stating, "The Executive Order directs the Labor Secretary to consider suspending, revising, or rescinding any rules from the prior administration that would have barred investment firms from considering environmental, social and governance factors, including climate-related risks, in their investment decisions related to workers' pensions.").

¹⁰⁴ U.S. Department of Labor Statement Regarding Enforcement of its Final Rules on ESG Investments and Proxy Voting by Employee Benefit Plans (Mar. 10, 2021), available at www.dol.gov/sites/dolgov/files/ebsa/laws-and-regulations/laws/erisa/statement-on-enforcement-of-final-rules-on-esg-investments-and-proxy-voting.pdf.

those plans. Based on the sources below, the Department estimates that about 20 percent of plans will be affected by this final rule.

Another subset of affected plans includes ERISA-covered plans (pension, health, and other welfare) that hold shares of corporate stock. This subset of plans will be affected by the proposed modifications to paragraph (d) (relating to proxy voting) of § 2550.404a-1. Some plans will be in both subsets, some in only one subset, and some in neither. There is substantial uncertainty about the number and size of affected plans.

1. Subset of Plans Affected by Proposed Modifications of Paragraphs (b) and (c) of § 2550.404a-1

The Department estimates that 20 percent of plans, both defined contribution (DC) and defined benefit (DB), will be affected by the proposed modifications of paragraphs (b) and (c) of § 2550.404a-1 because their fiduciaries consider or will begin considering climate change or other ESG factors when selecting investments. The administrative data and surveys relied upon for this estimate are discussed below.

According to a survey by the NEPC, LLC (2018), approximately 12 percent of private pension plans (both DB and DC) have adopted ESG investing.¹⁰⁵ A survey conducted by the Callan Institute (2021), which included a greater share of DB plans, found that about 20 percent of private sector pension plans consider ESG factors in investment decisions.¹⁰⁶ In a comment letter on the NPRM, Morningstar estimates that approximately 36 percent of large plans (with at least 100 participants) use ESG information to consider their investments. Their analysis is based on whether a fund's prospectus references considering ESG information when selecting securities. It includes both DB and DC plans.

To focus on ESG investing by participant-directed defined contribution plans, the Department draws from several sources. According to the Plan Sponsor Council of America (PSCA, 2021), about 5 percent of 401(k) and/or profit-sharing ERISA plans offered at least one ESG-themed

¹⁰⁵ Brad Smith and Kelly Regan, *NEPC ESG Survey: A Profile of Corporate & Healthcare Plan Decisionmakers' Perspectives*, NEPC (Jul. 11, 2018), <https://cdn2.hubspot.net/hubfs/2529352/files/2018%2007%20NEPC%20ESG%20Survey%20Results%20.pdf>.

¹⁰⁶ 2021 ESG Survey, Callan Institute (2021), <https://www.callan.com/e508ca6d-4014-4c99-b0aa-9fb15170bb18>.

investment option in 2020.¹⁰⁷ The PSCA survey was cited by several commenters on the NPRM. NEPC (2022) surveyed DC plans, the vast majority of which were in the private sector, and found that 6 percent of DC plans in 2020 had at least one fund labeled as “socially responsible” or “ESG.”¹⁰⁸ Vanguard’s administrative data for 2021 indicated that approximately 13 percent of DC plans offered one or more “socially responsible” funds.¹⁰⁹ Moreover, about 30 percent of participants were offered at least one “socially responsible” fund, and of those participants, 6 percent were using these funds. In a comment letter received on the 2020 NPRM *Financial Factors in Selecting Plan Investments*, Fidelity Investments reported that approximately 14.5 percent of corporate DC plans with fewer than 50 participants offered an ESG option, and that the figure is higher for large plans with at least 1,000 participants.

While survey and administrative data is the best information available, it is not perfect. For instance, a plan fiduciary responding to a survey likely bases their answer on whether the plan offers an investment with a name indicating it is a “sustainable” fund or with advertising emphasizing that it pursues ESG. If the plan offers a fund that does not have these characteristics, even if the asset manager factors in ESG information, the plan fiduciary may not be aware of this and would respond to a survey by saying the plan does not consider any ESG factors. To the degree this situation occurs, it would lead to survey data that underestimate the consideration of ESG factors.

It is also likely that ESG investing will increase in the future. Many of the sources above show increases in ESG investing in recent years, and a trend towards ESG investing has also been observed in the wider universe of all investors. A study from Morningstar (2021) shows that between 2018 and 2020, assets under management in sustainable funds increased over three hundred percent.¹¹⁰ Additionally, U.S. SIF (2020) estimates that U.S.-domiciled assets under management using

sustainable investing strategies reached \$17.1 trillion at the start of 2020, an increase of 42 percent since 2018.¹¹¹ The Deloitte Center for Financial Services (2020) estimates that assets under management with mandates related to ESG factors could comprise half of all professionally managed investments in the U.S. by 2025. This study also finds investment managers are likely to launch up to 200 new ESG funds by 2023, more than double the activity in the previous three years.¹¹²

The Department received several comments and resources exploring the perception of ESG investing from investors. A survey of individual investors by the Morgan Stanley Institute for Sustainable Investing (2019) finds that 85 percent of investors overall, and 95 percent of millennial investors, are interested in sustainable investing. About 88 percent of all surveyed investors are “very” or “somewhat” interested in pursuing sustainable investing in 401(k) plans.¹¹³ A survey of consumers between ages 45 and 75 by Schroders (2021) found that 90 percent said that “they invested in ESG options when they were aware of their availability in their DC plan.” Of those who said their plans did not offer ESG investment options or did not know, 69 percent said they would increase their overall contribution rate if they were offered an ESG option.¹¹⁴ A survey conducted by CNBC (2021) finds that “about one-third of millennials often or exclusively use investments that take ESG factors into account, compared to 19 percent of Gen Z, 16 percent of Gen X, and 2 percent of Baby Boomers.”¹¹⁵ A study by Natixis finds that “7 in 10 individual investors believe it is important to make a

positive social impact through their investments.”¹¹⁶

These studies suggest that investor demand for ESG is strong and is poised to increase, given the preferences of younger investors. Taking into account likely future growth, the Department’s best estimate of the share of plans that will be affected by the final rule is 20 percent. This is an increase from the 11 percent estimate in the NPRM; the Department increased the estimate based on updated data, comment letters, and to account for future growth. This is an overall estimate, and it is unclear how the share affected may vary between DB and DC plans. An estimate of 20 percent of plans means that approximately 149,300 plans will be affected.¹¹⁷ The Department estimates that more than 28.5 million participants belong to plans that will be affected.¹¹⁸ The proportion of plan assets actually invested in ESG options, however, may be much less than 20 percent; the PSCA survey indicates that the average participant-directed DC plan has approximately 0.03 percent of its assets invested in ESG funds in 2020.¹¹⁹

2. Subset of Plans Affected by the Modifications to Paragraph (d) of § 2550.404a–1

The final rule, at paragraph (d), will codify longstanding principles of prudence and loyalty applicable to the exercise of shareholder rights, including proxy voting, the use of written proxy voting policies and guidelines, and the selection and monitoring of proxy advisory firms. In particular, paragraph (d) of the final rule will adopt the Department’s longstanding position, which was first issued in guidance in the 1980s, that the fiduciary act of managing plan assets includes the management of voting rights (as well as other shareholder rights) appurtenant to shares of stock. Paragraph (d) of the final rule also eliminates the two safe harbors from paragraphs (d)(3)(i)(A) and (B) of § 2550.404a–1.

Under paragraph (d) of the final rule, when deciding whether to exercise shareholder rights and how to exercise

¹⁰⁷ 64th Annual Survey of Profit Sharing and 401(k) Plans, Plan Sponsor Council of America (2021).

¹⁰⁸ NEPC 2021 Defined Contribution Plan Trends and Fee Survey Results, NEPC (February 2022).

¹⁰⁹ How America Saves 2022, Vanguard (June 2022), https://institutional.vanguard.com/content/dam/inst/vanguard-has/insights-pdfs/22_TL_HAS_FullReport_2022.pdf.

¹¹⁰ Morningstar, “Sustainable Funds U.S. Landscape Report: More Funds, More Flows, and Impressive Returns in 2020” (February 10, 2021), <https://www.morningstar.com/lp/sustainable-funds-landscape-report>.

¹¹¹ US SIF, “US SIF Trends Report Executive Summary: Report on US Sustainable and Impact Investing Trends 2020,” <https://www.ussif.org/files/US%20SIF%20Trends%20Report%202020%20Executive%20Summary.pdf>.

¹¹² Sean Collins and Kristen Sullivan, “Advancing Environmental, Social, and Governance Investing: A Holistic approach for Investment Management Firms” (February 2020), <https://www2.deloitte.com/us/en/insights/industry/financial-services/esg-investing-performance.html>.

¹¹³ Morgan Stanley Institute for Sustainable Investing, “Sustainable Signals: Individual Investor Interest Driven by Impact, Conviction, and Choice” (2019), https://www.morganstanley.com/pub/content/dam/msdotcom/infographics/sustainable-investing/Sustainable_Signals_Individual_Investor_White_Paper_Final.pdf.

¹¹⁴ Schroders, “Schroders US Retirement Survey Results—2021,” <https://www.schroders.com/en/us/defined-contribution/dc/retirement-survey-2021>.

¹¹⁵ Alicia Adamczyk, “Millennials Spurred Growth in Sustainable Investing for Years. Now All Generations are Interested in ESG Options,” CNBC (May 2021), <https://www.cnbc.com/2021/05/21/millennials-spurred-growth-in-esg-investing-now-all-ages-are-on-board.html>.

¹¹⁶ Natixis, “ESG Investing Survey: Investors Want the Best of Both Worlds,” (2019), <https://www.im.natixis.com/us/research/esg-investing-report-2019>.

¹¹⁷ This estimate is calculated as: 20% × 746,610 pension plans = 149,322 pension plans, rounded to 149,300. (Source Private Pension Plan Bulletin: Abstract of 2020 Form 5500 Annual Reports, Employee Benefits Security Administration (2022; forthcoming), Table B1.)

¹¹⁸ *Id.* This estimate is calculated as: 20% × 142.3 = 28.5 million total participants.

¹¹⁹ 64th Annual Survey of Profit Sharing and 401(k) Plans, Plan Sponsor Council of America (2021).

such rights, including the voting of proxies, fiduciaries must carry out their duties prudently and solely in the interests of the participants and beneficiaries and for the exclusive purpose of providing benefit to participants and beneficiaries and defraying the reasonable expenses of administering the plan. An assessment of affected parties follows, but the Department believes that the estimate of affected plans is likely an overestimate.

Paragraph (d) of the final rule will affect ERISA-covered pension, health, and other welfare plans that hold shares of corporate stock. It will affect plans with respect to stocks that they hold directly, as well as with respect to stocks they hold through ERISA-covered intermediaries, such as common trusts, master trusts, pooled separate accounts, and 103–12 investment entities.

Paragraph (d) will not affect plans with respect to stock held through registered investment companies, such as mutual funds, because it will not apply to such

funds' internal management of such underlying investments. Paragraph (d) of the final rule also will not apply to voting, tender, and similar rights with respect to securities that are passed through pursuant to the terms of an individual account plan to participants and beneficiaries with accounts holding such securities.

ERISA-covered plans annually report data on their asset holdings. However, only plans that file the Form 5500 schedule H report their stock holdings as a separate line item (see Table 1). Most plans filing schedule H have 100 or more participants (large plans).¹²⁰ All plans with employer stock report their holdings on either schedule H or schedule I. However, schedule I lacks the specificity to determine if small plans hold employer stock or other employer securities. Approximately 25,900 defined contribution plans and 4,600 defined benefit plans, with approximately 83.6 million participants, filed the schedule H in 2020 and report

holding common stocks or are an Employee Stock Ownership Plan (ESOP). Additionally, 518 health and other welfare plans file the schedule H and report holding common stocks either directly or indirectly. In total, pension plans and welfare plans filing schedule H hold approximately \$2.4 trillion in common stock value.

Common stocks constitute about 28 percent of total assets of those pension plans that are not ESOPs and hold common stock. Out of the 24,100 pension plans that hold common stock and are not ESOPs, about 19,300 plans hold common stock through an ERISA-covered intermediary and approximately 3,300 plans hold common stock directly. A smaller number of plans hold stock both directly and indirectly.¹²¹ In total, information is available on approximately 30,500 pension plans, welfare plans, and ESOPs that hold either common stock or employer stock.

TABLE 1—NUMBER OF PENSION AND WELFARE PLANS REPORTING HOLDING COMMON STOCKS OR ESOP BY TYPE OF PLAN, 2020^a

| Common stock (no employer securities) | Defined benefit | Defined contribution | Total pension plans | Welfare plans | Total all plans |
|---|--------------------|-------------------------|------------------------|---------------|-----------------|
| Direct Holdings Only | 1,059 | 2,228 | 3,288 | 517 | 3,805 |
| Indirect Holdings Only | 2,649 | 16,691 | 19,340 | | 19,340 |
| Both Direct and Indirect | 849 | 645 | 1,494 | 1 | 1,495 |
| Total | 4,558 | 19,564 | 24,122 | 518 | 24,640 |
| ESOP (No Common Stock) | | 5,809 | 5,809 | | 5,809 |
| Common Stock and ESOP | | 574 | 574 | | 574 |
| Total All Plans Holding Stocks | 4,558 | 25,947 | 30,505 | 518 | 31,023 |

^a DOL calculations from the 2020 Form 5500 Pension Research Files.

There are approximately 652,900 small pension plans that hold assets that could be invested in stock.¹²² Given that fewer than 1 percent of small plans file a Schedule H, there is minimal data available about small plans' stock holdings. While most participants and assets are in large plans, most plans are small plans. The Department lacks sufficient data to estimate the number of small plans that hold stock, but the Department expects that many small plans are only exposed to stock through

mutual funds and consequently will not be significantly affected by paragraph (d) of the final rule. For purposes of estimating the number of small plans that will be affected, the Department assumes that five percent of small plans, or approximately 32,600 small pension plans, hold stock.¹²³ In the NPRM, the Department solicited comments on the impact of small plans holding stock only through mutual funds and on the assumption that five percent of small

plans hold stock. No comments were received in response to either inquiry.

The combined effect of these assumptions is an estimate of 63,700 plans, large and small, that will be affected by the final rule pertaining to proxy voting.¹²⁴

While paragraph (d) of this final rule will directly affect ERISA-covered plans that possess the relevant shareholder rights, the activities covered under paragraph (d) will be carried out by responsible fiduciaries on plans' behalf.

¹²⁰ 487 plans with less than 100 participants filed the Form 5500 schedule H and reported holding common stock.

¹²¹ DOL estimates from the 2020 Form 5500 Pension Research Files.

¹²² The Form 5500 does not require these plans to categorize the assets as common stock, so the Department does not know if they hold stock. (Source *Private Pension Plan Bulletin: Abstract of 2020 Form 5500 Annual Reports*, Employee Benefits Security Administration (2022; forthcoming), Table B1.)

¹²³ This estimate is calculated as 652,935 pension plans × 5% = 32,647 plans, rounded to 32,600. To assess the reasonableness of the five percent estimate, the Department looked at the number of pension plans filing the 2020 Form 5500, just above the threshold (100 participants) for needing to file the schedule H. Common stock or employer stock in an ESOP was held by eight percent of pension plans with 100 participants up to 109 participants. Common stock or employer stock in an ESOP was held by twelve percent of pension plans with 110 participants up to 119 participants. While both

percentages are above five percent, the percentage falls as the plan size decreases, suggesting that five percent is a reasonable estimate of the percent of small plans holding common stock or employer stock in an ESOP.

¹²⁴ This estimate is calculated as 30,505 large pension plans holding common stock or employer stock + 518 large health or welfare plans holding common stock or employer stock + 32,647 small pension plans holding stock = 63,670 plans rounded to 63,700.

Many plans hire asset managers to carry out fiduciary asset management functions, including proxy voting. The Department estimates that large ERISA plans use approximately 17,600 different service providers, some of whom provide services related to the exercise of plans' shareholder rights.¹²⁵ Such service providers include trustees, trust companies, banks, investment advisers, investment managers, and proxy advisory firms.¹²⁶ Asset managers hired as fiduciaries to carry out proxy voting functions will be subject to the final rule to the same extent as a plan trustee or named fiduciary. The final rule could indirectly affect proxy advisory firms to the extent that plan fiduciaries opt for customized recommendations about which proxy proposals to vote or how they should cast their vote. Plans' preferences for proxy advice services moreover could shift to prioritize services offering more rigorous and impartial recommendations. These effects may be more muted, however; recent rule amendments by the Securities and Exchange Commission (SEC) may enhance the transparency, accuracy, and completeness of the information provided to clients of proxy advisory firms in connection with proxy voting decisions.¹²⁷

¹²⁵ DOL estimates are derived from the historical Form 5500 Schedule C data. This value reflects the number of entities that have ever been reported with the service codes associated with trustees (individual, bank, trust company, or similar financial institution), plan investment advisory, or investment management.

¹²⁶ A commenter on the proposal for the 2020 rule shared results from a proprietary survey of the largest pension funds and defined contribution plans. The survey finds that approximately 92 percent of the respondents indicated that they have formally delegated proxy voting responsibilities to another named fiduciary and approximately 42 percent of respondents engage a proxy advisory firm (directly or indirectly) to help with voting some or all proxies.

¹²⁷ In September 2019, the SEC issued an interpretation and guidance addressing the application of the proxy rules to proxy voting advice businesses. (See 84 FR 47416). In July of 2020, the SEC adopted amendments to 17 CFR 240.14a-1(l), 240.14a-2(b), and 240.14a-9 concerning proxy voting advice (the "2020 Rule Amendments"). (See 85 FR 55082) On June 1, 2021, SEC Chair Gary Gensler directed SEC staff to consider whether to recommend further regulatory action regarding proxy voting advice. SEC staff were asked to consider whether to recommend that the SEC revisit its 2020 codification of the definition of solicitation as encompassing proxy voting advice, the 2019 Interpretation and Guidance regarding that definition, and the conditions on exemptions from the information and filing requirements in the 2020 Rule Amendments, among other matters. In July, 2022, the SEC adopted final amendments that, among other things, rescinded certain conditions that were adopted in the 2020 Rule Amendments to the availability of certain exemptions from the information and filing requirements of the Federal proxy rules for proxy advisory firms. (See 87 FR 43168)

D. Benefits

The final rule will clarify the legal standard imposed by sections 404(a)(1)(A) and 404(a)(1)(B) of ERISA with respect to the selection of a plan investment or investment course of action, and the exercise of shareholder rights, including proxy voting. As indicated above, the final rule will benefit plans by making clear that plan fiduciaries are permitted to consider risk and return ESG factors and to exercise shareholder rights that may enhance the value of plan investments. The Department is concerned that the current regulation dissuades plan fiduciaries from such considerations and activities even when they are financially relevant to the plan. Prior to the NPRM, stakeholders told the Department that the current regulation had already had a chilling effect on appropriate use of ESG factors in investment decisions. Acting on relevant ESG factors in a manner consistent with the final rule will redound to the benefit of employee benefit plans, participants, and beneficiaries covered by ERISA. The public provided many comments about the proposal and cited many studies and reports which have helped the Department to assess what the effects of the rule will be. The literature examined by the Department generally shows that the consideration of ESG factors can be beneficial to investing in many circumstances. The Department anticipates that the benefits of this final rule will be significant.

1. Benefits of Paragraphs (b) and (c)

Paragraph (b) of the final rule addresses ERISA section 404(a)(1)(B)'s duty of prudence and clarifies how that duty applies to a fiduciary's consideration of an investment or investment course of action. Paragraphs (b)(1) through (3) of the final rule carry forward much of the same regulatory language that has been in place since 1979. The preservation of settled law should minimize new costs attributable to the final rule.

Paragraph (b)(4) addresses uncertainty under the current regulation as to whether a fiduciary may consider ESG factors in making investment decisions under ERISA. This paragraph clarifies that when selecting an investment or investment course of action plan fiduciaries must base their determination on factors that the fiduciary reasonably determines are relevant to a risk and return analysis. Paragraph (b)(4) further clarifies that risk and return factors may, depending on particular facts and circumstances,

include the economic effects of climate change and other ESG factors. The intent of this paragraph is to establish that ESG factors that may be relevant in a risk-return analysis of an investment do not need to be treated differently than other relevant investment factors, and to remove prejudice to the contrary contained in the current regulation. When relevant to a risk and return analysis of an investment, ESG factors may be weighted and factored into investment decisions alongside other relevant factors, as prudently determined by the fiduciary.

For the sake of clarity and to eliminate any doubt caused by the current regulation, the preamble further explains paragraph (b)(4) by providing examples of factors that may be relevant to a fiduciary's risk and return analysis depending on the particular facts and circumstances. For example, such factors may include: (i) climate change-related factors, such as a corporation's exposure to the real and potential economic effects of climate change, including exposure to the physical and transitional risks of climate change and the positive or negative effects of government regulations and policies related to climate change; (ii) governance factors, such as those involving board composition, executive compensation, transparency and accountability in corporate decision-making, as well as a corporation's avoidance of criminal liability and compliance with labor, employment, environmental, tax, and other applicable laws and regulations; and (iii) workforce practices, including the corporation's progress on workforce diversity, inclusion, and other drivers of employee hiring, promotion, and retention; its investment in training to develop its workforce's skill; equal employment opportunity; and labor relations.

To its list of examples in section III.B.1.(f)(2) of this preamble the Department added other examples to emphasize that the examples are merely illustrative, and not intended to limit a fiduciary's discretion to identify factors that are relevant to its risk/return analysis of any particular investment or investment course of action. This expansion of examples is intended to avoid regulatory bias and not favor particular investments or investment strategies. As paragraph (b)(4) explicitly states, whether any particular factor is relevant to a risk and return analysis depends upon the individual facts and circumstances.

Paragraph (c)(1) of the final rule addresses the application of the duty of loyalty under ERISA as applied to a fiduciary's consideration of an

investment or investment course of action. The primary benefit of this provision to plan participants and beneficiaries is that it clarifies in no uncertain terms that a plan fiduciary may not subordinate the interests of participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives, and may not sacrifice investment return or take on additional investment risk to promote benefits or goals unrelated to the interests of participants and beneficiaries in their retirement income or financial benefits under the plan. By ensuring that plan fiduciaries may not sacrifice investment returns or take on additional investment risk to promote unrelated goals, paragraph (c)(1) protects the investment returns that accrue to participants and sponsors of ERISA-covered plans. Over the years, the Department has stated this bedrock principle of loyalty many times in non-regulatory guidance, and this final rule, like the current regulation, incorporates the principle directly into title 29 of the Code of Federal Regulations. This incorporation will result in a higher degree of permanency and certainty for plan fiduciaries, relative to periodic restatements in non-regulatory guidance, and as such is considered a benefit.

Much of the anticipated economic benefits under this final rule is derived from paragraph (b)(4) of the final rule and the examples earlier in section III.B.1.(f)(2) of this preamble and the clarity they provide to plan fiduciaries. In the Department's view, and consistent with the comments of the concerned stakeholders mentioned above, the examples in the preamble should overcome unwarranted concerns about investing in ESG-themed funds that are economically advantageous to plans. Removing this uncertainty is considered a primary benefit of this final rule.

Two comments on the proposal argued against the Department's assertion that the current regulation has had a chilling effect. One argued that the Department did not articulate what confusion it had created, while the other said the Department had failed to demonstrate that it had a negative impact.

However, many comments on the NPRM agreed with the Department's assessment of the impact of the 2020 rule, noting the 2020 rule created confusion on whether ERISA fiduciaries should incorporate ESG factors into their decision-making and that this confusion created a chilling effect. One comment states that the 2020 rule had introduced "significant uncertainty"

and "potential legal liability" for fiduciaries making investment decisions. Some of the commenters assert that the documentation requirement in the 2020 rule could chill investments in ESG assets. According to Lipton (2020), under the 2020 rule it would be harder for 401(k) plans to offer ESG investment options and fewer plan participants would have access to these options.¹²⁸ According to the United Nations Principles for Responsible Investment, the uncertainty in how considerations of ESG factors fall within the legal standard of ERISA has precluded plan fiduciaries from considering ESG factors within their investment analysis.¹²⁹ Avoiding the chilling effects described by these comments and reports will be a benefit to participants and beneficiaries.

As described in the preamble, paragraph (c)(2) of the final rule will replace the tiebreaker provision in the current regulation with a formulation that is intended to be broader. Paragraph (c)(2) provides that if a fiduciary prudently concludes that competing investments or investment courses of action equally serve the financial interests of the plan over the appropriate time horizon, the fiduciary is not prohibited from selecting the investment, or investment course of action, based on collateral benefits other than investment returns. Paragraph (c)(2) of the final rule will not carry forward the documentation requirements contained in paragraphs (c)(2)(i) through (iii) of the current regulation.

Commenters said these requirements are burdensome and have the effect of singling out ESG investments for special scrutiny. Stakeholders point to these special, heightened documentation provisions as casting an unnecessarily negative shadow on investments or investment courses of action that are prudent. Paragraph (c)(2) of the final rule permits fiduciaries to take into account an investment's potential collateral benefits, including potential increases in plan contributions, to break a tie. The Department received several comments citing research that increased access to ESG investment could increase contributions to retirement plans. Avoiding unnecessarily burdensome

¹²⁸ Martin Lipton, "DOL Proposes New Rules Regulating ESG Investments," *Harvard Law School Forum on Corporate Governance* (2020), <https://corpgov.law.harvard.edu/2020/07/07/dol-proposes-new-rules-regulating-esg-investments/>.

¹²⁹ Rory Sullivan, Will Martindale, Elodie Feller, and Anna Bordon, "Fiduciary Duty in the 21st Century," *United Nations Principles for Responsible Investment*, <https://www.unpri.org/download?ac=1378>.

documentation and clarifying the extent to which fiduciaries may factor in collateral benefits to break ties are benefits of the final rule.

Several commenters supported the proposed changes to the tiebreaker. One commenter noted that under the current rule, fiduciaries may only consider the collateral benefit between two investments if the fiduciaries are unable to distinguish between two investments based on pecuniary factors. However, it may be unclear under what circumstances, if any, two investment courses of action would meet the current rule's standard. The proposed rule recognizes that competing investments can equally serve the financial interests of the plan. However, several commenters expressed that the proposed provisions were still too narrow, while other commenters argued that the tiebreaker should be eliminated altogether. One commenter argued that the test was obsolete and additional tests or documentation would increase costs for plan participants and beneficiaries without a corresponding benefit.

Paragraph (c)(3) of the final rule confirms that plan fiduciaries do not violate the paragraph (c)(1) duty of loyalty solely because they take participant preferences into consideration. Plan fiduciaries must ensure that consideration of participant preferences is consistent with the requirements in paragraph (b). This clarification may lead to investment options that are more aligned with employee preferences and that, accordingly, result in increased contributions to the plan and greater retirement savings.

Commenters on the NPRM supported the idea that reflecting participant preferences in investment options has a positive effect on participation and retirement savings, including comments from institutional asset managers and asset custodians. This is supported by a survey conducted by Schroders (2021) of consumers between ages 45 and 75, finding that 69 percent of participants, who said their plans did not offer ESG investment options or did not know, would increase their overall contribution rate if an ESG option was offered.¹³⁰ Commenters also suggested that not considering participant preferences may be detrimental to retirement savings. A few of the commenters argued that participants may not utilize ERISA plans that do not offer investments reflective of their

¹³⁰ Schroders, "Schroders US Retirement Survey Results—2021," <https://www.schroders.com/en/us/defined-contribution/dc/retirement-survey-2021>.

values, resulting in some individuals foregoing saving for retirement or choosing to save outside of a qualified plan.

The current regulation prohibits fiduciaries from adding or retaining any investment fund, product, or model portfolio as a qualified default investment alternative (QDIA) as described in 29 CFR 2550.404c-5 if the fund, product, or model portfolio reflects non-pecuniary objectives in its investment objectives or principal investment strategies. The final rule amends the current regulation to remove the stricter rules for QDIAs, such that, under the final rule, the same standards apply to QDIAs as to investments generally. The Department expects to see an increase in the number of QDIAs that are ESG funds. This will affect many participants since a large and growing share of plans use automatic enrollment. For example, Vanguard administrative data shows that 70 percent of participants in 2021 were in plans with automatic enrollment.¹³¹ It is difficult to obtain data on how many of these participants' accounts were invested in a QDIA.

The clarifications provided by paragraphs (b) and (c) of this final rule relate to the appropriate use of ESG factors by plan fiduciaries in selecting investments or investment courses of action. Outside the ERISA context, investors may choose to invest in funds that promote collateral objectives, and even choose to sacrifice return or increase risk to achieve those objectives. Such conduct, however, would be impermissible for ERISA plan fiduciaries, who cannot sacrifice return or increase risk for the purpose of promoting collateral goals unrelated to the economic interests of plan participants in their benefits.

In the proposal, the Department requested comment on the financial materiality of ESG factors in various investment contexts. In the analysis below, the Department has considered and taken into account the comments received and the resources referenced by commenters as well as other resources that came to its attention. The studies and reports often examine investing circumstances that are outside of ERISA and may not apply to an ERISA context. Several comments on the NPRM criticized the Department's survey of the literature. For example, one commenter asserted that there was an oversampling of studies showing better returns from ESG investing, compared to literature showing lower returns. The comparison between the

various studies cited is difficult, however, as studies differ between whether they consider corporate or investment performance, which benchmarks are considered, the time horizon studied, and how ESG is incorporated into the company or investment strategy. The Department has reviewed the literature received from commenters and summarized the findings.

(a) Challenges of Determining the Relationship Between Performance and ESG Factors

The primary types of ESG portfolio management are integration, negative screening, and positive screening. Integration incorporates ESG factors into the investment analysis and decisions. Screening filters investments based on ESG-related preferences. Negative screening excludes investments based on the investment's sector, issuer, activity, or other ESG criteria; positive screening includes investments based on similar characteristics. Positive screening is often referred to as "best-in-class" investing.¹³²

The Royal Bank of Canada (RBC, 2019) outlines the challenges of comparing studies on ESG. This report divides the research literature on socially responsible investment (SRI) into four categories: index comparison, mutual fund comparison, hypothetical portfolios, and company performance. In their review, they find that research comparing equity SRI and non-SRI indices generally find that equity SRI indices do not underperform traditional indices, with much of the literature finding that SRI indices outperformed traditional indices. However, mutual fund comparison studies prove difficult to compare because of the variety of funds and investment strategies considered as SRI, resulting in mixed and inconclusive results from this type of study. Similarly, hypothetical portfolio studies may use different techniques to incorporate ESG, making it difficult to compare results.¹³³

Other research has pointed to the lack of a standardized definition for ESG as a cause of mixed conclusions on the benefits of ESG. For instance, Lioui and Tarelli (2022) analyze ESG data from three vendors, comparing the properties

of their ESG factors. They find that the different factor construction methodologies can contribute to the mixed evidence on the ESG performance in the literature and that disagreement across data vendors has substantial implications for the performances of ESG factors.¹³⁴ Similarly, Cornell, and Damodaran (2020) review ESG literature and note that while there is evidence that "being good" benefits a company's operating performance, the literature's findings are sensitive to how ESG is defined and profitability is measured.¹³⁵

Likewise, the comments on the proposal are mixed in their assessment on the relationship between ESG performance and corporate or investment performance. Several comments note that ESG factors are financially material for financial returns. For example, a comment notes that firms with strong ratings on material sustainability issues have better performance than firms with inferior ratings. One commenter states that ESG-focused companies in the MSCI ACWI Index saw higher returns, stronger earnings, and higher dividends. Another commenter notes that the iShares ESG Aware MSCI USA ETF outperformed the S&P 500 index by five percentage points from the beginning of 2020 to the second quarter of 2021. Still another commenter notes that ignoring the entire category of information and analysis that comprises ESG factors could be deemed an abrogation of a fiduciary's responsibility to consider all relevant information when assessing the risk and return of an investment opportunity.

Conversely, several commenters assert that ESG factors are not relevant for financial returns and may be detrimental to returns and retirement savings. For instance, one commenter remarks that the time horizon associated with ESG risks often surpasses the time horizon of retirement investors. Other commenters note that ESG return premiums are due to larger weights placed on technology stocks, which have experienced increased value but also present increased risk. A commenter asserts that the claim in the NPRM that the proposal would lead to increased investment returns is unsubstantiated.

¹³² United Nations Principles for Responsible Investment, "An Introduction to Responsible Investment: Screening" (May 2020), <https://www.unpri.org/an-introduction-to-responsible-investment/an-introduction-to-responsible-investment-screening/5834.article>.

¹³³ RBC Global Asset Management, "Does socially responsible investing hurt investment returns?" (2019), <https://www.rbcgam.com/documents/en/articles/does-socially-responsible-investing-hurt-investment-returns.pdf>.

¹³⁴ Abraham Lioui and Andrea Tarelli, "Chasing the ESG Factor," *Journal of Banking and Finance*, forthcoming (March 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3878314.

¹³⁵ Bradford Cornell and Aswath Damodaran, "Valuing ESG: Doing Good or Sounding Good?" *The Journal of Impact and ESG Investing*, Fall 2020, 1(1). <https://jesg.pm-research.com/content/1/1/76>.

¹³¹ *How America Saves 2022*, Vanguard, 2022.

(b) Meta-Studies

The body of research evaluating ESG investing shows ESG investing can have financial benefits, although the literature overall has varied findings. In a meta-analysis of over 1,000 studies published between 2015 and 2020, Whelan et al. (2021) report that of the studies concerning corporate performance—focusing on measurements such as return on equity, return on assets, and stock price for an individual firm—58 percent find a positive relationship between corporate financial performance and ESG, while 13 percent find a neutral relationship, 21 percent find a mixed relationship, and 8 percent find a negative relationship. For the studies concerning investment performance—focusing on risk-adjusted return measurements for a portfolio of stocks—33 percent find a positive relationship between investment performance and ESG, 26 percent find a neutral impact, 28 percent find mixed results, and 14 percent find negative results.¹³⁶ They found similar results when focusing only on studies about climate change and financial performance. Clark, Feiner, and Vieha (2014) conduct a meta-study analyzing more than 200 studies, 45 of which looked at operational performance, and showed that 88 percent of these studies found that ESG practices lead to better operational performance. Additionally, 41 of the operational performance studies review the relationship between sustainability and financial market performance, of which 80 percent show that stock price performance of companies is positively influenced by good sustainability practices.¹³⁷ Friede et al. (2015) find in their meta-study that only 10.0 percent of studies found a negative ESG performance relationship, while 47.9 percent of vote-count

studies¹³⁸ and 62.6 percent of meta-studies¹³⁹ show positive findings.¹⁴⁰

(c) Association Between ESG Investing and Performance

Ito, Managi, and Matsuda (2013) find that socially responsible funds outperformed conventional funds in the European Union and United States.¹⁴¹ The Morgan Stanley Institute for Sustainable Investing (2019) compared the performance of sustainable funds to traditional funds between 2004 and 2018 and found that sustainable funds provided returns in line with comparable traditional funds such that the returns, net of fees, were not statistically significantly different.¹⁴² Morningstar (2022) finds that of trailing three- and five-year periods, 44 percent of sustainable funds, as defined by Morningstar, ranked in the top quartile of their respective categories.¹⁴³ Curtis, Fisch, and Robertson (2021) measures ESG orientation of mutual fund portfolios from four rating providers to analyze returns of ESG funds between 2018 and 2019. They find that ESG funds did not perform worse in terms of either raw or risk-adjusted returns.¹⁴⁴

¹³⁸ A “vote count study” in this context is a review study which counts the number of primary studies with significant positive, negative, and non-significant results and “votes” the category with the highest share as winner.

¹³⁹ A “meta-study” in this context is a review study which directly imports effect sizes and sample sizes of primary studies to compute a summary effect across all primary studies.

¹⁴⁰ In this study, the authors analyze 60 review studies on ESG performance, encompassing the finding of 2,250 unique underlying studies. (See Gunnar Friede, Michael Lewis, Alexander Bassen, and Timo Busch. “ESG & Corporate Financial Performance: Mapping the global landscape.” DWS, University of Hamburg (December 2015). <https://download.dws.com/download?elib-assetguid=2c2023f453ef4284be4430003b0fbee>.)

¹⁴¹ Yutaka Ito, Shunsuke Managi, and Akimi Matsuda, “Performances of Socially Responsible Investment and Environmentally Friendly Funds,” 64 *Journal of the Operational Research Society* 11 (2013).

¹⁴² Morgan Stanley Institute for Sustainable Investing, “Sustainable Reality: Analyzing Risk and Returns of Sustainable Funds,” https://www.morganstanley.com/pub/content/dam/msdotcom/ideas/sustainable-investing-offers-financial-performance-lowered-risk/Sustainable-Reality_Analyzing_Risk_and_Returns_of_Sustainable_Funds.pdf.

¹⁴³ Morningstar Manager Research, “Sustainable U.S. Landscape Report. 2021: Another Year of Broken Records” (January 2022), https://assets.contentstack.io/v3/assets/blt4eb669caa7dc65b2/blt4326c09c190e82b/62100fefcf85c1619ad897b2/U.S._Sustainable_Funds_Landscape_2022.pdf.

¹⁴⁴ In this study, the authors identify ESG funds based on their fund names. (See Quinn Curtis, Jill Fisch, and Adriana Robertson, “Do ESG Funds Deliver on Their Promises?” *Michigan Law Review*, Vol. 120(3) (2021), https://repository.law.umich.edu/cgi/viewcontent.cgi?params=/context/mlr/article/7846/&path_info=#:..text=We%20find%20that%20ESG%20funds,increasing%20costs%20or%20reducing%20returns.)

In contrast, other studies have found that ESG investing has resulted in lower returns than conventional investing. For example, Winegarden (2019) shows that over ten years, a portfolio of ESG funds has a net return that is 43.9 percent lower than if it had been invested in an S&P 500 index fund.¹⁴⁵ One commenter criticizes the Winegarden report, saying that the study does not isolate how incorporation of ESG data affects performance. Trinks and Scholten (2017) examine socially responsible investment funds and find that a market portfolio based on negative screening significantly underperforms an unscreened market portfolio.¹⁴⁶ Ferruz, Muñoz, and Vicente (2012) find that a portfolio of mutual funds that implements negative screening¹⁴⁷ underperforms a portfolio of conventionally matched pairs.¹⁴⁸ Ciciretti, Dalò, and Dam (2019) analyze a global sample of operating companies and find that companies that score poorly on ESG indicators have higher expected returns.¹⁴⁹

Furthermore, there are many studies with inconclusive results. Goldreyer and Diltz (1999) find that employing positive social screens does not affect the investment performance of mutual funds, based on analysis of 49 socially responsible mutual funds.¹⁵⁰ Similarly, Renneboog, Ter Horst, and Zhang (2008) find that the risk-adjusted returns of socially responsible mutual funds are not statistically different from conventional funds when analyzing a sample of global socially responsible mutual funds.¹⁵¹ Research by Bello

¹⁴⁵ Wayne Winegarden, “Environmental, Social, and Governance (ESG) Investing: An Evaluation of the Evidence,” Pacific Research Institute (2019), https://www.pacificresearch.org/wp-content/uploads/2019/05/ESG_Funds_F_web.pdf.

¹⁴⁶ Pieter Jan Trinks and Bert Scholtens, “The Opportunity Cost of Negative Screening in Socially Responsible Investing” *Journal of Business Ethics* 140, 193–208 (2017).

¹⁴⁷ The authors describe a negative screening strategy as one that “removes stocks” that do not align with the socially responsible ideology for a portfolio. Comparatively, a positive screening strategy “selects stocks” that align with the socially responsible ideology for a portfolio.

¹⁴⁸ Luis Ferruz, Fernando Muñoz, and Ruth Vicente, “Effect of Positive Screens on Financial Performance: Evidence from Ethical Mutual Fund Industry” (2012), https://www.efmaefm.org/0efmameetings/efma%20annual%20meetings/2012-Barcelona/papers/EFMA2012_0183_fullpaper.pdf.

¹⁴⁹ Rocco Ciciretti, Ambrogio Dalò, and Lammertjan Dam, “The Contributions of Betas versus Characteristics to the ESG Premium,” (2019).

¹⁵⁰ Elizabeth Goldreyer and David Diltz, “The Performance of Socially Responsible Mutual Funds: Incorporating Sociopolitical Information in Portfolio Selection,” 25 *Managerial Finance* 1 (1999).

¹⁵¹ Luc Renneboog, Jenke Ter Horst, and Chendi Zhang, “The Price of Ethics and Stakeholder

¹³⁶ Tenise Whelan, Ulrich Atz, Tracy Van Holt, and Casey Clark, “ESG and Financial Performance: Uncovering the Relationship by Aggregating Evidence from 1,000 Plus Studies Published Between 2015 and 2020,” *Journal of Sustainable Finance & Investment* (2021), https://www.stern.nyu.edu/sites/default/files/assets/documents/NYU-RAM_ESG-Paper_2021%20Rev_0.pdf.

¹³⁷ Gordon Clark, Andreas Feiner, and Michael Viehs, “From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance,” University of Oxford and Arabesque Partner (2014), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2508281.

(2005), which examines 126 mutual funds, finds that the long-run investment performance is not statistically different between conventional and socially responsible funds.¹⁵² Likewise, Ferruz, Muñoz, and Vicente (2012) finds that a portfolio of mutual funds that implement positive screening performs equally well as a comparable conventional mutual funds, matched based on fund age, size, risk factors.¹⁵³ Humphrey and Tan (2014), which examines socially responsible investment funds, finds no evidence of negative screening affecting the risks or returns of portfolios.¹⁵⁴

Marsat and Williams (2020) uses the Markowitz Portfolio optimization model, the direct application of modern portfolio theory, to create the “best complete portfolio” by allocating to the optimal risky portfolio and the risk-free asset. It does so assuming that investors are risk averse and that, given equal returns, an investor would prefer the one with less risk. Backtesting various constructed portfolios over the past 10 years, the study did not observe a correlation between high ESG scores and financial returns. The study observes a wide range of performance depending on the provider of ESG data.¹⁵⁵

A few of the studies referenced in the comments discussed the performance of ESG funds during the COVID-19 pandemic. Whieldon and Clark (2021) look at the performance of 26 ESG exchange traded funds (ETFs) and mutual funds with more than \$250 million in assets between March of 2020 and 2021 and found that 19 of the 26 funds outperformed the S&P 500.¹⁵⁶ The Morgan Stanley Institute for Sustainable Investing (2020) finds that, three out of four sustainable equity funds beat their Morningstar category average. The authors posit that the performance of sustainable funds in 2020 demonstrates

that investing strategies that manage material ESG risks can produce good returns in an uncertain economic environment. The study finds that between January and June of 2020, domestic sustainable equity funds outperformed their traditional peers by a median of 3.9 percentage points.¹⁵⁷

(d) Fees

Some commenters expressed concern that higher fees associated with ESG investments will result in lower returns and retirement savings. The Department recognizes that ESG investing requires information collection and research that will incur costs. For instance, a 2020 study estimates that, globally, investment managers would spend \$745 million in 2020 on ESG information.¹⁵⁸

The findings in the literature discussing fees on ESG funds were mixed. Morningstar (2020) finds that sustainable funds have higher asset-weighted average expense ratios (0.61 percent) than their traditional peers (0.41 percent).¹⁵⁹ According to Wursthorn (2021), at the end of 2020, the average fee for ESG funds was 0.20 percent, compared to 0.14 percent for standard ETFs that invest in U.S. large-cap stocks.¹⁶⁰ Winegarden (2019) analyzes 30 ESG funds that have either existed for more than 10 years or have outperformed the S&P 500 over a short-term timeframe and finds that the average expense ratio was 0.69 percent for the 30 ESG funds, compared to an expense ratio of 0.09 percent for a S&P 500 index fund.¹⁶¹ Conversely, a study conducted by Curtis, Fisch, and Robertson (2021) found that when controlling for whether a fund is an actively managed fund or an index fund, as well as net assets by fund manager, fund, and class, there is not a statistically significant difference

between the fees of ESG funds and the fees that would be expected given fund characteristics.¹⁶²

There has been some reduction in sustainable funds fees. Morningstar (2020) finds that the average fee charged by sustainable funds fell 27 percent between 2011 and 2021 and that this decline in average fees has been driven by the rise of low-fee sustainable index mutual funds and ETFs.¹⁶³

The studies of ESG investment performance discussed in this document generally take fees into account.

(e) Sectoral Bias

Some of the literature addresses the role of sectoral biases within ESG investing. A study by Morningstar (2021) finds that between November 2020 and March 2021, a rally in energy prices may have hampered sustainable equity fund returns.¹⁶⁴ Hale (2020) notes that the performance of sustainable funds during the first quarter of 2020 was helped by having less exposure to energy stocks and a larger exposure to technology stocks than the comparable market indices. The study estimates that U.S. ‘sustainable index funds’ energy-sector under-weightings contributed an average of 0.43 percent to their outperformance of the S&P 500 during this period. Information technology was the quarter’s best-performing sector, and sustainable funds generally had a higher proportion of assets invested in the sector than broad market indices. The study estimates information technology contributed an average of 0.21 percent to the funds’ outperformance of the S&P 500. Nevertheless, the author posits that “the biggest reason for their outperformance is that sustainable funds appear to have benefited from selecting stocks with better ESG credentials.”¹⁶⁵ Bruno, Esakia, and Goltz (2021) addresses sectorial bias in general, finding that over representation of the technology sector increases ESG performance. The study finds that when

Governance: The Performance of Socially Responsible Mutual Funds”, 14 *Journal of Corporate Finance* 3 (2008).

¹⁵² Zakri Bello, “Socially Responsible Investing and Portfolio Diversification,” 28 *Journal of Financial Research* 1 (2005).

¹⁵³ Ferruz, Muñoz, and Vicente, “Effect of Positive Screens on Financial Performance,” 2012.

¹⁵⁴ Jacquelyn Humphrey and David Tan, “Does It Really Hurt to be Responsible?,” 122 *Journal of Business Ethics* 3 (2014).

¹⁵⁵ Organisation for Economic Co-operation and Development (OECD), “ESG Investing: Practices, Progress and Challenges” (2020). <https://www.oecd.org/finance/ESG-Investing-Practices-Progress-Challenges.pdf>.

¹⁵⁶ Esther Whieldon and Robert Clark, “ESG Funds Beat Out S&P 500 in 1st Year of COVID-19: How 1 Fund Shot to the Top,” S&P Global Market Intelligence (2021), <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/esg-funds-beat-out-s-p-500-in-1st-year-of-covid-19-how-1-fund-shot-to-the-top-63224550>.

¹⁵⁷ Morgan Stanley Institute for Sustainable Investing, “Sustainable Reality: 2020 Update,” Morgan Stanley (2020), https://www.morganstanley.com/content/dam/msdotcom/en/assets/pdfs/3190436-20-09-15_Sustainable-Reality-2020-update_Final-Revised.pdf.

¹⁵⁸ Sean Collins and Kristen Sullivan, “Advancing ESG Investing: a Holistic Approach for Investment Management Firms,” Harvard Law School Forum on Corporate Governance (March 2020), <https://corpgov.law.harvard.edu/2020/03/11/advancing-esg-investing-a-holistic-approach-for-investment-management-firms/>.

¹⁵⁹ Morningstar, “2020 U.S. Fund Fee Study: Fees Keep Falling” (August 2021), <https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/annual-us-fund-fee-study-updated.pdf>.

¹⁶⁰ Michael Wursthorn, “Tidal Wave of ESG Funds Brings Profit to Wall Street,” *Wall Street Journal* (March 2021), <https://www.wsj.com/articles/tidal-wave-of-esg-funds-brings-profit-to-wall-street-11615887004>.

¹⁶¹ Winegarden, “Environmental, Social, and Governance (ESG) Investing,” 2019.

¹⁶² Curtis, Fisch, and Robertson, “Do ESG Funds Deliver on Their Promises?” 2021.

¹⁶³ Morningstar, “2020 U.S. Fund Fee Study: Fees Keep Falling,” Morningstar (2020), <https://assets.contentstack.io/v3/assets/blt4eb669caa7dc65b2/blt0b2eed63bf1eb8b/619f8bf6224a1b121d540f7e/annual-us-fund-fee-study-updated.pdf>.

¹⁶⁴ Morningstar Manager Research, “Sustainable U.S. Landscape Report. 2021: Another Year of Broken Records” (Jan. 2022), https://assets.contentstack.io/v3/assets/blt4eb669caa7dc65b2/blta4326c09c190e82b/62100fefc85c1619ad897b2/U.S._Sustainable_Funds_Landscape_2022.pdf.

¹⁶⁵ Jon Hale, “Sustainable Funds Weather the First Quarter Better than Conventional Funds,” Morningstar (April 2020), <https://www.morningstar.com/articles/976361/sustainable-funds-weather-the-first-quarter-better-thanconventional-funds>.

the sectoral weights of portfolios are rebalanced to more closely resemble the overall sectoral composition of the market, ESG strategies “consistently deliver zero alpha.”¹⁶⁶ However, Lefkovitz (2021) refutes the claims that ESG performance is entirely due to sectorial bias, observing that companies with a sustainable competitive advantage have often experienced lower volatility. The author posits that while sectoral bias contributes to the performance of ESG strategies, security selection also contributes to the outperformance.¹⁶⁷

Conversely, Brav, and Heaton (2021) compare the returns of high-carbon assets and low-carbon assets. The study found that, for firms included in the S&P 500, the average return for the energy sector in 2021 was 64.8 percent, compared to an average return of 28.7 percent for all companies not in the energy sector. Similarly, for firms included in the Russell 3000, the average return for the energy sector was 74.4 percent, compared to an average return of 25.5 percent for all companies not in the energy sector. The authors state that the transition to a low-carbon economy may fail and investors should not avoid high-carbon assets.¹⁶⁸

(f) Investment Screening

As discussed above, one of the ESG investment strategies used is investment screening. One commenter noted that many of the studies cited by the Department in the proposal finding ESG underperformance focus on the implications of negative screening or a socially responsible investing lens. The commenter notes that most of the studies cited by the Department showing ESG as beneficial to returns focus on ESG as a means to maximize risk-adjusted returns. The commenter further notes that most plan sponsors, except for those relying on the tiebreaker test, would rely on a modern, financially material ESG lens to select investments. Similarly, one commenter called integrated ESG analysis a tool in the modern investment toolkit to be used alongside traditional fundamental

analysis, valuation assessment, or quantitative analysis. For instance, one asset manager with more than \$50 billion assets under management commented that they seek to generate superior, risk-adjusted investment returns by investing in assets they believe are better positioned to seize opportunities and mitigate risks associated with the transition to a more sustainable economy. Another commenter noted that the “digitalization of the economy and pioneering research has helped generate awareness of critical issues that were previously not considered significant for investors, including, but not limited to, climate change, data privacy and social justice issues.” The commenter notes that the drawdowns and the risks associated with these ESG issues are factors that financial markets and ERISA fiduciaries must consider when making business, investment and voting decisions.

Several studies have specifically addressed the ESG investment strategy of screening. For instance, the U.S. Commodity Futures Trading Commission (2020) refutes the historical view that ESG investing is a values-driven activity inconsistent with fiduciary duty. The study notes that this view “ignore[s] the evolution of a wide range of financial ESG factors and strategies, as well as the proposition that impact investing may yield additional returns.”¹⁶⁹

Verheyden, Eccles, and Feiner (2016) analyze stock portfolios that were selected using ESG screening.¹⁷⁰ The study finds that screening tends to increase a stock portfolio’s annual performance by 0.16 percent. Similarly, Kempf, and Osthoff (2007) examine stocks in the S&P 500 and the Domini 400 Social Index (renamed as the MSCI KLD 400 Social Index in 2010) and find that it is financially beneficial for investors to positively screen their portfolios.¹⁷¹ A study from Morningstar (2021), looking at the performance of 69 ESG-screened Morningstar indices, finds that 75 percent “outperformed

their broad market equivalents in 2020”, 88 percent outperformed between 2015 and 2020, and 91 percent “lost less than their broad market equivalents during down markets over the past five years, including the bear market in the first quarter of 2020.”¹⁷²

Trinks and Scholtens (2017) explores the effect of negative screening stocks related to abortion, adult entertainment, alcohol, animal testing, contraceptives, controversial weapons, fur, gambling, genetic engineering, meat, nuclear power, pork, embryonic stem cells, and tobacco has on investment returns. Looking at a sample of 1,763 stocks between 1991 and 2013, the authors note that negative screens decrease the investment universe and limit the ability to diversify. The study finds that there is an opportunity cost in negative screening of “refraining from investing in controversial firms.” The study finds that screened portfolios underperformed the unscreened portfolio and notes that there “can be a trade-off between values and beliefs and financial returns.”¹⁷³ AQR Capital Management warns that the performance of a constrained portfolio will always ex-ante be less than or equal to an unconstrained portfolio.¹⁷⁴ Similarly, Cornell and Damodaran (2020) present a theoretical framework demonstrating that adding an ESG constraint to investing increases expected returns is counter intuitive, as a constrained optimum can, at best, match an unconstrained one, and most of the time, the constraint will create a cost.¹⁷⁵ Sharfman (2021) argues that “screening techniques based on non-financial factors lead to an increased probability that the big winners in the stock market will be excluded from or underweighted in an investment portfolio.” Based on this premise, the author concludes that screening will result in lower expected risk-adjusted returns, relative to a benchmark index.¹⁷⁶

¹⁷² Dan Lefkovitz, “Morningstar’s ESG Indexes have Outperformed and Protected on the Downside” (February 2021), <https://www.morningstar.com/insights/2021/02/08/morningstars-esg-indexes-have-outperformed-and-protected-on-the-downside>.

¹⁷³ Trinks and Scholtens, “The Opportunity Cost of Negative Screening in Socially Responsible Investing,” 2017.

¹⁷⁴ Cliff Asness, “Virtue Is Its Own Reward: Or, One Man’s Ceiling Is Another Man’s Floor,” AQR Capital (May 2017), <https://www.aqr.com/Insights/Perspectives/Virtue-is-its-Own-Reward-Or-One-Mans-Ceiling-is-Another-Mans-Floor>.

¹⁷⁵ Cornell and Damodaran, “Valuing ESG,” 2020.

¹⁷⁶ Bernard Sharfman, “ESG Investing Under ERISA,” *Yale Journal on Regulation Bulletin*, Vol. 38 (March 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3809129.

¹⁶⁶ Giovanni Bruno, Mikheil Esakia, and Felix Goltz, “‘Honey, I Shrunk the ESG Alpha’: Risk-Adjusting ESG Portfolio Returns” (April 2021), <https://cdn.ihsmarket.com/www/pdf/0521/Honey-I-Shrunk-the-ESG-Alpha.pdf>.

¹⁶⁷ Dan Lefkovitz, “Morningstar’s ESG Indexes have Outperformed and Protected on the Downside” (February 2021), <https://www.morningstar.com/insights/2021/02/08/morningstars-esg-indexes-have-outperformed-and-protected-on-the-downside>.

¹⁶⁸ Alon Brav and J.B. Heaton, “Brown Assets for the Prudent Investor,” *Harvard Business Law Review* (2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3895887.

¹⁶⁹ U.S. Commodity Futures Trading Commission, “Managing Climate Risk in the U.S. Financial System” (2020), <https://www.cftc.gov/sites/default/files/2020-09/9-9-20%20Report%20of%20the%20Subcommittee%20on%20Climate-Related%20Market%20Risk%20-%20Managing%20Climate%20Risk%20in%20the%20U.S.%20Financial%20System%20for%20posting.pdf>.

¹⁷⁰ Tim Verheyden, Robert G. Eccles, and Andreas Feiner, “ESG for All? The Impact of ESG Screening on Return, Risk, and Diversification,” 28 *Journal of Applied Corporate Finance* 2 (2016).

¹⁷¹ Alexander Kempf and Peer Osthoff, *The Effect of Socially Responsible Investing on Portfolio Performance*, 13 *European Financial Management* 5 (2007).

(g) ESG Factors and Risk

In addition to performance, the ESG literature also addresses the relationship between ESG factors and risk. Common ESG factors are also common risk factors, for both companies and investors. As such, ESG integration inherently serves as a risk management function. For instance, the E in ESG may include risks from climate change, deforestation, or water scarcity. The S may consider risk associated with data protection and privacy, employee engagement, or labor standards within a supply chain. The G may address issues with bribery and corruption, board and executive compensation, and whistleblower protections.¹⁷⁷ Each of these factors has direct connections to the profitability and resilience of an investment, but as pointed out by Kumar et al. (2016), may also be relevant with respect to the reputation, political, and regulatory risk faced by the investment.¹⁷⁸ As a reference to the magnitude of risks associated with ESG factors, a study by Schroders (2019) estimates that the negative externalities of listed companies equate to almost half of their combined earnings. The authors posit that these economic costs will become tangible in the future, affecting financial cost and income.¹⁷⁹

This was confirmed by several commenters. Some commenters on the NPRM state that ESG funds have lower downside risk or lower systematic volatility. One commenter noted that ESG consideration is a form of risk mitigation that can confer an investment edge and that neglecting ESG-related risk can impact a company's competitive advantage and diminish long-term economic gains. Another commenter noted that ESG factors should be treated no differently than other risk and return factors, as appropriate for a given industry and investment timeframe.

Several studies have found that the consideration of ESG factors in investment processes can mitigate risk. For instance, a meta study by Clark et al. (2014) observes that most of the studies (90 percent) addressing the relationship between sustainability standards and the cost of capital show

that incorporating sustainability standards is associated with a lower cost of equity or cost of debt.¹⁸⁰ This finding suggests that incorporating sustainable standards is associated with lower risk. The consensus of the relationship between ESG factors and risk has also been confirmed by more recent studies. Campagna, Spellman, and Mishra (2020) find that higher ESG performance is associated with lower volatility.¹⁸¹ The Morgan Stanley Institute for Sustainable Investing (2019) shows that when comparing downside deviation,¹⁸² sustainable funds were less risky. On average the distribution of downside deviation for sustainable funds was 20.0 percent less than what traditional fund investors experienced in the same period.¹⁸³

Surveys of the investment industry and investors indicate that the application of ESG factors in risk-management is a common practice. In an investigation performed by the Government Accountability Office (GAO) (2020), 12 of 14 interviewed institutional investors seek information on ESG to better understand risks that could affect company financial performance over time, and five of seven public pension funds seek ESG information to enhance their understanding of risks that could affect a companies' value over time.¹⁸⁴

¹⁸⁰ This meta study analyzes more than 200 studies, of which 29 discuss the cost of capital. (See Clark, Feiner, and Viehs, "From the Stockholder to the Stakeholder," 2014.)

¹⁸¹ This study looks at the relationship between ESG ratings and returns for 534 securities, with a market cap exceeding \$250 million, between 2013 and 2019. (See Anthony Campagna, G. Kevin Spellman, and Subodh Mishra, "ESG Matters," *Harvard Law School Forum on Corporate Governance* (2020), <https://corpgov.law.harvard.edu/2020/01/14/esg-matters/>.)

¹⁸² Downside deviation is a risk measurement that focuses on returns below a minimum threshold. (See Mark Jahn, "Downside Deviation," *Investopedia* (2022), <https://www.investopedia.com/terms/d/downside-deviation.asp#:~:text=Downside%20deviation%20is%20a%20measure,measure%20of%20risk%2Dadjusted%20return.>)

¹⁸³ This study compares the performance of sustainable funds to traditional funds between 2004 and 2018 using Morningstar data on ETF and open-ended mutual funds. Funds considered to be ESG-focused are defined as those that prioritize investments based on multiple screens for numerous ESG factors and a variety of strategies. (See Morgan Stanley Institute for Sustainable Investing, "Sustainable Reality: Analyzing Risk and Returns of Sustainable Funds" (2019), https://www.morganstanley.com/pub/content/dam/msdotcom/ideas/sustainable-investing-offers-financial-performance-lowered-risk/Sustainable_Reality_Analyzing_Risk_and_Returns_of_Sustainable_Funds.pdf.)

¹⁸⁴ GAO, "Report to the Honorable Mark Warner U.S. Senate: Disclosure of Environmental, Social, and Governance Factors and Options to Enhance Them" (July 2020), <https://www.gao.gov/assets/gao-20-530.pdf>.

Similarly, survey data reported by Natixis (2018) observes that 46 percent of institutional investors implementing ESG say that the analysis of ESG-related factors is "as important to their investment process as traditional fundamental analysis" and that 56 percent of institutional investors believe incorporating ESG mitigates governance and social risks.¹⁸⁵ According to a survey conducted by FTSE Russell (2021), 64 percent of asset owners implementing or evaluating sustainability in portfolios cite risk as a motivator.¹⁸⁶

The Department agrees that considering relevant ESG factors plays an important role in mitigating risks in the portfolios of ERISA plan participants and beneficiaries.

(h) Market Pricing of ESG Risks

In the proposal, the Department also welcomed comments on the extent to which climate-related financial risk is not already incorporated into market pricing. The Department received two comments that argued that climate risks are not yet fully reflected in asset prices. Conversely, another commenter criticized that the proposal's regulatory impact analysis did not provide a rational basis for the contention that climate change and other ESG factors are not already priced into the market. This commenter argued that if climate change and ESG factors are already priced into the market, then further consideration would not result in investment gains.

Commenters also referenced literature exploring market pricing. For instance, Brest, Gilson, and Wolfson (2018) argue that if ESG ratings and investments in ESG affect productivity, then they should already be reflected in stock prices.¹⁸⁷ However, Condon (2021) identifies several sources of mispricing pertaining to climate risks, including limited asset-level data, reliance on outdated risk assessments, misaligned incentives, and regulatory distortions within the market. Although the efficient market hypothesis posits that arbitrageurs would exploit mispriced assets until the assets are no longer

¹⁸⁵ Natixis Investment Managers, "Looking for the Best of Both Worlds" (2019), <https://www.im.natixis.com/us/resources/esg-investing-survey-2019>.

¹⁸⁶ FTSE Russell, "Sustainable Investment Is Now Standard According to Global Asset Owner Survey" (October 2021), <https://www.ftserussell.com/press/sustainable-investment-now-standard-according-global-asset-owner-survey>.

¹⁸⁷ Paul Brest, Ronald Gilson, and Mark Wolfson, "How Investors Can (and Can't) Create Social Value," *Columbia Law School Scholarship Archive* (2018), https://scholarship.law.columbia.edu/cgi/viewcontent.cgi?article=3099&context=faculty_scholarship.

¹⁷⁷ CFA Institute, "The Rise of ESG Investing: What is Sustainable Investing?" <https://interactive.cfainstitute.org/ESG-guide/what-is-sustainable-investing-238UB-188048.html>.

¹⁷⁸ Ashwin Kumar, Camille Smith, Leila Badis, Nan Wang, Paz Amroxy, and Rodrigo Tavres, "ESG Factors and Risk-Adjusted Performance: A New Quantitative Model," *Journal of Sustainable Finance & Investment* (2016) Vol. 6, No. 4, 292-300.

¹⁷⁹ Schroders, "SustainEx" (April 2019), <https://www.schroders.com/en/sysglobalassets/digital/insights/2019/pdfs/sustainability/sustainex-sustainex-short.pdf>.

mispriced, the author acknowledges that the role of arbitrage in the real world is limited by imperfect information, heterogeneous expectations about the future, and uncertainty about when climate-related risks will occur.¹⁸⁸ Brav and Heaton (2021) notes that research in this area is difficult, as the theories rely on expected returns, while researchers only have access to realized returns. The authors note, “When researchers study average, realized returns, it is always uncertain whether the realized price reflected one of the possible price realizations that investors anticipated at the probability they assigned it, or whether that price reflected a change in the underlying probability distribution.”¹⁸⁹

(i) Literature on Environmental Factors

Reflective of the significant economic impacts of climate change to date across various sectors of the economy, the Department believes it can be as appropriate to treat climate change as a relevant factor in assessing the risks and returns of investments as any other relevant factor a prudent fiduciary would consider.

In the proposal, the Department requested comments on whether fiduciaries should consider climate change as presumptively material in their assessment of investment risks and returns, if adopted. The Department received numerous comments specifically addressing the materiality of climate change and environmental risks. Some of the commenters note that while climate change risks are often considered strategic and regulatory, they are also operational risks. One commenter notes that the physical and transition impacts from climate change are already materially affecting public companies and financial institutions. Another commenter notes that weak control of environmental activities, such as pollution, over-consumption of raw materials, or lack of recycling, can lead to volatile or lower financial margins or returns to investors. A few commenters note that climate-related financial risks are especially relevant to retirement investors, who invest over decades and

¹⁸⁸ Madison Condon, “Market Myopia’s Climate Bubble,” 1 *Utah Law Review* 63 (2022), Boston University School of Law Research Paper (February 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3782675.

¹⁸⁹ Alon Brav and J.B. Heaton, “Brown Assets for the Prudent Investor,” *Harvard Business Law Review* (2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3895887.

are often universal owners with exposure to many at-risk sectors.

There is a breadth of literature that provides evidence for the materiality of climate change as a driver of risk-adjusted returns. These risks are often referred to in two broad categories: physical risk and transition risk. Physical risk captures the financial impacts associated with a rise in extreme weather events and a changing climate, both chronic and acute. The literature maintains that these risks can be especially material for long duration assets and grow in severity the more that climate mitigation and adaptation are neglected. We are already seeing significant economic costs as a result of warming, and a certain amount of additional warming is guaranteed based on the greenhouse gas pollution already in the atmosphere.¹⁹⁰ This implies that the physical risks of climate change to our economy and to investments will persist. A 2019 report from BlackRock notes that the physical risk of extreme weather poses growing risks that are underpriced in certain sectors and asset classes.¹⁹¹ Additionally, S&P Trucost found that almost 60 percent of the companies in the S&P500 index hold assets that were at high risk to the physical effects of climate change.¹⁹² The Treasury Financial Stability Oversight Council (2021) provides a sense of the magnitude of the effect, noting that in 2020, there were 22 weather and climate disasters with damages exceeding a billion dollars, resulting in a combined \$95 billion in damages.¹⁹³ The report asserted that

¹⁹⁰ Renee Cho, “How Climate Change Impacts the Economy” (June 20, 2019), <https://news.climate.columbia.edu/2019/06/20/climate-change-economy-impacts/>. Celso Brunetti, Benjamin Dennis, Dylan Gates, Diana Hancock, David Ignell, Elizabeth K. Kiser, Gurubala Kotta, Anna Kovner, Richard J. Rosen, and Nicholas K. Tabor, “Climate Change and Financial Stability,” FEDS Notes. Washington: Board of Governors of the Federal Reserve System, March 19, 2021, <https://doi.org/10.17016/2380-7172.2893>.

¹⁹¹ BlackRock Investment Institute, “Getting Physical: Assessing Climate Risks” (2019), <https://www.blackrock.com/us/individual/insights/blackrock-investment-institute/physical-climaterisks>.

¹⁹² S&P Trucost Limited, Understanding Climate Risk at the Asset Level: The Interplay of Transition and Physical Risks (2019), https://www.spglobal.com/division_assets/images/specialeditorial/understanding-climate-risk-at-the-assetlevel/sp-trucost-interplay-of-transition-and-physical-risk-report-05a.pdf.

¹⁹³ U.S. Treasury Financial Stability Oversight Council, “Report on Climate-Related Financial Risk: 2021” (2021), <https://home.treasury.gov/system/files/261/FSOC-Climate-Report.pdf>.

weather and climate disasters may result in credit and market risks, associated with loss of income, defaults, changes in the value of assets, liquidity risks, operational risks, and legal risks.¹⁹⁴

In contrast, transition risk reflects the risks that carbon-dependent businesses lose profitability and market share as government policies and new technology drive the transition to a carbon-neutral economy. Existing government policies and increasingly ambitious national and international greenhouse reduction goals will continue to create significant transition risk for investments. Studies assess the value of global financial assets at risk from climate change to be in the range of \$2.5 trillion to \$4.2 trillion, including transition risks and other impacts from climate change.

The U.S. Commodity Futures Trading Commission (CFTC, 2020) warns that much of the risk associated with climate change is not priced into the market, which increases the risk for a systemic shock. The report notes that a “sudden revision of market participants’ perceptions about climate risk could trigger a disorderly repricing of assets, which could have cascading effects on portfolios and balance sheets and, therefore, systemic implications for financial stability.”¹⁹⁵ A Federal Reserve Board report from 2020, which states “[c]limate change, which increases the likelihood of dislocations and disruptions in the economy, is likely to increase financial shocks and financial system vulnerabilities that could further amplify these shocks.”¹⁹⁶ The report continues: “Opacity of exposures and heterogeneous beliefs of market participants about exposures to climate risks can lead to mispricing of assets and the risk of downward price shocks.”¹⁹⁷

¹⁹⁴ *Id.*

¹⁹⁵ Climate-Related Market Risk Subcommittee, “Managing Climate Risk in the U.S. Financial System,” U.S. Commodity Futures Trading Commission, Market Risk Advisory Committee (2020), <https://www.cftc.gov/sites/default/files/2020-09/9-9-20%20Report%20of%20the%20Subcommittee%20on%20Climate-Related%20Market%20Risk%20-%20Managing%20Climate%20Risk%20in%20the%20U.S.%20Financial%20System%20for%20posting.pdf>.

¹⁹⁶ Board of Governors of the Federal Reserve System, “Financial Stability Report” (November 2020), <https://www.federalreserve.gov/publications/files/financial-stability-report-20201109.pdf>.

¹⁹⁷ *Id.*

Several studies quantify the direct economic effects of climate change. For instance, the CFTC estimates that by the end of the century, climate change will decrease the U.S. annual GDP by 1.2 percent for every 1 degree Celsius increase and that by 2090, total impacts from extreme heat conditions could result in more than 2 billion lost labor hours, corresponding to \$160 billion (2015) in lost wages.¹⁹⁸ CFTC (2020) notes that transition risks may lead to both stranded capital—where capital assets are at-risk from devaluation—or stranded value—where the market-value of a project or firm is at-risk from devaluation or otherwise negatively discounted.¹⁹⁹ Mecure et al. (2018) estimates that the stranded fossil fuel assets may result in a discounted global wealth loss between \$1 trillion and \$4 trillion.²⁰⁰ Similarly, a Mercer and the Center for International Environmental Law 2016 report estimates that the coal subsector may lose as much as 84 percent of its annual return potential over the next 35 years. The study also estimates that the annual returns for the oil and utilities subsectors could fall by as much as 63 percent, and 39 percent, respectively. In comparison, the study estimates that annual returns for renewables could increase by as much as 54 percent over the same period.²⁰¹

The risks associated with climate change are also expected to have direct implication for retirement investors. For example, Mercer and the Center for International Environmental Law (2016)

finds that the total value of assets in an average U.S. public pension portfolio could be 6 percent lower by 2050 than under a business-as-usual scenario due largely to transition risks associated with climate change.²⁰²

However, it is worth noting that climate change also represents an investment opportunity, with research suggesting that investment in climate change mitigation will produce increasingly attractive yields.²⁰³ Addressing transition risks can present opportunities to identify investments that are strategically positioned to succeed in the transition. Gradual shifts in investor preferences toward sustainability and the growing recognition that climate risk is investment risk may lead to a reallocation of capital. For instance, Matthews, Eaton, and Benoit (2021) estimates that to meet global energy demand and climate aspirations, annual investments in clean energy would need to grow from \$1.1 trillion in 2021 to \$3.4 trillion until 2030.²⁰⁴

(j) Literature on Social Factors

The literature also has findings on the materiality of weighing social factors in investment processes. The aforementioned meta-analysis by Friede et al. (2015) finds that 55.1 percent of the studies reviewed found a positive correlation between corporate financial performance and social-focused investing.²⁰⁵ Two topics focused on in the literature were (1) diversity and inclusion and (2) worker voice.

(1) Diversity and Inclusion

Many studies show the material financial benefits of diverse and inclusive workplaces. The Department received several comments noting that diversity is material to financial performance. For instance, one commenter notes that high staff turnover, high strike rates, absenteeism, or death have all been linked to lower

productivity and poor-quality control. There are three main vectors across which a company's diversity and inclusion practices that can have a financially material impact on their business: employee recruitment and retention, performance and productivity, and litigation.

(a) Employee Recruitment and Retention

There is evidence that corporate social responsibility affects employee recruitment, productivity, satisfaction, and retention.²⁰⁶ While not all turnover is undesirable, turnover is costly. These costs are both direct and indirect. Direct costs include staff time to off-board the former employee, covering the reduced capacity with a contingent employee or with existing staff, and the cost of recruitment. The indirect costs include on-the-job training, employee socialization, and productivity gaps between the new and former employees.²⁰⁷ These costs are commonly estimated as equating to 6 to 9 months of the salary for the position (or 50 to 75 percent of the salary) on top of the salary itself, depending on how exhaustively one catalogues the different types of costs.²⁰⁸

- In a survey of 2,745 respondents, the job site Glassdoor found that 76 percent of employees and job seekers overall look at workforce diversity when evaluating an offer.²⁰⁹

- The Level Playing Institute (2007) estimates firms incur a cost of \$64

²⁰⁶ Hong-yan Wang and Zhi-Xia Chen, "Corporate Social Responsibility and Job Applicant Attraction: a Moderated-Mediation Model," *PLOS ONE* 17(3): e0260125. <https://doi.org/10.1371/journal.pone.0260125>. DiversityInc., "Millennial and Gen Z Jobseekers: An Emphasis on Social Responsibility," <https://www.diversityincbestpractices.com/millennial-and-gen-z-jobseekers-an-emphasis-on-social-responsibility/>.

²⁰⁷ David Allen, "Retaining Talent," Society for Human Resources Management Foundation (2008), <https://www.shrm.org/hr-today/trends-and-forecasting/special-reports-and-expert-views/documents/retaining-talent.pdf>.

²⁰⁸ Shane McFeely and Wigert, Ben, "This Fixable Problem Costs U.S. Businesses \$1 Trillion," Gallup (March 2019), <https://www.gallup.com/workplace/247391/fixable-problem-costs-businesses-trillion.aspx#:~:text=The%20cost%20of%20replacing%20an,to%20%242.6%20million%20per%20year>. John Hall, "The Cost of Turnover Can Kill Your Business and Make Things Less Fun," *Forbes* (May 2019), <https://www.forbes.com/sites/johnhall/2019/05/09/the-cost-of-turnover-can-kill-your-business-and-make-things-less-fun/?sh=323adfac7943>. Aharon Tziner and Assa Birati, "Assessing Employee Turnover Costs: A Revised Approach," *Human Resources Management Review* (1996). 118–119.

²⁰⁹ Glassdoor, "Diversity & Inclusion Workplace Survey" (September 2020), https://b2b-assets.glassdoor.com/glassdoor-diversity-inclusion-workplace-survey.pdf?_gl=1*14tssal*_ga*MTY5NTI5NTgwMi4xNjYwNjUzMDY3*_ga_RC95PMVB3H*MTY2MDY1MzA2N3S41Mq.

¹⁹⁸ U.S. Commodity Futures Trading Commission, "Managing Climate Risk in the U.S. Financial System" (2020), <https://www.cftc.gov/sites/default/files/2020-09/9-9-20%20Report%20of%20the%20Subcommittee%20on%20Climate-Related%20Market%20Risk%20-%20Managing%20Climate%20Risk%20in%20the%20U.S.%20Financial%20System%20for%20posting.pdf>.

¹⁹⁹ U.S. Commodity Futures Trading Commission, "Managing Climate Risk in the U.S. Financial System," (2020). <https://www.cftc.gov/sites/default/files/2020-09/9-9-20%20Report%20of%20the%20Subcommittee%20on%20Climate-Related%20Market%20Risk%20-%20Managing%20Climate%20Risk%20in%20the%20U.S.%20Financial%20System%20for%20posting.pdf>.

²⁰⁰ J.F. Mercure, H. Pollitt, J.E. Viñuales, N.R. Edwards, P.B. Holden, U. Chewpreecha, P. Salas, I. Sognaes, A. Lam, and F. Knobloch, "Macroeconomic Impact of Stranded Fossil Fuel Assets," *Nature Climate Change* 8, 588–593 (2018).

²⁰¹ Mercer and the Center for International Environmental Law, "Trillion-Dollar Transformation: A Guide to Climate Change Investment Risk Management for US Public Defined Benefit Trustees" (2016), <https://static1.squarespace.com/static/569da6479cadb6436a8fecc8/t/584dcf37893fc01633e3572a/1481494366264/gl-2016-responsible-investments-a-guide-to-climate-change-investment-risk-management-for-us-public-defined-benefit-plan-trustees-mercerc.pdf>.

²⁰² *Id.*

²⁰³ Jason Channell, Elizabeth Curmi, Phuc Nguyen, Elaine Prior, Alastair Syme, Heath Jansen, Ebrahim Rahbari, Edward Morse, Seth Kleinman, and Tim Kruger, "Energy Darwinism II: Why a Low Carbon Future Doesn't Have to Cost the Earth," *Citi* (August 2015). <https://www.citivelocity.com/citigps/energy-darwinism-ii/>.

²⁰⁴ Christopher Matthews, Collin Eaton, and Faucun Benoit, "Behind the Energy Crisis: Fossil Fuel Investment Drops, and Renewables Aren't Ready," *Wall Street Journal* (October 2021), <https://www.proquest.com/docview/258260391?accountid=41086>.

²⁰⁵ Gunnar Friede, Michael Lewis, and Alexander Bassen, Timo Busch, "ESG & Corporate Financial Performance: Mapping the Global Landscape," *Deutsche Asset & Wealth Management, University of Hamburg* (December 2015). <https://download.dws.com/download?elib-assetguid=2c2023f453ef4284be4430003b0fbee>.

billion per year from losing and replacing over 2 million American professionals and managers who leave their jobs each year due to unfairness and discrimination.²¹⁰

- Robinson and Dechant (1997) estimate that replacing a departing employee costs between \$5,000 and \$10,000 for an hourly worker, and between \$75,000 and \$211,000 for an executive making \$100,000 per year.²¹¹

(b) Performance and Productivity

- Chen, Leung, and Evans (2018) find that increased representation of women on corporate boards is associated with an increase in the number of patents and citations, when controlling for the amount of research and development spending.²¹²

- Lorenzo et al. (2017) review of 171 German, Swiss, and Austrian companies finds that management diversity has a positive and statistically significant relationship to higher revenue from new products and services.²¹³

- Phillips, Lijenquist, and Neale (2008) find that socially different group members do more than simply introduce new viewpoints or approaches. In the study, diverse groups outperformed more homogeneous groups not because of an influx of new ideas, but because diversity triggered more careful information processing that is absent in homogeneous groups.²¹⁴

- A study from Deloitte (2013) finds employee perception of an organization's commitment to diversity and inclusion is associated with higher levels of innovation, responsiveness to customer needs, and team collaboration.²¹⁵

²¹⁰ Level Playing Field Institute, "The Cost of Employee Turnover Due Solely to Unfairness in the Workplace" (2007).

²¹¹ Gail Robinson and Kathleen Dechant, "Building a Business Case for Diversity," *Academy of Management Executive* 11 (3) (1997): 21–31.

²¹² Jie Chen, Woon Sau Leung, and Kevin P. Evans, "Female Board Representation, Corporate Innovation and Firm Performance," *Journal of Empirical Finance* 48 (September 2018): 236–254.

²¹³ Rocio Lorenzo, Nicole Voigt, Karin Schetelig, Annika Zawadzki, Isabelle Welpel, and Prisca Brosi, "The Mix that Matters: Innovation through Diversity," BCG (2017), <https://www.bcg.com/publications/2017/people-organization-leadership-talent-innovation-through-diversity-mix-that-matters>.

²¹⁴ Katherine W. Phillips, Katie A. Lijenquist, and Margaret A. Neale "Is the Pain Worth the Gain? The Advantages and Liabilities of Agreeing with Socially Distinct Newcomers," *Personality and Social Psychology Bulletin* (December 2008), <https://journals.sagepub.com/doi/abs/10.1177/0146167208328062>.

²¹⁵ Deloitte, "Waiter, Is that Inclusion in My Soup? A New Recipe to Improve Business Performance," Deloitte (2013), <https://www2.deloitte.com/content/dam/Deloitte/au/Documents/human-capital/deloitte-au-hc-diversity-inclusion-soup-051>.

- A 2013 report released by the Center for Talent Innovation (CTI) finds that employees at publicly traded companies that exhibit both inherent and acquired diversity²¹⁶ reported substantial benefits. CTI conducted a survey and found that employees at diverse companies were 70 percent more likely to report that they had captured a new market, and 75 percent more likely to report that their ideas had become productized. Employees were also as much as 158 percent more likely to report that they believed they understood their target end-users if one or more members on the team represent the user's demographic.²¹⁷

- Companies in the top quartile for ethnic and racial diversity in management were 36 percent more likely to have financial returns above the median for their industry in their country, and those in the top quartile for gender diversity were 25 percent more likely to have returns above the median for their industry in their country.²¹⁸

- Companies in the top quartile of gender diversity or ethnic diversity on executive teams were more likely to outperform peer companies in the bottom quartile of diversity on executive teams, in terms of profitability.²¹⁹

(c) Litigation

- The U.S. Equal Employment Opportunity Commission (EEOC) received 67,448 charges of workplace discrimination in Fiscal Year (FY) 2020. The agency secured \$439.2 million for victims of discrimination in the private sector and state and local government workplaces through voluntary resolutions and litigation.²²⁰

(d) Studies Covering Multiple Topics

- A meta-analysis on 7,939 business units in 36 companies further confirms

²¹⁶ The report defined inherent diversity to include gender, race, age, religious background, socioeconomic background, sexual orientation, disability, and nationality. The report defines acquired diversity to include cultural fluency, generational savviness, gender smarts, social media skills, cross-functional knowledge, global mindset, military experience, and language skills.

²¹⁷ Sylvia Ann Hewlett, Melinda Marshall, Laura Sherbin, and Tara Gonsalves, "Innovation, Diversity, and Market Growth," *Center for Talent Innovation* (2013), https://coqual.org/wp-content/uploads/2020/09/31_innovationdiversityandmarketgrowth_keyfindings-1.pdf.

²¹⁸ Vivian Hunt, Sara Prince, Sundiatu Dixon-Fyle, and Kevin Dolan, "Diversity Wins: How Inclusion Matters," McKinsey & Company (2020), <https://www.mckinsey.com/~/media/mckinsey/featured%20insights/diversity%20and%20inclusion/diversity%20wins%20how%20inclusion%20matters/diversity-wins-how-inclusion-matters-vf.pdf>.

²¹⁹ *Ibid.*

²²⁰ "EEOC Releases Fiscal Year 2020 Enforcement and Litigation Data," (2021).

that higher employee satisfaction levels are associated with higher profitability, higher customer satisfaction, and lower employee turnover.²²¹

- One study found that "companies reporting highest levels of racial diversity brought in nearly 15 times more sales revenue on average than those with lowest levels of racial diversity." It also found that "[c]ompanies with highest rates reported an average of 35,000 customers compared to 22,700 average customers among those companies with lowest rates of racial diversity."²²²

- A study of Federal agencies finds that diversity management is strongly linked to both work group performance and job satisfaction, and people of color see benefits from diversity management above and beyond those experienced by white employees.²²³

- A 6-month research study "found evidence that a growing number of companies known for their hard-nosed approach to business—such as Gap Inc., PayPal, and Cigna—have found new sources of growth and profit by driving equitable outcomes for employees, customers, and communities of color."²²⁴

However, some studies surveyed by the Department did not find a statistically significant link between board diversity and corporate financial performance. For instance:

- A 2016 meta-analysis finds that the correlation between gender diversity and corporate financial performance is either nonexistent or very small.²²⁵

- A 2021 review found that most of the literature used to support diversity mandates on corporate boards does not identify causal effects and that the conclusions of studies that do isolate a causal effect are mixed.²²⁶

²²¹ James K. Harter, Frank L. Schmidt, and Theodore L. Hayes, "Business-Unit-Level Relationship Between Employee Satisfaction, Employee Engagement, and Business Outcomes: A Meta-Analysis," *Journal of Applied Psychology* 87(2) (2002) 268–279.

²²² Cedric Herring, "Does Diversity Pay? Race, Gender, and the Business Case for Diversity," *American Sociological Review* (2009).

²²³ David Pitts, "Diversity Management, Job Satisfaction, and Performance: Evidence from U.S. Federal Agencies," *Public Administration Review* (2009).

²²⁴ Angela Glover Blackwell, Mark Kramer, Lalitha Vaidyanathan, Lakshmi Iyer, and Josh Kirschenbaum, "The Competitive Advantage of Racial Equity," FSG and PolicyLink (2018).

²²⁵ Alive Eagly, "When Passionate Advocates Meet Research on Diversity, Does the Honest Broker Stand a Chance," *Journal of Social Issues*, Vol. 72, No. 1 (2016), <https://web.p.ebscohost.com/ehost/pdfviewer/pdfviewer?vid=1&sid=8ad704e4-79e4-4998-827b-07473bb39c31%40redis>.

²²⁶ Jonathan Klick, "Review of the Literature on Diversity on Corporate Boards," American Enterprise Institute (2021), <https://www.aei.org/>

- A 2010 study did not find a statistically significant relationship between the gender or ethnic diversity of boards and financial performance.²²⁷

- A 2015 meta-analysis from 20 studies on 3,097 companies analyzed the relationship between female representation on corporate boards and firm performance. The analysis found the mean-weighted correlation between female representation and firm performance was small and non-significant. However, the authors note that a higher representation of females on corporate boards was also not associated with a detrimental effect on firm financial performance.²²⁸

One study cautions that “the empirical connection between a single dimension of board structure and firm performance may be too nuanced to statistically tease out. Research that empirically links board structure to board or firm actions is a much better method to test if a relationship between board composition and performance exists than an analysis that attempts to go from board structure directly to firm performance and skips over board and firm actions.”²²⁹ Another study cautioned that when diversity is enforced by regulation, there was no effect on performance.²³⁰

(2) Worker Voice

The research literature also finds material financial benefits from employee engagement and representation in corporate governance as employees’ voices are amplified through unions or through direct representation on corporate boards.

research-products/report/review-of-the-literature-on-diversity-on-corporate-boards/.

²²⁷ David A. Carter, Frank D’Souza, Betty J. Simkins, and W. Gary Simpson, “The Gender and Ethnic Diversity of US Boards and Board Committees and Firm Financial Performance,” *Corporate Governance: An International Review* 18, no. 5 (2010): 396–414, <https://wedc-online.wildapricot.org/Resources/WEDC-Documents/Women%20On%20Board/Gender%20Diversity%20and%20Boards.pdf>.

²²⁸ Jan Luca Pletzer, Romina Nikolova, Karina Karolina Kedzior, and Sven Constantin Voelpel, “Does Gender Matter? Female Representation on Corporate Boards and Firm Financial Performance—A Meta-Analysis” (June 2015), <https://journals.plos.org/plosone/article/file?id=10.1371/journal.pone.0130005&type=printable>.

²²⁹ David A. Carter, Frank D’Souza, Betty J. Simkins, and W. Gary Simpson, “The Gender and Ethnic Diversity of US Boards and Board Committees and Firm Financial Performance,” *Corporate Governance: An International Review* 18, no. 5 (2010): 396–414, <https://wedc-online.wildapricot.org/Resources/WEDC-Documents/Women%20On%20Board/Gender%20Diversity%20and%20Boards.pdf>.

²³⁰ Deloitte and Nyenrode Research Program, “Good Governance Driving Corporate Performance? A Meta-Analysis of Academic Research & Invitation to Engage in the Dialogue” (December 2016).

Similar to the literature on diversity and inclusion, the literature focuses on the benefits of employee retention and productivity.

Much of the literature on employee voice builds on the tradeoff between exit and voice laid out by Hirschman (1970), in which management becomes aware of failures either by actors, such as employees, leaving the organization (“quitting”) or by actors expressing dissatisfaction to management (“voicing”).²³¹ A review of theoretical and empirical research by Palladino (2021) finds that when employees have access to voice mechanisms, such as union representation, firms are likely to experience fewer employee “exits.”²³² For example, Freeman (1980) shows empirically that the presence of unions reduces turnover.²³³

The literature surveyed by Palladino (2021) also suggests that unionization and worker voice improves employee productivity.²³⁴ Freeman and Lazear (1995) model the economic value of workers’ councils, finding that workers’ councils may reduce economic inefficiencies by decreasing information asymmetries and aligning employer and worker incentives during difficult times. Their modeling also finds that workers’ councils with co-determination rights were associated with increased perceptions of job security amongst workers, aligning long-run interests of the worker and employer, and ultimately increasing productivity.²³⁵ Jäger et al. (2021) performed an empirical analysis of the impact of a policy reform in Germany affecting the degree of worker representation on corporate boards.²³⁶ They found that

²³¹ Albert Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States*, Harvard University Press, Cambridge, Massachusetts (1970).

²³² Lenore Palladino, “Economic Democracy at Work: Why (and How) Workers Should be Represented on US Corporate Boards,” *Journal of Law and Political Economy*, Vol. 1, No. 3 (2021).

²³³ Richard B. Freeman, “The Exit-Voice Tradeoff in the Labor Market: Unionism, Job Tenure, Quits, and Separations,” *The Quarterly Journal of Economics*, Vol. 94, No. 4 (1980), https://www.jstor.org/stable/pdf/1885662.pdf?refreqid=excelsior%3A04abe825526feaf1f141b7b509419d18&ab_segments=&origin=&acceptTC=1.

²³⁴ Lenore Palladino, “Economic Democracy at Work: Why (and How) Workers Should be Represented on US Corporate Boards,” *Journal of Law and Political Economy*, Vol. 1, No. 3 (2021).

²³⁵ Richard Freeman and Edward Lazear, “An Economic Analysis of Works Councils,” *Works Councils: Consultation, Representation, and Cooperation in Industrial Relations*, University of Chicago Press (1995), <https://www.nber.org/system/files/chapters/c11555/c11555.pdf>.

²³⁶ Simon Jäger, Benjamin Schoefer, Jörg Heining, “Labor in the Boardroom,” *Quarterly Journal of Economics*, Vol. 136, Issue 2, 2021, <https://doi.org/10.1093/qje/qjaa038>.

worker representation does not lower wages or reduce capital formation.

(k) ESG Data, Ratings, and Disclosures

The research community and commenters also weighed in on the data, ratings, and disclosures used to inform ESG investments. Surveys conducted by Natixis Investment Managers in 2018 found that among investment managers implementing ESG, 70 percent of institutions rely on sustainability ratings to evaluate ESG performance, which is higher than the percent of institutions relying on company reports (37 percent), rankings and awards (37 percent), regulatory filings (24 percent), news reports (24 percent), and non-governmental organizations (23 percent).²³⁷

Research indicates that one of the challenges faced by investment managers and rating agencies is that many of the company disclosures on ESG-related issues are voluntary. Condon (2022) finds that, as of 2018, complying companies, on average, provided less than four of the eleven disclosure metrics recommended by the Task Force on Climate-related Financial Disclosures. The study also finds that voluntary disclosures are more likely to focus on transition risks than physical risks.²³⁸

To mitigate missing information in voluntary disclosures, ESG rating agencies and investment professionals have begun to utilize alternative data and artificial intelligence. These techniques allow the industry to uncover material data that were not disclosed by the company.²³⁹ For instance, Morgan Stanley Capital International (MSCI) estimates that only 35 percent of the data inputs for the MSCI ESG Ratings model are from voluntary disclosures.²⁴⁰ Additionally, a 2020 survey of CFA Institute members finds that 71 percent of the participants polled agreed that alternative data reinforce sustainability analysis and 43

²³⁷ Natixis Investment Managers, “Looking for the Best of Both Worlds” (2019), <https://www.im.natixis.com/us/resources/esg-investing-survey-2019>.

²³⁸ Madison Condon, “Market Myopia’s Climate Bubble,” 1 *Utah Law Review* 63 (2022), Boston University School of Law Research Paper (February 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3782675.

²³⁹ Sean Collins and Kristen Sullivan, “Advancing ESG Investing: a Holistic Approach for Investment Management Firms,” *Harvard Law School Forum on Corporate Governance* (March 2020), <https://corpgov.law.harvard.edu/2020/03/11/advancing-esg-investing-a-holistic-approach-for-investment-management-firms/>.

²⁴⁰ Samuel Block, “Using Alternative Data to Spot ESG Risks,” MSCI (June 2019), <https://www.msci.com/www/blog-posts/using-alternative-data-to-spot/01516155636>.

percent expect applying artificial intelligence to sustainability analysis will further improve the analysis.²⁴¹

Another challenge faced by investment managers and rating agencies is a lack of standardization in ESG terminology, which makes it difficult to do relative comparisons or to create well-defined categories.²⁴² In a 2020 report to Congress, the GAO reviewed annual reports, 10-K filings, proxy statements, and voluntary sustainability reports for 32 companies and interviewed 14 large and midsized institutional investors. The report found that the “differences in methods and measures companies use to disclose quantitative information make it difficult to compare across companies.”²⁴³ Similarly, the CFA Institute notes that differing terminology, such as the same measure being called different names or different measures sharing the same name, makes it difficult to do relative comparisons.²⁴⁴

While ESG rating agencies have improved their methods and transparency in recent years, rating providers vary significantly in scoring methodology, data, analyses, metric weighting, materiality, and how missing information is accounted for.²⁴⁵ Several studies analyze how ratings differ between agencies. For instance, Feifei and Polychronopoulos (2020) construct four separate portfolios, two in the United States and two in Europe, using ESG ratings data from two providers. The study simulates portfolio performance between July 2010 and June 2018. The authors found that the two constructed portfolios “have a performance dispersion of 70 basis points (bps) a year in Europe (9.4 percent versus 8.7 percent) and 130 bps a year in the United States (14.2 percent versus 12.9 percent).”²⁴⁶ Similarly, a

2020 study from the OECD constructed portfolios using ESG scores from different rating providers and found that risk-adjusted returns varied significantly between different rating providers.²⁴⁷

Berg, Kölbel, and Rigobon (2022) compared 709 ESG indicators from different rating systems, to estimate how measurement, scope, and weight divergence account for the differences between ESG ratings. They find that measurement divergence accounts for 56 percent of the difference, while scope and weight divergence account for 38 percent and 6 percent, respectively.²⁴⁸ They caution that inconsistency with ESG ratings sends mixed signals to companies as to which actions are expected and will be valued by the market. They believe that the divergence of ratings poses a challenge for empirical research, as using one rater versus another may alter a study’s results and conclusions.

Curtis, Fisch, and Robertson (2021) find that there is substantial heterogeneity in ESG ratings of companies but more consistency in ESG ratings of portfolios, and that in general ESG portfolios provide a degree of ESG characteristics.²⁴⁹ They argue this is what really matters from an investor’s point of view. They make the analogy that the concerns with an ESG mutual fund are similar to those of a growth mutual fund—neither has a standardized definition, but they offer investors certain characteristics to a degree even if those characteristics vary widely across funds and even if different ratings providers rate them differently.

A 2021 study from MSCI finds that ESG ratings within the same category can have low pairwise correlations, which the study attributes to the use of different ESG metrics and weights.²⁵⁰ The study creates a composite ESG rating based on subindustry specific weights of E, S, and G and finds composite ratings tend to outperform any of the individual E, S, or G ratings. The bottom quintile of E, S, G, and composite ratings tend to have more stock drawdowns than their top quintile, especially when it comes to large drawdowns. From 2007 to 2019,

the bottom quintiles of E, S, G, and composite scores all performed worse than their top quintile. In this longer run analysis, E, S, and G scores had about equal effects, with the composite score improving on all these ratings. However, the top E, S, and G scores underperformed the bottom quintile during some time periods of their analysis. The top quintile of the composite ESG score outperformed for the entire time period.²⁵¹

Many commenters, academic researchers, and industry observers have raised serious questions about the reliability of ESG ratings. Fiduciaries use ratings as tools to synthesize large amounts of information. Reliability concerns make it more challenging for fiduciaries to conduct an analysis, but making decisions based on imperfect information is not limited to ESG investing. The Department anticipates that fiduciaries will give the same careful consideration to the usefulness and shortcomings of data sources pertaining to ESG as they do to any relevant data source.

(l) Summary of the Literature Reviewed

Paragraphs (b) and (c) of the final rule will reduce the uncertainty that fiduciaries might have about considering ESG factors, thereby permitting them to take into account the beneficial impact that ESG can have on investing. The studies examined by the Department show that ESG can have a beneficial impact on investing in many circumstances. However, that impact is not universal and does not mean that ESG investing will result in improved performance or reduced risk in every circumstance. The current lack of standardized ratings also makes it difficult to directly measure the full impact of ESG strategies.

2. Cost Savings Relating to Paragraphs (c), Relative to the Current Regulation

The current regulation expressly requires a fiduciary making an investment decision on collateral benefits when using the tiebreaker to document why pecuniary factors were not sufficient to select the investment, how the selected investment compares to alternative investments with regard to the factors listed in paragraphs (b)(2)(ii)(A) through (C) of the current regulation, and how the chosen non-pecuniary factors are consistent with the interests of the plan. This provision implemented a more rigid, heightened documentation requirement, which

²⁴¹ CFA Institute, “Future of Sustainability in Investment Management: From Ideas to Reality,” <https://www.cfainstitute.org/-/media/documents/survey/future-of-sustainability.ashx>.

²⁴² CFA Institute, “Global ESG Disclosure Standards for Investment Products” (2021), <https://www.cfainstitute.org/-/media/documents/ESG-standards/Global-ESG-Disclosure-Standards-for-Investment-Products.pdf>.

²⁴³ GAO, “Report to the Honorable Mark Warner U.S. Senate: Disclosure of Environmental, Social, and Governance Factors and Options to Enhance Them” (July 2020), <https://www.gao.gov/assets/gao-20-530.pdf>.

²⁴⁴ CFA Institute, “Global ESG Disclosure Standards for Investment Products” (2021).

²⁴⁵ OECD, “ESG Investing: Practices, Progress and Challenges” (2020), <https://www.oecd.org/finance/ESG-Investing-Practices-Progress-Challenges.pdf>.

²⁴⁶ Feifei Li and Ari Polychronopoulos, “What a Different an ESG Ratings Provider Makes!” Research Affiliates (January 2020), <https://www.researchaffiliates.com/content/dam/ra/documents/770-what-a-difference-an-esg-ratings-provider-makes.pdf>.

²⁴⁷ OECD, “ESG Investing: Practices, Progress and Challenges” (2020), <https://www.oecd.org/finance/ESG-Investing-Practices-Progress-Challenges.pdf>.

²⁴⁸ Florian Berg, Julian Kölbel, and Roberto Rigobon, “Aggregate Confusion: The Divergence of ESG Ratings,” 2022, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3438533.

²⁴⁹ Curtis, Fisch, and Robertson, “Do ESG Funds Deliver on Their Promises?” 2021.

²⁵⁰ MSCI’s ESG ratings are based on subindustry level ratings, selected from 37 ESG metrics. For each subindustry, metrics are weighted based on subindustry specific weights.

²⁵¹ MSCI ESG Research, “Deconstructing ESG Ratings Performance” (2021), <https://www.msci.com/our-solutions/esg-investing/deconstructing-esg-performance>.

imposed an annual cost burden of \$122,115 according to the impact analysis of the current rule. This view was also supported by commenters, who stated that the current regulation created an extra burden of documentation. The final rule eliminates this special documentation requirement. The removal of this provision does not excuse ERISA fiduciaries from the documentation required to satisfy their general prudence obligations.

Removing the special documentation leads to a cost savings. Like in the current regulation, the Department estimates that one percent of plans will invoke the tiebreaker in an investment decision each year, and the special documentation would have required two hours of labor from both a plan fiduciary and clerical worker. Assuming an hourly labor cost of \$129.74 for a plan fiduciary and \$61.01 for a clerical worker,²⁵² the Department estimates that this elimination, updated for revised affected entity estimates, will save approximately \$506,000 annually.²⁵³

²⁵² The Department estimates labor costs by occupation. Estimates for total compensation are based on mean hourly wages by occupation from the 2021 Occupational Employment Statistics and estimates of wages and salaries as a percentage of total compensation by occupation from the December 2021 National Compensation Survey's Employee Cost for Employee Compensation. Estimates for overhead costs for services are imputed from the 2020 Service Annual Survey. To estimate overhead cost on an occupational basis, the Office of Research and Analysis (ORA) allocates total industry overhead cost to unique occupations using a matrix of detailed occupational employment for each North American Industry Classification System (NAICS) industry. All values are in 2022 dollars. For more information in how the labor costs are estimated see: *Labor Cost Inputs Used in the Employee Benefits Security Administration, Office of Policy and Research's Regulatory Impact Analyses and Paperwork Reduction Act Burden Calculation, Employee Benefits Security Administration* (June 2019), www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/technical-appendices/labor-cost-inputs-used-in-eba-spr-ria-and-pra-burden-calculations-june-2019.pdf.

²⁵³ In the 2020 final rule published on November 13, it was estimated that that plan fiduciaries and clerical staff would each expend, on average, two hours of labor to maintain the needed documentation, resulting in an annual burden estimate of 1,290 hours annually, with an equivalent cost of \$122,115 for plans with ESG investments. For the purposes of this analysis, the Department assumes that DB plans will change investments annually, while DC plans review their investments every three years, on average. Updated to reflect updated estimates for affected plans and labor costs, the Department estimates the updated costs as: (124,302 DB plans that use ESG × 1% of plans that have ties × 2 hours × \$129.74 per hour for a plan fiduciary) + (124,302 DB plans that use ESG × 1% of plans that have ties × 2 hours × \$61.01 per hour for a clerical worker) + (25,020 DC plans that use ESG × 1% of plans that have ties × 1/3 of plans reviewing investments annually × 2 hours × \$129.74 per hour for a plan fiduciary) + (25,020 DC plans that use ESG × 1% of plans that have ties ×

3. Benefits of Paragraph (d)

Paragraph (d) of the final rule contains provisions addressing the application of the prudence and loyalty duties to the exercise of shareholder rights, including proxy voting, the use of written proxy voting guidelines, and the selection and monitoring of proxy advisory firms. The final rule's paragraph (d) will benefit plans by providing improved guidance regarding these activities. As discussed above, non-regulatory guidance that the Department has previously issued over the years may have led to the misapprehension that fiduciaries are required to participate in all proxy votes presented to them or, conversely, that they may not participate in proxy votes unless they first perform a formal cost-benefit analysis and quantify net benefits. Although the current regulation sought to address the first misunderstanding (*i.e.*, that fiduciaries are required to participate in all proxy votes) with express language, the Department is concerned that the language used may have effectively reinstated the second misunderstanding—that they may not participate in proxy votes unless they first perform a formal cost-benefit analysis and quantify net benefits—by suggesting that fiduciaries need special justification to participate in proxy votes. Several commenters stated that this misinterpretation leads some fiduciaries to abstain from many proxy votes out of an abundance of caution. These abstentions leave the interests of plans, participants, and beneficiaries unrepresented in proxy votes. An increase in proxy votes by plans will improve corporate accountability.

The Department believes that the principles-based approach retained in paragraph (d) of the final rule will address these misunderstandings and clarify that neither extreme is required. Instead, plan fiduciaries, after an evaluation of relevant facts that form the basis for any particular proxy vote or other exercise of shareholder rights, must make a reasoned judgment both in deciding whether to exercise shareholder rights and how to exercise such rights. In making this judgment, plan fiduciaries must act in accordance with the economic interest of the plan, must consider any costs involved, and must never subordinate the interests of

$\frac{1}{3}$ of plans reviewing investments annually × 2 hours × \$61.01 per hour for a clerical worker) = \$506,029. This requirement has been eliminated in the finalized rule. 85 FR 72846. (Source *Private Pension Plan Bulletin: Abstract of 2020 Form 5500 Annual Reports*, Employee Benefits Security Administration (2022; forthcoming), Table D3.)

participants in their retirement benefits to unrelated goals.

The clarifications offered in this final rule will lead to increased proxy voting activity compared to the baseline. The reason is that the final rule will address the misunderstanding that fiduciaries need special justification to participate in proxy votes. With this additional guidance, fiduciaries will have sufficient clarity to participate in proxy votes unless a responsible plan fiduciary determines it is not in the plan's best interest. The Department believes this is beneficial because it ensures that shareholders' interests, as a company's owners, are protected. By extension, this means the interests of plan participants and beneficiaries as shareholders are also protected.

Preserving flexibility, paragraph (d) of the final rule carries forward core elements of the provision from the current regulation that allows a plan to have written proxy voting policies that govern decisions on when to vote on different categories or types of proposals, subject to the aforementioned principles. With the ability for plans to adopt policies to govern the decision whether to vote on a matter or class of matters, plan fiduciaries will be in a better position to conserve plan assets by establishing specific parameters designed to serve the plan's interests.

The Department received several comments on the NPRM expressing support for proxy voting as an essential fiduciary function. One commenter argued that proxy voting can help reduce investment risk and pointed to the success of shareholder resolutions in reducing hazardous chemicals and pesticides, which could cause reputational and financial damage to firms if improperly managed. Several commenters argued that proxy votes can provide critical oversight of management, which can reduce downside risk. One investment management firm commented that they approach proxy voting with "the consistent goal of promoting strong corporate governance, acting in the best interest of [. . .] shareholders and clients." Another commenter argued that the Department should go further and require voting in favor of proxy votes that align holdings with ESG metrics when in the interest of plan participants and beneficiaries, citing the financial effects that waste reduction efforts can have on lowering business costs. The Department considered this suggestion, but believes that the Department's longstanding view of ERISA with regards to proxy voting sets out a more balanced approach. The Department believes that proxies should

be voted as part of the process of managing the plan's investment in company stock unless a responsible plan fiduciary determines a proxy vote may not be in the plan's best interest; for example, if the costs associated with voting outweigh the expected benefits.

Commenters provided literature on the cost, benefits, and effects of shareholder engagement and proxy voting.

(a) Changes in Levels of Proxy Voting

The Department expects that the final rule will promote, rather than deter, responsible proxy voting compared to the 2020 rule; however, it is less certain that it will result in any increase in proxy voting as compared to the pre-regulatory guidance, which took a similar approach. In the NPRM, the Department invited comments on whether the proposed rule would increase proxy voting as compared to the pre-regulatory guidance but did not receive any comments on the question.

Some commenters discussed how the proposed rule would affect proxy voting activity. For instance, one commenter noted that the proposed rule would help support appropriate levels of proxy voting, though they did not specify how, while recognizing that a professional advisor across many accounts can play a practical role in alleviating the costs and burdens of voting at the plan level. Conversely, another commenter noted that even large funds could be "rationally apathetic" because the costs of analyzing a given proxy vote and overcoming conflicts of interest will likely outweigh the marginal benefits of a "correct" proxy vote. This commenter expressed that unless there are explicit standards in place making clear that proxy voting is a fiduciary obligation, there is a significant risk of sub-optimal proxy votes. The Department's longstanding view of ERISA is that proxies should be voted as part of the process of managing the plan's investment in company stock unless a responsible plan fiduciary determines a proxy vote may not be in the plan's best interest. We believe that this standard highlights the importance of proxy voting, while also allowing a fiduciary to make prudent decisions regarding the costs and benefits of any particular proxy vote.

(b) Trends in Proxy Voting

Commenters provided literature on the state of proxy voting. Orowitz, Kumar, and Hagel (2022) observe that by June of the 2022 proxy season there were already 924 shareholder proposal

submissions.²⁵⁴ Even though the 2022 proxy season was not complete at the time of the study, this figure represented a 10 percent increase from 2021, when 837 shareholder proposals were submitted. There was a similar 11 percent increase between 2020 and 2021, when the number of proposals increased from 754 to 837. Based on projections for the rest of the year, the authors state that it is possible that 621 of these shareholder resolutions may eventually come to a vote. This would represent a 42 percent increase from 2021.²⁵⁵

Cook and Solberg (2021) examined the number of shareholder resolutions brought to a vote regarding environmental and social issues. The authors observed 171 votes on shareholder-sponsored resolutions pertaining to environmental and social issues between July 1, 2020 and June 30, 2021, down from 220 votes in 2017. The study attributes the decline in environmental and social shareholder resolution votes to SEC regulations, which discouraged climate shareholder resolutions. Of the 171 resolutions, however, a record 36 resolutions passed with majority support. Despite the decline in shareholder resolutions received, average support rose to 34 percent, which is five percentage points higher than the previous record set in 2019.²⁵⁶

Koningsburg, Thorne, and Cahill (2021) analyzes trends across annual general meetings in 2021. The authors find that U.S. shareholders submitted 115 proposals related to the environment, with 74 percent of those being related to climate. This is a significant increase from 2020, when shareholders submitted 89 environmental resolutions, with 54 percent of those related to climate. There were 9 shareholder resolutions filed on diversity disclosure, three of which requested public disclosure of EEO-1 data and six of which requested enhanced reporting on diversity, equity, and inclusion data. Further, there were eight shareholder proposals on racial equity audits. For governance, in 2021, there was 95 percent support for re-election of directors in the Russell 3000; however, the proportion of directors receiving less than 80 percent support

²⁵⁴ Hannah Orowitz, Rajeev Kumar, and Lee Ann Hagel, "An Early Look at the 2022 Proxy Season," *The Harvard Law School Forum on Corporate Governance* (7 June 2022), <https://corpgov.law.harvard.edu/2022/06/07/an-early-look-at-the-2022-proxy-season/>.

²⁵⁵ *Id.*

²⁵⁶ Jackie Cook and Lauren Solberg, "The 2021 Proxy Season in Charts," Morningstar (August 2021), <https://www.morningstar.com/articles/1052234/the-2021-proxy-voting-season-in-7-charts>.

has increased in recent years. The authors attribute the decline in support to lack of progress by the board on climate change and diversity.²⁵⁷

Another important facet of proxy voting is the investor's approach to proposals by management. Shareholder resolutions are often the most discussed aspect of proxy voting, but only make up a small share of total proxy votes. According to ICI (2019), 98 percent of proxy proposals at the 3,000 largest publicly traded firms were submitted by management, with the majority of those proposals being related to compensation, personnel, and other key business decisions. ICI also finds investors are significantly more likely to support management resolutions than they are shareholder resolutions. They found that 94 percent of the votes were cast in favor of proposals by management, whereas only 34 percent of votes were cast in favor of shareholder resolutions. This relationship also held with respect to the recommendations of proxy advisors. Proxy advisors recommended voting in favor of 93 percent of management proposals, but only 65 percent of shareholder proposals.²⁵⁸

(c) The Role of Proxy Advisory Firms

Several commenters weighed in on the role of proxy advisory firms. Multiple commenters expressed concerns over the role of the proxy advisory service industry, which they observed as being highly concentrated. Several commenters argued that proxy advisory firms do not have the knowledge or sufficient staff necessary to adequately conduct the type of analysis necessary for making recommendations to fiduciaries. One commenter went on to further express concern that proxy advisory firms have no obligation to explain their recommendations or provide the underlying research to back them up.

In addition to concerns over the role of proxy advisory firms, several commenters expressed concerns regarding the potential for conflicts of interests at these firms. If a proxy advisory firm makes proxy voting recommendations that promote ESG it may increase their lines of business providing ESG ratings and advising companies on how to increase their ESG ratings.

²⁵⁷ Dan Koningsburg, Sharon Thorne, and Stephen Cahill, "Investor Behavior in the 2021 Proxy Season," *Harvard Law School Forum on Corporate Governance* (2021), <https://corpgov.law.harvard.edu/2021/11/10/investor-behavior-in-the-2021-proxy-season/>.

²⁵⁸ "ICI Research Perspective", ICI (2019), <https://www.ici.org/system/files/attachments/per25-05.pdf>.

Commenters primarily focused on four sections of the final rule which they asserted would lead to increased reliance on proxy advisory firms. First, commenters pointed to the rescission of language from paragraph (e)(2)(ii) of the current regulation stating that “the fiduciary duty to manage shareholder rights appurtenant to shares of stock does not require the voting of every proxy or the exercise of every shareholder right.” They believe that removing this language will encourage higher levels of proxy voting by fiduciaries and that fiduciaries will rely on proxy advisory services to deal with the workload from increased proxy voting. Second, commenters stated that removing the specific monitoring provisions from paragraph (e)(2)(ii) of the existing regulation would reduce the effort associated with using proxy advisory firms while simultaneously reducing accountability and monitoring of those firms. Third, commenters stated that the removal of specific recordkeeping requirements from paragraph (e)(2)(ii)(E) of the current regulation would similarly make it easier to rely on proxy advisory firms, while also impeding the ability of participants to ensure that ERISA plan proxies are being voted in a manner consistent with the financial interest of the plan. Finally, the commenters point to the removal of two safe harbors from paragraphs (e)(3)(i)(A) and (B) of the current regulation, which specified policies of limiting voting based on voting type and holding size. Other commenters stated that the safe harbors applied to instances in which proxy voting would not be expected to have an economic effect. They further expanded that without the safe harbors, fiduciaries would participate in all proxy votes, which would require increased reliance on proxy advisory firms.

The Department understands these concerns, and notes that fiduciaries still have a duty under the final rule’s general monitoring provision, at paragraph (d)(2)(ii)(E) to prudently select and monitor the provider of proxy advisory services. However, the Department did not find it necessary to retain an additional provision to differentiate the monitoring of a proxy advisory firm from the monitoring of any other service providers that a fiduciary may utilize. Additionally, section 404 (a)(1)(B) of ERISA already requires proper documentation both of the activities of the investment manager and of the named fiduciary of the plan in monitoring the activities of the investment manager. This would require the investment manager or other

responsible fiduciary to keep accurate records as to the voting of proxies, and periodically review the voting procedures and individual votes. The Department did not find it necessary to retain additional recordkeeping requirements beyond these that were already required of fiduciaries. With regards to the safe harbors, the Department notes that fiduciaries may still develop written guidelines to determine their decisions to participate in proxy votes. The Department reiterates its longstanding view of ERISA that proxies should be voted unless a responsible plan fiduciary determines a proxy vote is not in the plan’s best interest.

Several commenters referenced studies discussing the role of proxy advisory firms. A central theme in this literature was the argument that shareholder resolutions are heavily influenced by the proxy advisory service industry. Malenko and Shen (2016) studied the effects of the proxy advisory industry on say-on-pay proposals from 2010 to 2011. The authors observed that negative recommendations by proxy advisory firms reduced support for proposals by 25 percentage points.²⁵⁹ A Timothy Doyle (2018) report also observed that certain large institutional investors vote in line with proxy advisory firm recommendations 80–95 percent of the time for positive recommendations, and 50–85 percent for negative recommendations.²⁶⁰ At its most extreme, this influence can manifest into “robovoting” whereby investors follow a proxy advisory firm’s voting guidance without any independent review. Another report by Timothy Doyle (2018) finds that 175 asset managers representing more than \$5 trillion in assets under management and who voted on more than 100 shareholder resolutions voted in line with proxy advisory firm recommendations more than 95 percent of the time. Of these 175 asset managers, 82 voted with proxy advisory services more than 99 percent of the time.²⁶¹ In a similar vein, Paul Rose (2019) found

²⁵⁹ Nadya Malenko and Yao Shen, “The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design,” *The Review of Financial Studies*, Volume 29, Issue 12, December 2016, Pages 3394–3427, <https://doi.org/10.1093/rfs/hhw070>.

²⁶⁰ Timothy Doyle, “The Conflicted Role of Proxy Advisors,” American Council for Capital Formation (May 2018), <https://accf.org/wp-content/uploads/2018/05/ACCF-The-Conflicted-Role-of-Proxy-Advisor-FINAL.pdf>.

²⁶¹ Timothy Doyle, “The Realities of Robo-Voting,” American Council on Capital Formation (November 2018), https://accfcorgov.org/wp-content/uploads/ACCF-RoboVoting-Report_11_8_FINAL.pdf.

98 investors, representing \$3.2 trillion in assets under management, voted in alignment with ISS more than 99.5 percent of the time.²⁶²

In addition to concerns over the influence of proxy advisory firms, some literature also took issue with the quality of their recommendations. Larcker, McCall, and Ormazabal (2015) find that companies faced with the prospect of a negative proxy advisory service recommendation on say-on-pay proposals will often change their compensation programs “in a manner consistent with the features known to be favored by proxy advisory firms.” The stock market reaction to these pre-emptive changes is statistically negative.²⁶³

Some literature was more skeptical on the level of influence by the proxy advisory service industry. Nili and Kastiel (2020) find that the success rates of the two largest proxy advisory firms, Glass Lewis and ISS, varies significantly from year to year.²⁶⁴ From 2005 to 2017, the percentage of proxy fights won by the dissidents when supported by Glass Lewis has been as low as 33 percent in 2012 and as high as 100 percent in 2010. When supported by ISS, the percentage of proxy fights won by the dissidents has been as low as 43 percent in 2006 and as high as 89 percent in 2014.

Similar variation was found in the percentage of proxy fights won by management when supported by these proxy advisory firms. The authors found that these mixed findings were consistent with the overall corporate governance literature on proxy advisory services. In a review of relevant literature, Larcker, Tayan, and Copland (2015), observe that “the empirical evidence shows that an against recommendation is associated with a reduction in the favorable vote count by 10 percent to 30 percent.”²⁶⁵ Choi, Fisch, and Kahan (2010) estimate that the negative recommendations of proxy advisory firms only shifted investor votes by 6 to 10 percent after controlling

²⁶² Paul Rose, “Robovoting and Proxy Vote Disclosure” (November 2019), <https://ssrn.com/abstract=3486322>.

²⁶³ David F. Larcker, Allan McCall, and Gaizka Ormazabal, “The Economic Consequences of Proxy Advisor Say-on-Pay Voting Policies,” *Journal of Law and Economics*, vol. 58, no. 1, Feb. 2015, pp. 173–204, <https://doi.org/10.2139/ssrn.2101453>.

²⁶⁴ Yaron Nili and Kobi Kastiel, “Competing for Votes,” *Wisconsin Law School Legal Studies Research Paper Series Paper*, No. 1605 (2020), <https://ssrn.com/abstract=3681541>.

²⁶⁵ David F. Larcker, Brian Tayan, and James R. Copland, “The Big Thumb on the Scale: An Overview of the Proxy Access Advisory Industry,” *Harvard Law School Forum on Corporate Governance* (June 14, 2018), <https://corpgov.law.harvard.edu/2018/06/14/the-big-thumb-on-the-scale-an-overview-of-the-proxy-advisory-industry/>.

for observable factors.²⁶⁶ McCahery, Sauthner, and Starks (2015) find that “55 percent of institutional investors agree that proxy advisory firms help them make more informed voting decisions,” but concluded that institutional investors rely on the advice of proxy advisory firms as a complement to their decision-making, rather than a substitute.²⁶⁷

As stated in the preamble, the Department believes that the solution to proxy-voting costs is for the fiduciary to be prudent in incurring expenses to make proxy decisions and, wherever possible, to rely on efficient structures, which may include the use of proxy advisory services. However, paragraph (d)(2)(iii) of the final rule states that a fiduciary may not adopt a practice of following the recommendations of a proxy advisory firm or other service provider without a determination that such firm or service provider’s proxy voting guidelines are consistent with the fiduciary’s obligations described in paragraphs (d)(2)(ii)(A) through (E) of this section. The Department recognizes some commenters’ continued concerns about the role of proxy advisory firms, but this provision (in conjunction with the general monitoring provision in paragraph (d)(2)(ii)(E), discussed above) will protect plan participants and beneficiaries by ensuring adequate oversight of proxy advisory firms.

(d) Costs of Proxy Voting and Shareholder Engagement and Its Effect on Company Behavior

The effects of proxy voting and shareholder engagement on company activity is the subject of a diverse body of literature. Much of the research on proxy voting and shareholder engagement focuses on the effects of proxy voting and shareholder engagement on a company’s ESG performance, which could then affect a company’s financial performance. The association between ESG and financial performance was discussed in detail in previous sections.

Another body of research looks at the effectiveness of shareholder resolutions as a tool to incite change. For instance, Kölbel, Heeb, Paetzold, and Busch (2020) review five studies on shareholder resolutions and found that 18 to 60 percent of shareholder

resolutions are successful in changing company behavior.²⁶⁸ The 18 percent finding by Dimson, Karakas, and Li (2015) comes from the oldest sample period (1999–2009) of the five papers, with more recent studies suggesting higher success rates.²⁶⁹ One of the studies reviewed went on to further demonstrate an increase in ESG ratings as a result of these shareholder resolutions.²⁷⁰

Literature on the direct financial effects of proxy voting on stock returns is more limited. A literature summary by Clark, Feiner, and Viehs (2014) finds that most papers on proxy voting find inconclusive or statistically insignificant results on the relationship to stock returns. The authors find that the reviewed literature “only provides limited evidence that proxy voting is an effective tool to promote proper ESG standards, or that it is helpful in creating superior financial performance at investee firms.”²⁷¹

Cuña, Gine, and Guadalupe (2012) find that companies with successful shareholder governance proposals yielded abnormal returns—1.3 percent higher than firms with failed proposals on the day of the vote. Over the week of the vote, these abnormal returns accumulate to 2.4 percent. This gain in shareholder value is more pronounced regarding anti-takeover provisions, like eliminating classified boards and poison pills. This effect is also stronger at firms with more concentrated ownership, more anti-takeover provisions in place, more research and development (R&D) expenditures, and more shareholder proposals in the past. The effect is also larger for proposals made by institutional shareholders rather than individuals. The authors further find that actually implementing these accepted proposals increases the shareholder value effect to 2.8 percent.²⁷²

In summary, the literature provided leads the Department to believe that proxy voting and shareholder

engagement is increasing in its frequency and scope. The effects of this activity are not uniformly agreed upon in the literature, however there is evidence of proxy voting and shareholder engagement leading to increased shareholder value and financial returns at firms. There is also evidence of proxy voting and shareholder engagement being able to increase a company’s ESG performance, which may have financial performance benefits that were discussed previously. Proxy voting and shareholder engagement has a tangible time cost, which can be reduced through the use of efficient structures, including proxy voting guidelines, and proxy advisers/managers that act on behalf of large aggregates of investors. Evidence regarding the influence of these proxy advisory firms is mixed, and varies from year to year, company to company, and topic to topic. Accordingly, the Department stresses fiduciaries’ obligation to monitor the performance of proxy advisory firms to ensure that they are performing their work in a way that is consistent with the plan’s best interest.

4. Cost Savings Relating to Paragraphs (d) and (e), Relative to the Current Regulation

In the cost savings estimates below, the Department assumes an hourly labor cost of \$129.74 for a plan fiduciary and \$61.01 for a clerical worker.²⁷³

Paragraph (d) of the final rule eliminates the recordkeeping requirement in paragraph (e)(2)(ii)(E) of the current regulation which provides that, when deciding whether to exercise shareholder rights and when exercising shareholder rights, plan fiduciaries must maintain records on proxy voting activities and other exercises of shareholder rights. The change is

²⁷³ The Department estimates labor costs by occupation. Estimates for total compensation are based on mean hourly wages by occupation from the 2021 Occupational Employment Statistics and estimates of wages and salaries as a percentage of total compensation by occupation from the December 2021 National Compensation Survey’s Employee Cost for Employee Compensation. Estimates for overhead costs for services are imputed from the 2020 Service Annual Survey. To estimate overhead cost on an occupational basis, ORA allocates total industry overhead cost to unique occupations using a matrix of detailed occupational employment for each NAICS industry. All values are in 2022 dollars. For more information on how the labor costs are estimated see: *Labor Cost Inputs Used in the Employee Benefits Security Administration, Office of Policy and Research’s Regulatory Impact Analyses and Paperwork Reduction Act Burden Calculation*, Employee Benefits Security Administration (June 2019), www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/technical-appendices/labor-cost-inputs-used-in-ebsa-opr-ria-and-pra-burden-calculations-june-2019.pdf.

²⁶⁶ Stephen Choi, Jill Fisch, and Marcel Kahan, “The Power of Proxy Advisors: Myth or Reality?” 59 *Emory Law Journal* 869, 882 (2010), <https://scholarlycommons.law.emory.edu/elj/vol59/iss4/2/>.

²⁶⁷ Joseph A. McCahery, Zacharias Sautner, and Laura T. Starks, “Behind the Scenes: The Corporate Governance Preferences of Institutional Investors,” 71 *Journal of Finance*, 2905, 2928 (2016). https://www.jstor.org/stable/44155408#metadata_info_tab_contents.

²⁶⁸ Julian F. Kölbel, Florian Heeb, Falko Paetzold, and Timo Busch, “Can Sustainable Investing Save the World? Reviewing the Mechanisms of Investor Impact,” *Organization & Environment*, vol. 33, no. 4, 2020, pp. 554–574, <https://doi.org/10.1117/1086026620919202>.

²⁶⁹ E. Dimson, O. Karakas, and X Li, “Active Ownership,” *Review of Financial Studies*, volume 28, issue 12, p. 3225–3268, 2015.

²⁷⁰ Kölbel, Heeb, Paetzold, and Busch, “Can Sustainable Investing Save the World?” 2020.

²⁷¹ Clark, Feiner, and Viehs, “From the Stockholder to the Stakeholder,” 2014.

²⁷² Cuñat Vicente, Mireia Gine, and Maria Guadalupe, “The Vote Is Cast: The Effect of Corporate Governance on Shareholder Value,” *The Journal of Finance*, vol. 67, no. 5, 2012, pp. 1943–1977, <https://doi.org/10.1111/j.1540-6261.2012.01776.x>.

expected to produce a cost savings of \$6.1 million per year relative to the current regulation.²⁷⁴ This cost savings was confirmed by one commenter.

The final rule amends the provision of the current regulation that addresses proxy voting policies, paragraph (e)(3)(i) of the current regulation, by removing the two “safe harbor” examples for proxy voting policies that would be permissible under the provisions of the current regulation. As discussed earlier in the preamble to this regulation, the Department believes that the two “safe harbor” examples would likely become widely adopted by plan fiduciaries if maintained. When adopting the current regulation, the Department estimated that it would take a legal professional two hours to evaluate and implement changes to proxy voting policies within the scope of the safe harbors. In the final rule, without the safe harbors, the Department estimates that it will take a legal professional 30 minutes to update policies and procedures. This final rule thus reduces the burden related to evaluating, updating, and implementing proxy voting policies and procedures and voting by \$11.6 million in the first year relative to the current regulation.²⁷⁵

The total costs savings associated with the amendments to paragraph (d) are estimated to be approximately \$17.7 million.

E. Costs

The Department expects the amendments made by the final rule will change plan fiduciary investment behavior; however, the overall effect of amendments on investment behavior is largely uncertain. In the analysis below, the Department has carefully considered the costs associated with the amendments and quantified the costs

expected to result from the final rule, with the acknowledgment that a precise quantification of all costs stemming from changes in behavior is not possible. Nevertheless, the Department expects the incremental costs of the final rule to be relatively small and the overall benefits to outweigh the costs. As shown in the analysis below, the known incremental costs of the proposal are expected to be minimal on a per-plan basis.

The analysis below is based on labor cost estimates of \$153.21 for a legal professional.²⁷⁶

1. Cost of Reviewing the Final Rule and Reviewing Plan Practices

Plans, plan fiduciaries, and their service providers will need to read the final rule and evaluate how it will impact their practices. To estimate the costs associated with reviewing the amended rule, the Department considers two sub-groups of plans: plans that consider ESG factors in their investment process and plans that hold corporate stock with voting rights.

The Department estimates that approximately 149,300 plans will consider ESG factors in their investment practice and will be affected by the finalized amendments in paragraphs (b) and (c).²⁷⁷ For each plan, a legal professional will need to review paragraphs (b) and (c) of the final rule, evaluate how these provisions might affect their investment practices and assess whether the plan will need to make changes to investment practices. The Department estimates that this review will take a legal professional approximately four hours to complete, resulting in an aggregate cost burden of approximately \$91.5 million²⁷⁸ or a per-

plan cost burden of approximately \$613.²⁷⁹

The Department estimates that 63,670 plans hold corporate stock with voting rights and will be affected by the finalized amendments pertaining to proxy voting in paragraph (d). For each plan, a legal professional will need to review paragraph (d) of the amended rule and evaluate how it affects their proxy voting practices. The Department estimates that this review process will require a legal professional, on average, approximately four hours to complete, resulting in an aggregate cost burden of approximately \$39.0 million²⁸⁰ or a per-plan cost of approximately \$613.²⁸¹

The Department believes that most plans, in both subsets discussed above, will rely on a service provider to perform such a review and that each service provider will likely oversee multiple plans. The Department does not have data that would allow it to estimate the number of service providers acting in such a capacity for these plans. While the Department believes that this cost is likely an overestimate, given the lack of data, the Department believes it is reasonable.

2. Possible Changeover Costs

The Department expects that some plans may change investments or investment processes in light of the clarifications in the final rule. For example, plans may decide to replace existing investments with ESG investments. This may involve some short-term costs. In the Department’s view, this will be net beneficial because compliant acquisitions of ESG assets will be done with the aim of reducing the plan’s ESG-related financial risk or improving the plan’s investment performance. Thus, even if there are short-term costs associated with changed investment practices, the benefits to the plan of reduced ESG-related financial risk are expected to exceed these costs over time. The Department lacks data to estimate the likely size of this impact. The Department solicited comments on this assumption in the NPRM but did not receive any comments.

\$153.21 is used for a legal professional. The cost is estimated as follows: 149,322 plans × 4 hours × \$153.21 = \$91,510,494.

²⁷⁹ The per-plan burden is estimated as follows: \$91,510,494/149,322 plans = \$612.84, rounded to \$613.

²⁸⁰ The burden is estimated as follows: 63,670 plans × 4 hours = 254,680 hours. A labor rate of \$153.21 is used for a lawyer. The cost burden is estimated as follows: 63,670 plans × 4 hours × \$153.21 = \$39,019,523.

²⁸¹ The per-plan burden is estimated as follows: \$39,019,523/63,670 plans = \$612.84, rounded to \$613.

²⁷⁴ In the 2020 final rule published on December 16, it was estimated that a plan fiduciary and a clerical staff would expend, on average, 30 minutes each to fulfill the recordkeeping requirement. The burden in the 2020 rule was estimated as \$6.05 million. Updated to reflect updated estimates for affected plans and labor costs, the Department estimates the updated costs as: (63,670 plans × 0.5 hours × \$129.74 per hour for a plan fiduciary) + (63,670 plans × 0.5 hours × \$61.01 per hour for a clerical worker) = \$6,072,526, or \$6.1 million.

²⁷⁵ In the 2020 final rule published on December 16, it was estimated that a legal professional would expend, on average, two hours to update policies and procedures. The burden in the 2020 rule was estimated as \$17.2 million. Updated to reflect updated estimates for affected plans and labor costs, the Department estimates the updated costs for the original requirement as: 63,670 plans × 2 hours × \$129.74 per hour for a plan fiduciary = \$16,521,092. As discussed in the Cost section of this analysis, the Department estimates that it will take a legal professional just thirty minutes to update policies and procedures for each of the estimated 63,670 plans affected by the rule, resulting in a cost of \$4,877,440. This results in a cost savings of \$11,643,651, or \$11.6 million. 85 FR 81658.

²⁷⁶ The Department estimates labor costs by occupation. Estimates for total compensation are based on mean hourly wages by occupation from the 2021 Occupational Employment Statistics and estimates of wages and salaries as a percentage of total compensation by occupation from the December 2021 National Compensation Survey’s Employee Cost for Employee Compensation. Estimates for overhead costs for services are imputed from the 2020 Service Annual Survey. To estimate overhead cost on an occupational basis, ORA allocates total industry overhead cost to unique occupations using a matrix of detailed occupational employment for each NAICS industry. All values are in 2022 dollars. For more information on how the labor costs are estimated see: *Labor Cost Inputs Used in the Employee Benefits Security Administration, Office of Policy and Research’s Regulatory Impact Analyses and Paperwork Reduction Act Burden Calculation, Employee Benefits Security Administration* (June 2019), www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/technical-appendices/labor-cost-inputs-used-in-eba-sa-opr-ria-and-pra-burden-calculations-june-2019.pdf.

²⁷⁷ For more information on this estimate, refer to the discussion of affected entities in section IV.C.

²⁷⁸ The burden is estimated as follows: 149,322 plans × 4 hours = 597,288 hours. A labor rate of

3. Cost Associated With Changes in Investment or Investment Course of Action

Paragraphs (b) and (c)(1) of the final rule address a fiduciary's duty of prudence and loyalty under ERISA with respect to consideration of an investment or investment course of action. Paragraph (c)(1) of the final rule provides that a fiduciary may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives, and may not sacrifice investment return or take on additional investment risk to promote benefits or goals unrelated to said interests of the participants and beneficiaries. Paragraph (b)(4) of the final rule, in relevant part, provides that 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 section 402(b)(1) of ERISA. These provisions will require a fiduciary to perform an evaluation, including a prudent analysis of risk and return factors. These provisions provide direction on what to include in that evaluation.

In the NPRM, the Department did not attribute a cost to these requirements, with the understanding that many plan fiduciaries already undertake such evaluations as part of their investment selection decision-making process, including documentation of their decisions, process, and reasoning. One commenter refuted this assumption, noting that the industry lacks consistent definitions on ESG topics and stating that evaluating ESG topics would be a manual process for plan sponsors, requiring time and resources. Conversely, another commenter noted that data collection costs imposed by the rule would likely be de minimis, as the investment community is collecting ESG data independent of the rulemaking process.

The commenters have not persuaded the Department to change its views on this topic. Plan fiduciaries generally already undertake deliberative

evaluations as part of their investment selection decision-making process and this final rule does not add burden to those deliberations; but rather, the final rule clarifies that the scope of those deliberations may include climate change and other ESG factors within the confines of paragraphs (b)(4) and (c)(1) of the final rule. The Department does not intend to increase fiduciaries' burden of care attendant to such consideration; therefore, no incremental costs are estimated for these requirements.

4. Cost Associated With Changes to the "Tiebreaker" Rule

The final rule, at paragraph (c)(2), implements a version of the tiebreaker concept that is comparable to and commensurate with the formulation previously expressed in Interpretive Bulletin 2015-1 (and first explained in Interpretive Bulletin 94-1). The final rule's tiebreaker provision is relevant and operable only once a prudent fiduciary determines that competing alternative investments equally serve the financial interests of the plan. In these circumstances, the plan fiduciary may focus on the collateral benefits of an investment or investment course of action to decide the outcome. This version of the tiebreaker is more flexible than the regulation this rule replaces, which requires that the risk and reward of competing investments be indistinguishable before the tiebreaker can be utilized.

While the provision implies a requirement for analysis and documentation, the Department expects that the analytics and documentation requirements of the tiebreaker provision are subsumed in the analytics and documentation requirements of the risk and return analysis required by paragraphs (c)(1) and (b)(4) of the final rule. The analysis of risk and return factors under paragraphs (c)(1) and (b)(4) of the final rule in the first instance will necessarily reveal any collateral benefits of an investment or investment course of action, which may then be used to break a tie pursuant to paragraph (c)(2) of the final rule. In this sense, paragraph (c)(2) of the final rule thus imposes no distinct process, and therefore no significant additional costs, apart from a plan's ordinary investment selection process. Based on this

assumption, the Department attributes no costs to paragraph (c)(2) of the final rule.

5. Cost To Update Plan's Written Proxy Voting Policies

Paragraph (d)(3)(i) of the final rule provides that plan fiduciaries may adopt proxy voting policies on when to vote a proxy ballot. Such a policy must be prudently designed to serve the plan's interests in providing benefits to participants and their beneficiaries and to defray reasonable expenses of administering the plan. In addition, plan fiduciaries must periodically review any such proxy voting policies under paragraph (d)(3)(ii).

The Department estimates that 63,670 plans hold corporate stock with voting rights and will be affected by the finalized amendments pertaining to proxy voting in paragraph (d).²⁸² For each plan, the Department estimates that, on average, it will take a legal professional thirty minutes to update policies and procedures, resulting in an aggregate incremental cost of \$4.9 million,²⁸³ or a per-plan incremental cost of \$77,²⁸⁴ in the first year relative to the current rule.

The amended paragraph (d)(3)(ii) will require plans to periodically review proxy voting policies. However, the Department believes that the final rule largely comports with current practice for ERISA fiduciaries, such that plan fiduciaries already periodically review proxy voting policies to meet their obligations under ERISA. The Department does not expect that plans will incur additional cost associated with the periodic review.

6. Summary

The Department estimates that the total incremental costs associated with the final rule will be \$135.4 million in the first year with no additional costs in subsequent years. The aggregate and per-plan costs are summarized in Table 2.

²⁸² For more information on this estimate, refer to the discussion of affected entities in section IV.C.

²⁸³ The burden is estimated as follows: 63,670 plans × 0.5 hour = 31,835 hours. A labor rate of \$153.21 is used for a legal professional: (63,670 plans × 0.5 hour × \$153.21 = \$4,877,440).

²⁸⁴ The per-plan burden is estimated as follows: \$4,877,440/63,670 plans = \$76.61, rounded to \$77.

TABLE 2—COSTS FOR PLANS TO COMPLY WITH THE REQUIREMENTS

| Requirement | Aggregate cost | | Per-plan cost | |
|---|----------------|--------|---------------|--------|
| | Year 1 | Year 2 | Year 1 | Year 2 |
| Plans considering ESG factors when selecting investments | | | | |
| Review of Plan Investment Practices | \$91,510,494 | \$0.00 | \$612.84 | \$0.00 |
| Total | 91,510,494 | 0.00 | 612.84 | 0.00 |
| Plans holding corporate stock, directly or through ERISA-covered intermediaries | | | | |
| Review of Proxy Voting Practices | 39,019,523 | 0.00 | 612.84 | 0.00 |
| Update Proxy Voting Policies | 4,877,440 | 0.00 | 76.61 | 0.00 |
| Total | 43,896,963 | 0.00 | 689.45 | 0.00 |
| Plans that both consider ESG factors when selecting investments and hold corporate stock, directly or through ERISA-covered intermediaries | | | | |
| Total | 135,407,458 | 0 | 1,302.29 | 0.00 |

This cost estimate differs from the cost estimate in the NPRM in several ways. First, paragraph (c)(3) of the NPRM included a disclosure requirement when collateral benefits were used in a tiebreaker. The removal of this requirement in the final rule decreased the cost estimate. Additionally, in the NPRM, the Department estimated that 11 percent of retirement plans would be affected by paragraph (c) of the proposal. In the final rule, in consideration of comments received on the NPRM, this estimate was increased to 20 percent of retirement plans. This change increased the cost estimate. Finally, this cost estimate reflects more recent data on the number of retirement plans and updated estimates of labor costs. The incorporation of updated data also increased the cost estimate.

F. Transfers

The final rule will result in transfers. For instance, the final rule may facilitate changes in plan fiduciary behavior, resulting in transactions in which a party experiences increased returns while other parties experience decreased returns of equal magnitude, resulting in a transfer, due to either the selection of investments or the investment course of action.

In particular, transfers could arise as a result of substantially greater confidence on the part of fiduciaries that they may consider ESG factors going forward. As discussed previously, the public record reflects that the current regulation has already had a chilling effect on appropriate use of relevant ESG factors in investment decisions. Although the current regulation acknowledges that ESG factors can in some instances be taken

into account by a fiduciary, it also includes multiple statements that have been interpreted as discouraging their consideration. This conflicting guidance has disincentivized fiduciaries from considering relevant ESG factors in order to minimize potential legal liability under ERISA. Such a disincentive has a distortionary effect on the investment of ERISA plan assets well into the future by changing fiduciaries' investment decisions and preventing them from considering ESG factors that they would otherwise find economically advantageous. The Department expects the clear guidance in this final rule to eliminate this existing market distortion.

While the effect the amendments will have on assets is discussed as a benefit in section IV.D, this will also impact the flow of revenue to investment entities. For example, if, because of the amendments, plan assets are moved from Fund A to Fund B, Fund A's asset managers would experience a decrease in revenue while Fund B's asset managers would experience an increase in revenue. As a result, there would be a transfer from non-ESG product providers to ESG product providers. Similarly, there could be a transfer from companies with lower ESG ratings to companies with higher ESG ratings. Although the Department is unable to quantify the transfers that might result, the Department expects the magnitude of transfers will likely exceed \$100 million annually, given that roughly \$12.0 trillion is currently invested in ERISA plan assets,²⁸⁵ and the lower

bound estimate of plan assets invested using ESG factors in 2020 is 0.03 percent.²⁸⁶

Similarly, transfers also could arise as a result of the proposed changes to the proxy voting provisions in paragraph (e) of the current regulation (relocated to paragraph (d) of the amended rule). For instance, the current regulation may discourage plans from voting proxies as a result of the no-vote statement in paragraph (e)(2)(ii) and the two safe harbors in paragraphs (e)(3)(i)(A) and (B) of the current regulation. The final rule's rescission of these provisions, however, will increase plan proxy votes and effectively transfer some voting power from other shareholders back to ERISA plans. A common proxy vote where such an outcome may occur would be a vote to select a member of the Board of Directors, resulting in a shift in power from a losing candidate to a winning candidate. A transfer might also occur related to a proxy vote for one company to acquire another company.

G. Uncertainty

The Department's economic assessment of the final rule's effects is subject to uncertainty. Special areas of uncertainty are discussed below:

A significant source of uncertainty comes from the lack of a widely-accepted standard or definition of what ESG is. This uncertainty was echoed by commenters. The Department received several comments concerned with the lack of a standard definition of ESG.

Market, Second Quarter 2022, and the Federal Reserve Board's Financial Accounts of the United States Z1 September 9, 2022.

²⁸⁵ EBSA projected ERISA covered pension, welfare, and total assets based on the 2020 Form 5500 filings with the U.S. Department of Labor (DOL), reported SIMPLE assets from the Investment Company Institute (ICI) Report: The U.S. Retirement

²⁸⁶ 64th Annual Survey of Profit Sharing and 401(k) Plans, Plan Sponsor Council of America (2021).

One commenter noted that there is no way to uniformly assess or weight the separate E, S, and G factors. Another commenter noted that because ESG frameworks in the U.S. have been designed by the private sector and are voluntary in nature, there is no industry-wide standard for how to disclose information or comply under these frameworks.

In the affected-entities discussion of the regulatory impact analysis, the Department estimates that 20 percent of plans, both defined benefit (DB) and defined contribution (DC), consider or will begin considering ESG factors when selecting investments and, thus, will be affected by the final rule's amendments to paragraphs (b) and (c) of the current regulation. As discussed in the regulatory impact analysis, the Department referenced several sources and surveys for DB and DC plans to arrive at this estimate. However, the range of estimates from these resources confirms the degree of uncertainty of how many plan fiduciaries currently consider ESG factors when selecting investments. This is particularly true for DB plans. While there is some survey evidence on how many DB plans factor in ESG considerations, the surveys were based on small samples and yielded varying results.

It is also difficult to estimate the degree to which the use of ESG factors by ERISA fiduciaries will expand in the future. The clarification provided by this final rule may encourage more plan fiduciaries to use ESG factors. Trends in other countries suggest that pressure for such expansion may continue to increase.²⁸⁷ Based on current trends, the Department believes that the use of ESG factors by ERISA plan fiduciaries will likely increase in the future, although it is uncertain when or by how much.

For purposes of this analysis, the Department has prepared low-, mid-, and high-cost scenarios for costs associated with paragraphs (b) and (c), varying by the estimated number of affected plans. As discussed in the cost discussion, the Department's estimate of 20 percent of ERISA plans being affected by these provisions translated into approximately 149,300 affected plans and a cost of \$91.5 million. If instead, the Department were to rely on

the 5 percent estimate of 401(k) and/or profit-sharing plans offering at least one ESG themed investment option from the Plan Sponsor Council of America²⁸⁸ and the 12 percent estimate of private pension plans that have adopted ESG investing from NEPC,²⁸⁹ this would result in an estimate of approximately 46,100 affected plans and a cost of \$28.2 million.²⁹⁰ Further if the Department were to rely on the 36 percent estimate of large plans using ESG information to consider their investments provided by commenters to all plans, this would result in an estimate of approximately 268,800 affected plans and a cost of \$164.7 million.²⁹¹

Regarding paragraph (d) of the final rule, it is uncertain whether the amendments would create a demand for new or different services associated with proxy voting and if so, what alternate services or relationships with service providers might result and how overall plan expenses could be impacted. Similarly, it is unclear whether and to what extent paragraph (d) of the amended rule will cause plans to modify their securities holdings, for example, in favor of greater mutual fund holdings (to avoid management responsibilities with respect to holdings of individual companies).

The Department has heard from stakeholders that the current regulation, and investor confusion about it, has already had a chilling effect on appropriate use of ESG factors in investment decisions. Additionally, the Department received a significant number of comments on the impacts the current regulation has had on the appropriate use of ESG factors in investment decisions. A larger discussion of the comments received is included in the discussion of the benefits above.

²⁸⁸ 64th Annual Survey of Profit Sharing and 401(k) Plans, Plan Sponsor Council of America (2021).

²⁸⁹ Smith and Regan, *NEPC ESG Survey*, 2018.

²⁹⁰ The estimate of plans is calculated as: $(5\% \times 621,509 \text{ 401(k) type plans}) + (12\% \times 125,101 \text{ defined benefit and nonparticipant-directed defined contribution plans}) = 46,087 \text{ plans, rounded to } 46,100 \text{ plans. The cost estimate is calculated as: } 46,087 \text{ plans} \times 4 \text{ hours} = 184,348 \text{ hours. A labor rate of } \$153.21 \text{ is used for a lawyer. The cost burden is estimated as follows: } 46,087 \text{ plans} \times 4 \text{ hours} \times \$153.21 = \$28,243,957. (\text{Source } Private \text{ Pension Plan Bulletin: Abstract of 2020 Form 5500 Annual Reports, Employee Benefits Security Administration (2022; forthcoming), Table D3.})$

²⁹¹ The estimate of plans is calculated as: $(36\% \times 746,610 \text{ pension plans}) = 268,779 \text{ plans, rounded to } 268,800 \text{ plans. The cost estimate is calculated as: } 268,779 \text{ plans} \times 4 \text{ hours} = 1,075,116 \text{ hours. A labor rate of } \$153.21 \text{ is used for a lawyer. The cost burden is estimated as follows: } 268,779 \text{ plans} \times 4 \text{ hours} \times \$153.21 = \$164,718,522.$

H. Alternatives

In developing this final rule on the application of ERISA's fiduciary duties of prudence and loyalty to selecting investments and investment courses of action, the Department considered several regulatory approaches to the overarching rule and its various elements.

Beyond the major alternatives discussed below, the Department considered many other specific alternatives. For example, the Department considered eliminating the tiebreaker test in response to commenters' requests to do so. The Department decided against this alternative because the tiebreaker test has been relied on by fiduciaries for many years in making decisions about plan investments and investment courses of action, is consistent with the fiduciary obligations set forth in Section 404 of ERISA, and complete removal of the provision could lead to disruptions in plan investment activity. In addition, the Department, in response to commenters' requests, considered amending the current regulation to explicitly provide participants' preferences with a status equal to risk and return factors under the final regulation, such that participants' preferences could be considered and factored into decisions alongside risk and return factors, and weighted as determined appropriate by the plan's fiduciary. The Department decided against this alternative for many reasons, but mainly because plan fiduciaries must focus on financial benefits and fiduciaries may not add imprudent investment options to menus based on participant preferences or requests because that would violate ERISA's duty of prudence. Many other relatively more granular alternatives that were considered and not accepted are discussed throughout section III of this preamble in connection with views of the commenters.

In order to ensure a comprehensive review, the Department examined an alternative leaving the current regulation in place without change. However, as explained in more detail earlier in this document, following informal outreach activities with a wide variety of stakeholders, including asset managers, labor organizations and other plan sponsors, consumer groups, service providers and investment advisers, and after considering the significant volume of public comment on the NPRM, the Department believes that uncertainty with respect to the current regulation has and likely will continue to deter fiduciaries from taking steps that other

²⁸⁷ See generally Government Accountability Office Report No. 18-398, *Retirement Plan Investing: Clearer Information on Consideration of Environmental, Social, and Governance Factors Would Be Helpful* (May 2018), <https://www.gao.gov/products/gao-18-398>; Principles for Responsible Investment, *Fiduciary Duty in the 21st Century*, United Nations Environment Programme Finance Initiative (2019), <https://www.unepfi.org/wordpress/wp-content/uploads/2019/10/Fiduciary-duty-21st-century-final-report.pdf>.

marketplace investors might take to enhance investment value and performance, or improve investment portfolio resilience against the financial risks and impacts associated with climate change. This could hamper fiduciaries as they attempt to discharge their responsibilities prudently and solely in the interests of plan participants and beneficiaries. The Department therefore did not elect this alternative.

The Department also considered rescinding the *Financial Factors in Selecting Plan Investments and Fiduciary Duties Regarding Proxy Voting and Shareholder Rights* final rules. This alternative would remove the entire current regulation from the Code of Federal Regulations, including provisions that reflect the original 1979 Investment Duties regulation. The original Investment Duties regulation has been relied on by fiduciaries for many years in making decisions about plan investments and investment courses of action, and complete removal of the provisions could lead to disruptions in plan investment activity. Accordingly, the Department rejected this alternative. As discussed in section IV.D.4, the Department quantified some costs of the current rule related to proxy voting totaled \$17.7 million in the first year and \$6.1 million in subsequent years for the current rule. Rescission of the current rule would save this quantified amount, but these savings would be offset by the aforementioned disruptions.

As another alternative, the Department considered revising the current regulation by, in effect, reverting it to the original 1979 Investment Duties regulation. This would reduce the potential of disrupting plan investment activity that would be caused by complete rescission, as described above. However, because the Department's prior non-regulatory guidance on ESG investing and proxy voting was removed from the Code of Federal Regulations by the *Financial Factors in Selecting Plan Investments and Fiduciary Duties Regarding Proxy Voting and Shareholder Rights* final rules, this alternative will leave plan fiduciaries without any guidance on the consideration of ESG issues when relevant to plan financial interests. Similar to the first alternative described above, this could inhibit fiduciaries from taking steps that other marketplace investors might take in enhancing investment value and performance, or from improving investment portfolio resilience against the potential financial risks and impacts associated with climate change. The Department

therefore rejected this alternative. As discussed in section IV.D.2, the Department quantified some of the costs for the current rule related to the tiebreaker, which totaled approximately \$506,000 annually.

The Department also considered revising the current regulation by adopting changes similar to the fiduciary responsibilities as proposed by the European Commission.²⁹² The European Commission (EC) is amending existing rules on fiduciary duties in delegated acts for asset management, insurance, reinsurance and investment sectors to encompass sustainability risks such as the impact of climate change and environmental degradation on the value of investments. Specifically, the EC has added the requirement that fiduciaries must proactively solicit client's sustainability preferences, in addition to existing requirements that a fiduciary obtain information about the client's investment knowledge and experience, ability to bear losses, and risk tolerance as part of the suitability assessment. The European Union's guidelines for the supervision of institutions for occupational retirement provisions (IORPs) require member states to ensure that IORPs consider ESG factors related to investment assets in their investment decisions, as part of their prudential standards. Where ESG factors are considered, an assessment must be made of new or emerging risks, including risks related to climate change, use of resources and the environment, social risks and risks related to the depreciation of assets due to regulatory changes.²⁹³ One estimate

²⁹² Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: EU Taxonomy, Corporate Sustainability Reporting, Sustainability Preferences and Fiduciary Duties: Directing finance towards the European Green Deal Brussels, 21.4.2021 COM (2021) 188 final.

²⁹³ "It is essential that IORPs improve their risk management while taking into account the aim of having an equitable spread of risks and benefits between generations in occupational retirement provision, so that potential vulnerabilities in relation to the sustainability of pension schemes can be properly understood and discussed with the relevant competent authorities. IORPs should, as part of their risk management system, produce a risk assessment for their activities relating to pensions. That risk assessment should also be made available to the competent authorities and should, where relevant, include, inter alia, risks related to climate change, use of resources, the environment, social risks, and risks related to the depreciation of assets due to regulatory change ('stranded assets'). . . . Environmental, social and governance factors, as referred to in the United Nations-supported Principles for Responsible Investment, are important for the investment policy and risk management systems of IORPs. Member States should require IORPs to explicitly disclose where such factors are considered in investment decisions and how they form part of their risk management

finds that 89 percent of European pension funds take ESG risks into account as of 2019.²⁹⁴

Although this final rule clarifies that risk and return factors may include the economic effects of climate change and other ESG factors on the investment, the final rule does not require ERISA fiduciaries to solicit preferences regarding ESG factors nor are fiduciaries required to consider ESG factors when making all investment decisions. While aligning the U.S. to the European approach would have such benefits as harmonizing taxonomy for asset and investment managers across jurisdictions, the Department was concerned that incorporating such an approach would increase costs without a commensurate benefit, and could not be fully harmonized with ERISA's fiduciary provisions.

Finally, in the NPRM, the Department proposed a requirement to inform plan participants of the collateral benefits that influenced the selection of the investment or investment course of action, when such investment or investment course of action constitutes a designated investment alternative under a participant-directed individual account plan, so participants could understand whether their preferences regarding the collateral purpose aligned with the fiduciary's for a given investment option. Upon further consideration, including the comments received on the NPRM, the Department has decided to remove the disclosure requirement from this final rule for all the reasons set forth in section III.B.2 of this preamble.

I. Conclusion

In summary, a significant benefit of this final rule is to clarify the application of ERISA's fiduciary duties of prudence and loyalty to selecting investments and investment courses of action, exercising shareholder rights, such as proxy voting, and the use of written proxy voting policies and guidelines. These benefits, while difficult to quantify, are anticipated to outweigh the costs.

The amendments to paragraphs (b) and (c) are designed to ensure that plans do not improvidently avoid considering relevant ESG factors when selecting investments or exercising shareholder

system. The relevance and materiality of environmental, social and governance factors to a scheme's investments and how such factors are taken into account should be part of the information provided by an IORP under this Directive."

²⁹⁴ "ESG Becoming the New Normal for European Pensions" (August 31, 2020), <https://www.aitcio.com/news/esg-becoming-new-normal-european-pensions/>.

rights, as they might otherwise be inclined to do under the current regulation. The Department expects that acting on relevant ESG factors in these contexts, and in a manner consistent with the final rule, will redound to employee benefit plans, participants, and beneficiaries covered by ERISA. Further, by ensuring that plan fiduciaries will not give up investment returns or take on additional investment risk to promote unrelated goals, these amendments are expected to lead to increased investment returns over the long run.

The final rule will also make certain that proxy voting activity by plans will

be governed by the economic interests of the plan and its participants. The amendments require plan fiduciaries to make a reasoned judgment deciding whether to exercise shareholder rights and how to exercise such rights, while promoting the economic interest of the plan. This will promote management accountability to shareholders, including the affected shareholder plans.

The total cost of the final rule is approximately \$135.4 million in the first year with no additional costs in subsequent years. Over 10 years, the costs associated with the amendments will total approximately \$126.6 million,

annualized to \$18.0 million per year, applying a seven percent discount rate.²⁹⁵ In addition, the final rule is expected to result in cost savings. The total cost savings of the final rule is approximately \$18.2 million in the first year with an annual cost savings of \$6.6 million in subsequent years, relative to the current regulation. The estimates for cost and cost savings of the final rule are summarized in Table 3. Besides cost savings, the rule will have many other benefits that have not been quantified and are not shown in Table 3.

TABLE 3—QUANTIFIED COSTS AND COST SAVINGS ASSOCIATED WITH THE FINAL RULE

| Requirement | Year 1 | Year 2 |
|--|--------------|-----------|
| Aggregate Costs | | |
| Review of Plan Investment Practices | \$91,510,494 | \$0 |
| Review of Proxy Voting Practices | 39,019,523 | 0 |
| Update Proxy Voting Policies | 4,877,440 | 0 |
| Total | 135,407,458 | 0 |
| Cost Savings | | |
| Removal of the Special Collateral Benefit Documentation Requirement under the Tie-breaker Rule in the Current Rule | 506,029 | 0 |
| Removal of the Special Recordkeeping Requirement for Proxy Voting in the Current Rule | 6,072,526 | 6,072,526 |
| Removal of the Proxy Voting “Safe Harbors” in the Current Rule | 11,643,651 | 0 |
| Total | 18,222,207 | 6,072,526 |

V. Paperwork Reduction Act

The current regulations contain two collections of information with OMB Control Number 1210–0162 and OMB Control Number 1210–0165. In the notice of proposed rulemaking, the Department had announced its intent to discontinue OMB Control Number 1210–0165 and revise OMB Control Number 1210–0162 to only include the proposed disclosure requirement contained in the proposed amendment. Paragraph (c)(3) of the NPRM included a requirement that if a plan fiduciary uses the tiebreaker to select a designated investment alternative for a participant-directed individual account plan based on collateral benefits other than investment returns, “the plan fiduciary must ensure that the collateral-benefit characteristic of the fund, product, or model portfolio is prominently displayed in disclosure materials provided to participants and beneficiaries.” This would have been a new disclosure requirement under

ERISA. At this time, the Department has decided not to adopt the proposed disclosure requirement. As discussed in more detail earlier in the preamble, based on comments received, the Department has decided that a disclosure emphasizing matters collateral to the economics of an investment may not be in the best interests of plan participants. Plan fiduciaries will still have the ability to use collateral benefits to break a tie; they will not be required to make a special disclosure. The Department is aware that the SEC is conducting rulemaking on investment company names, addressing, among other things, “certain broad categories of investment company names that are likely to mislead investors about an investment company’s investments and risks.”²⁹⁶ The SEC also is conducting rulemaking on disclosures by mutual funds, other SEC-regulated investment companies, and SEC-regulated investment advisers designed to provide consistent standards for ESG disclosures, allowing

investors to make more informed decisions, including as they compare various ESG investments.²⁹⁷ The Department will monitor these rulemaking projects and may revisit the need for collateral benefit reporting or disclosure depending on the findings of that agency. The Department emphasizes that the decision against adopting a collateral benefit disclosure requirement in the final rule has no impact on a fiduciary’s duty to prudently document the tiebreaking decisions in accordance with section 404 of ERISA.

Therefore, upon publication of the final rule, the Department will request that OMB discontinue both information collection requests (ICRs) 1210–0162 and 1210–0165, eliminating all paperwork burden associated with the ICRs.

VI. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA)²⁹⁸ imposes certain requirements with respect to Federal rules that are

²⁹⁵ The costs would be \$131.5 million over 10-year period, annualized to \$15.4 million per year, if a three percent discount rate were applied.

²⁹⁶ 87 FR 36594 (June 17, 2022).

²⁹⁷ 87 FR 36654 (June 17, 2022).

²⁹⁸ 5 U.S.C. 601 *et seq.*

subject to the notice and comment requirements of section 553(b) of the Administrative Procedure Act²⁹⁹ and that are likely to have a significant economic impact on a substantial number of small entities. Unless the head of an agency determines that a final rule is not likely to have a significant economic impact on a substantial number of small entities, section 604 of the RFA requires the agency to present a final regulatory flexibility analysis of the final rule.

For purposes of analysis under the RFA, the Department considers a small entity to be an employee benefit plan with fewer than 100 participants.³⁰⁰ The basis of this definition is found in section 104(a)(2) of ERISA, which permits the Secretary of Labor to prescribe simplified annual reports for pension plans that cover fewer than 100 participants. Under section 104(a)(3), the Secretary may also provide for exemptions or simplified annual reporting and disclosure for welfare benefit plans. Pursuant to the authority of section 104(a)(3), the Department has previously issued—at 29 CFR 2520.104–20, 2520.104–21, 2520.104–41, 2520.104–46, and 2520.104b–10—certain simplified reporting provisions and limited exemptions from reporting and disclosure requirements for small plans. Such plans include unfunded or insured welfare plans covering fewer than 100 participants and satisfying certain other requirements. While some large employers may have small plans, in general small employers maintain small plans. Thus, EBSA believes that assessing the impact of these amendments on small plans is an appropriate substitute for evaluating the effect on small entities. The definition of small entity considered appropriate for this purpose differs, however, from a definition of small business that is based on size standards promulgated by the Small Business Administration (SBA)³⁰¹ pursuant to the Small Business Act.³⁰²

The Department has determined that this final rule could have a significant impact on a substantial number of small entities. Therefore, the Department has prepared a Final Regulatory Flexibility Analysis that is presented below.

²⁹⁹ 5 U.S.C. 553(b).

³⁰⁰ The Department consulted with the Small Business Administration's Office of Advocacy before making this determination, as required by 5 U.S.C. 603(c) and 13 CFR 121.903(c). Memorandum received from the U.S. Small Business Administration, Office of Advocacy on July 10, 2020.

³⁰¹ 13 CFR 121.201.

³⁰² 15 U.S.C. 631 *et seq.*

A. Need for and Objectives of the Rule

In late 2020, the Department published two final rules (the current regulation) pertaining to the selection of plan investments and the exercise of shareholder rights to address concerns that some investment products may be marketed to ERISA fiduciaries on the basis of purported benefits and goals unrelated to financial performance. Responses to the current regulation, however, suggest that it created further uncertainty and may have the undesirable effect of discouraging fiduciaries' consideration of financially relevant ESG factors in investment decisions, even when contrary to the interest of participants and beneficiaries.

The Department is concerned that uncertainty may deter plan fiduciaries, for small and large plans alike, from participating in investments or investment courses of action that enhance investment value and performance or improve investment portfolio resilience. The Department is particularly concerned that the current regulation created a perception that fiduciaries are at risk if they consider any ESG factors in the financial evaluation of plan investments and that they may need to have special justifications for even ordinary exercises of shareholder rights.

The amendments in this document are intended to address uncertainties stemming from the current regulation and related preamble discussions and to increase fiduciaries' clarity about their obligations. The Department expects that the final rule will improve the current regulation and further promote retirement income security and retirement savings, while safeguarding the interests of plan participants and beneficiaries.

B. Comments

The Department received more than 895 written comments and 21,469 petitions (*e.g.*, form letters) submitted during the open comment period. Comments received did not focus on the impacts to just small entities but focused on the impacts regardless of size. Comments are discussed by topic, and readers are directed to those respective sections for a summary of the significant comments and responses to those comments.

The Office of Advocacy of the Small Business Administration did not file a comment on the proposed rule.

C. Affected Small Entities

To estimate the costs associated with reviewing the final rule, the Department

considers two sub-groups of plans: plans that consider ESG factors in their investment process and plans that hold corporate stock with voting rights. Due to the nature of the finalized amendments, these subsets are not mutually exclusive and some plans may be included in both subsets. The Department does not have the data necessary to estimate how many plans are included in both subsets, so the affected entities and related costs are calculated separately in this analysis.

1. Small Plans Affected by the Proposed Modifications of Paragraphs (b) and (c) of § 2550.404a–1

Plans, as well as plan participants and beneficiaries, whose fiduciaries consider or will begin considering ESG factors when selecting investments will be affected by the modifications of paragraphs (b) and (c). As discussed in the regulatory impact analysis, the Department estimates that approximately 20 percent of plans consider or will begin considering ESG factors when selecting investments. This estimate is based on administrative data and surveys on investment behavior, which did not address how the investment behavior of small plans might differ from plans overall. The Department acknowledges that this likely overestimates the number of small plans affected. For instance, one survey indicates that only 0.03 percent of total participant-directed DC plan assets are invested in ESG funds. In fact, it finds that among 401(k) and profit-sharing plans with fewer than 50 participants, none of the plans offered an ESG investment option.³⁰³

For the purpose of this analysis, the Department assumes that the proportions of plans who consider or will begin considering ESG factors when selecting investments is uniform across plan size. Accordingly, the Department estimates that 20 percent of small plans will be affected by the modifications of paragraphs (b) and (c). According to the 2020 Form 5500, there were approximately 652,935 plans with fewer than 100 participants,³⁰⁴ resulting in an estimate of approximately 130,600 small plans that will be affected by the

³⁰³ 64th Annual Survey of Profit Sharing and 401(k) Plans, Plan Sponsor Council of America (2021).

³⁰⁴ DOL calculations reflecting plans with fewer than 100 participants. (Source *Private Pension Plan Bulletin: Abstract of 2020 Form 5500 Annual Reports*, Employee Benefits Security Administration (2022; forthcoming), Table B1.)

modifications of paragraphs (b) and (c).³⁰⁵

2. Subset of Plans Affected by Modifications of Paragraph (d) and (e) of § 2550.404a–1

Paragraphs (d) and (e) of the amended rule will affect small ERISA-covered pension, health, and other welfare plans, and plan participants and beneficiaries, that hold shares of corporate stock, directly or through ERISA-covered intermediaries, such as common trusts, master trusts, pooled separate accounts, and 103–12 investment entities. While the majority of participants and assets are in large plans, most plans are small plans.

There is limited data available about small plans' stock holdings. The primary source of information on assets held by pension plans is the Form 5500. Using the various asset schedules filed, only 3,900 small plans can be identified as holding stock, either employer securities or common stock.³⁰⁶ The Department assumes that small plans are significantly less likely to hold common stock than larger plans.³⁰⁷

For purposes of illustrating the number of small plans that could be affected, the Department assumes that five percent of small plans will be affected by the amendments to paragraphs (d) and (e). In 2020, there were approximately 652,500 small pension plans,³⁰⁸ resulting in an estimate of approximately 32,600 small plans that will be affected by the amended provisions.³⁰⁹ The Department requested comment on this assumption in the NPRM but did not receive any comments.

While paragraph (d) of this amended rule will directly affect ERISA-covered plans that possess the relevant shareholder rights, many plans hire asset managers to carry out fiduciary

³⁰⁵ *Id.* This estimate is calculated as: 20% × 652,935 pension plans = 130,587, rounded to 130,600.

³⁰⁶ Based on DOL calculations based on 2020 Form 5500 data, only the 3,900 small plans that filed schedule H would report a separate line item for stock holdings. The small plans filing the Form 5500–SF (595,565) or file schedule I (52,737) do not report stock as a separate line item, therefore these plans cannot be identified as to whether they hold common stock.

³⁰⁷ Many small plans have exposure to stocks only through mutual funds, and consequently will not be significantly affected by the finalized amendments to paragraphs (d) and (e).

³⁰⁸ DOL calculations of plans with fewer than 100 participants find that in 2020, there were 652,935 plans with less than 100 participants, rounded to 652,900. (*Source Private Pension Plan Bulletin: Abstract of 2020 Form 5500 Annual Reports*, Employee Benefits Security Administration (2022; forthcoming), Table B1.)

³⁰⁹ This estimate is calculated as: 652,935 small plans × 5% = 32,647, rounded to 32,600.

asset management functions, including proxy voting. The Department recognizes that service providers, including small service providers who act as asset managers, could also be impacted indirectly by this rule. The Department expects that service providers will pass incremental compliance costs onto plans.

D. Impact of the Rule

As described in the preamble and the regulatory impact analysis, the amendments will impose costs on small and large plans

1. Cost of Reviewing the Final Rule and Reviewing Plan Practices

Plans, plan fiduciaries, and their service providers will need to read the amended rule and evaluate how it will impact their practices. To estimate the costs associated with reviewing the amended rule, the Department considers two sub-groups of plans: plans that consider ESG factors in their investment process and plans that hold corporate stock with voting rights.

The Department estimates that approximately 130,600 small plans consider ESG factors in their investment practice and will be affected by the finalized amendments in paragraphs (b) and (c). For each plan, a legal professional will need to review paragraphs (b) and (c) of the final rule, evaluate how these provisions might affect their investment practices and assess whether the plan will be needed to make changes to investment practices. The Department estimates that this review will take a legal professional approximately four hours to complete, resulting in a per-plan cost burden of approximately \$612.84.³¹⁰

The Department estimates that approximately 32,600 small plans hold corporate stock with voting rights and will be affected by the finalized amendments pertaining to proxy voting in paragraph (d). For each plan, a legal professional will need to review paragraph (d) of the final rule and evaluate how it affects their proxy voting practices. The Department

³¹⁰ The Department estimates that it will take a lawyer at each plan four hours to review the rule. A labor rate of \$153.21 is used for a lawyer. The cost burden is estimated as follows: 4 hours × \$153.21 = \$612.86. Labor rates are based on DOL estimates for 2022. For more information in how the labor costs are estimated, see *Labor Cost Inputs Used in the Employee Benefits Security Administration, Office of Policy and Research's Regulatory Impact Analyses and Paperwork Reduction Act Burden Calculation*, Employee Benefits Security Administration (June 2019), www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/technical-appendices/labor-cost-inputs-used-in-ebssa-opr-ria-and-pra-burden-calculations-june-2019.pdf.

estimates that this review process will require a legal professional, on average, approximately four hours to complete, resulting in a per-plan cost of approximately \$612.84.³¹¹

The Department believes that most plans, in both subsets discussed above, will rely on a service provider to perform such a review and that each service provider will likely oversee multiple plans. The Department does not have data that would allow it to estimate the number of service providers acting in such a capacity for these plans. While the Department believes that this cost is likely an overestimate, given the lack of data, the Department believes it represents the best, most conservative estimate.

2. Cost To Update Written Proxy Voting Policies

Paragraph (d)(3)(i) of the final rule provides that, for purposes of deciding whether to vote a proxy, plan fiduciaries may adopt proxy voting policies if the authority to vote a proxy is exercised pursuant to specific parameters prudently designed to serve the plan's interests in providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan. The Department estimates that these provisions will impose additional cost to review such policies initially. The Department believes that the final rule largely comports with industry practice for ERISA fiduciaries; therefore, the Department estimates that on average, it will take a legal professional 30 minutes to update policies and procedures for each of the estimated 32,600 plans affected by these provisions. This results in a cost per plan of \$76.61 in the first year.³¹²

Paragraph (d)(3)(ii), also requires plan fiduciaries to periodically review any such proxy voting policies. The Department believes that the final rule largely comports with industry practice for ERISA fiduciaries, since plans are already required to periodically review proxy voting policies to meet their obligations under ERISA. Therefore, the Department does not expect that plans will incur additional cost associated with the periodic review.

³¹¹ The Department estimates that it will take a lawyer at each plan four hours to review the rule. A labor rate of \$153.21 is used for a lawyer. The cost burden is estimated as follows: 4 hours × \$153.21 = \$612.86.

³¹² The Department estimates that it will take a plan fiduciary at each plan 30 minutes to update policies and procedures. A labor rate of \$153.21 is used for a plan fiduciary: (0.5 hours × \$153.21 = \$76.61).

3. Summary of Costs

As illustrated in Table 4 below, the Department estimates, if a small plan both considers ESG factors in their

investment process and hold corporate stock with voting rights, the incremental cost associated with the finalized amendments will be \$1,302.29 per affected plan in year 1. There are no

costs expected in subsequent years. Some plans may only incur costs associated with considering ESG factors in their investment process or holding corporate stock with voting rights.

TABLE 4—COSTS FOR PLANS TO COMPLY WITH THE REQUIREMENTS

| Requirement | Labor rate | Hours | Year 1 cost | Year 2 cost |
|---|------------|-------|-------------|-------------|
| Plans considering ESG factors when selecting investments | | | | |
| Review of Plan Investment Practices: <i>Lawyer</i> | \$153.21 | 4 | \$612.84 | \$0.00 |
| Total | | 4 | 612.84 | 0.00 |
| Plans holding corporate stock, directly or through ERISA-covered intermediaries | | | | |
| Review of Proxy Voting Practices: <i>Lawyer</i> | 153.21 | 4 | 612.84 | 0.00 |
| Update Proxy Voting Policies: <i>Lawyer</i> | 153.21 | 0.5 | 76.61 | 0.00 |
| Total | | 4.5 | 689.49 | 0.00 |
| Plans that both consider ESG factors when selecting investments and hold corporate stock, directly or through ERISA-covered intermediaries | | | | |
| Total | | 8.5 | 1,302.29 | 0 |

The Department believes that this is likely an overestimate of the costs faced by small plans, as small plans are likely to rely on service providers that provide services to multiple plans. The Department expects that these costs will be passed on to plans, but by offering services to multiple plans, service providers create economies of scale.

E. Regulatory Alternatives

The final rule seeks to provide clarity and certainty regarding the scope of fiduciary duties surrounding ESG factors in investment practice and proxy voting policies. These duties apply to all affected entities, both large and small; therefore, the Department’s ability to craft specific alternatives for small plans is limited. Throughout the rulemaking process, the Department sought to minimize the burden placed on the affected entities overall; however, the Department did not identify any special consideration that could be made for small plans that would not lessen the protection of participants and beneficiaries in small plans. As discussed in the preamble, the Department has decided to provide a general applicability date of 60 days after publication in the **Federal Register** with two exceptions. In response to comments received on the NPRM, the Department has decided to delay applicability of paragraphs (d)(2)(iii) and (d)(4)(ii) of the final rule’s proxy voting provisions until 1 year after the date of publication. The delayed applicability of paragraph (d)(4)(ii) of the final rule will give fiduciaries of plans invested in pooled investment

vehicles additional time for reviewing any proxy voting policies of the investment vehicle’s investment manager and addressing any concerns. The delayed applicability of paragraph (d)(2)(iii) will give plan fiduciaries additional time to review proxy voting guidelines of proxy advisory firms and make any necessary changes in their arrangements with such firms. Outside of these two exceptions, the Department believes the requirements in the final rule are consistent with established Department views. As such, the Department does not believe it is appropriate to extend the applicability date for small plans.

The Department examined as an alternative leaving the current regulation in place without change and rescinding its enforcement statement issued on March 10, 2021. However, as explained in more detail earlier in this notice, following informal outreach activities with a wide variety of stakeholders, including asset managers, labor organizations and other plan sponsors, consumer groups, service providers, and investment advisers, the Department believes that uncertainty with respect to the current regulation may deter fiduciaries of small and large plans alike from taking steps that other marketplace investors might take in enhancing investment value and performance, or improving investment portfolio resilience against the potential financial risks associated with ESG factors. This could hamper fiduciaries as they attempt to discharge their responsibilities prudently and solely in

the interests of plan participants and beneficiaries. The Department therefore did not elect this alternative.

The Department also considered rescinding the *Financial Factors in Selecting Plan Investments* and *Fiduciary Duties Regarding Proxy Voting and Shareholder Rights* final rules. This alternative would remove the entire current regulation from the Code of Federal Regulations, including provisions that reflect the original 1979 Investment Duties regulation. The original Investment Duties regulation has been relied on by fiduciaries for many years in making decisions about plan investments and investment courses of action, and complete removal of the provisions could lead to potential disruptions in plan investment activity, regardless of plan size. The Department rejected this alternative.

Another alternative considered was revising the current regulation by, in effect, reverting it to the original 1979 Investment Duties regulation. As explained in more detail earlier in this notice, this alternative would reduce the potential of disrupting plan investment activity that would be caused by complete rescission, but would leave plan fiduciaries without any guidance published in the Code of Federal Regulations on the consideration of ESG issues. Similar to the first alternative described above, this could inhibit fiduciaries from taking steps that other marketplace investors might take in enhancing investment value and performance, or from improving investment portfolio resilience against the potential financial risks and impacts

associated with various ESG factors. The Department therefore rejected this alternative.

In the NPRM, the Department proposed a requirement to inform plan participants of the collateral benefits that influenced the selection of the investment or investment course of action, when such investment or investment course of action constitutes a designated investment alternative under a participant-directed individual account plan. The Department received one comment in favor of the collateral benefit disclosure for QDIAs, stating that participants and beneficiaries should have information about collateral benefits considered by their plan. Another commenter expressed that the requirement should go further, requiring the disclosure of specific collateral benefits considered. However, other commenters expressed concern that the disclosure requirement may chill the use of ESG factors in investments. Another commenter expressed concern that the disclosure requirement is unclear and could relegate ESG characteristics to collateral benefit characteristics. Upon further consideration, including the comments received on the NPRM, the Department has decided to remove the disclosure requirement from this final rule. Commenters expressed concern that the collateral benefit disclosure could distract plan participants from the important-related information required by the Department's other regulations.

F. Duplicate, Overlapping, or Relevant Federal Rules

For the requirements relating to investment practices, the Department is issuing this final rule under sections 404(a)(1)(A) and 404(a)(1)(B) of Title I under ERISA. The Department is the only agency with jurisdiction to interpret these provisions as they apply to plan fiduciaries' consideration in selecting plan investment funds. Therefore, there are no duplicate, overlapping, or relevant Federal rules.

For the requirements relating to proxy voting policies, the Department is monitoring other Federal agencies whose statutory and regulatory requirements overlap with ERISA. In particular, the Department is monitoring SEC rules and guidance to avoid creating duplicate or overlapping requirements with respect to proxy voting.

VII. Unfunded Mandates Reform Act

Title II of the Unfunded Mandates Reform Act of 1995³¹³ requires each

Federal agency to prepare a written statement assessing the effects of any Federal mandate in a proposed or final agency rule that may result in an expenditure of \$100 million or more (adjusted annually for inflation with the base year 1995) in any one year by state, local, and tribal governments, in the aggregate, or by the private sector. For purposes of the Unfunded Mandates Reform Act, this final rule does not include any Federal mandate that the Department expects would result in such expenditures by state, local, or tribal governments, or the private sector.

VIII. Federalism Statement

Executive Order 13132 outlines fundamental principles of federalism and requires the adherence to specific criteria by Federal agencies in the process of their formulation and implementation of policies that have "substantial direct effects" on the states, the relationship between the National Government and the states, or on the distribution of power and responsibilities among the various levels of government.³¹⁴ Federal agencies promulgating regulations that have federalism implications must consult with state and local officials, and describe the extent of their consultation and the nature of the concerns of state and local officials in the preamble to the proposed amendment.

In the Department's view, these finalized amendments will not have federalism implications because they will not have direct effects on the states, the relationship between the National Government and the states, or on the distribution of power and responsibilities among various levels of government. Section 514 of ERISA provides, with certain exceptions specifically enumerated, that the provisions of Titles I and IV of ERISA supersede any and all laws of the states as they relate to any employee benefit plan covered under ERISA. The requirements implemented in the finalized amendments do not alter the fundamental reporting and disclosure requirements of the statute with respect to employee benefit plans, and as such have no implications for the states or the relationship or distribution of power between the national government and the states.

Statutory Authority

This regulation is finalized pursuant to the authority in section 505 of ERISA (Pub. L. 93-406, 88 Stat. 894; 29 U.S.C. 1135) and section 102 of Reorganization

Plan No. 4 of 1978 (43 FR 47713, October 17, 1978), effective December 31, 1978 (44 FR 1065, January 3, 1979), 3 CFR, 1978 Comp., p. 332, and under Secretary of Labor's Order No. 1-2011, 77 FR 1088 (Jan. 9, 2012).

List of Subjects in 29 CFR Part 2550

Employee benefit plans, Employee Retirement Income Security Act, Exemptions, Fiduciaries, Investments, Pensions, Prohibited transactions, Reporting and recordkeeping requirements, Securities.

For the reasons set forth in the preamble, the Department amends part 2550 of subchapter F of chapter XXV of title 29 of the Code of Federal Regulations as follows:

Subchapter F—Fiduciary Responsibility Under the Employee Retirement Income Security Act of 1974

PART 2550—RULES AND REGULATIONS FOR FIDUCIARY RESPONSIBILITY

■ 1. The authority citation for part 2550 continues to read as follows:

Authority: 29 U.S.C. 1135 and Secretary of Labor's Order No. 1-2011, 77 FR 1088 (January 9, 2012). Sec. 102, Reorganization Plan No. 4 of 1978, 5 U.S.C. App. at 727 (2012). Sec. 2550.401c-1 also issued under 29 U.S.C. 1101. Sec. 2550.404a-1 also issued under sec. 657, Pub. L. 107-16, 115 Stat. 38. Sec. 2550.404a-2 also issued under sec. 657 of Pub. L. 107-16, 115 Stat. 38. Sections 2550.404c-1 and 2550.404c-5 also issued under 29 U.S.C. 1104. Sec. 2550.408b-1 also issued under 29 U.S.C. 1108(b)(1). Sec. 2550.408b-19 also issued under sec. 611, Pub. L. 109-280, 120 Stat. 780, 972. Sec. 2550.412-1 also issued under 29 U.S.C. 1112.

■ 2. Revise § 2550.404a-1 to read as follows:

§ 2550.404a-1 Investment duties.

(a) *In general.* Sections 404(a)(1)(A) and 404(a)(1)(B) of the Employee Retirement Income Security Act of 1974, as amended (ERISA or the Act) provide, in part, that a fiduciary shall discharge that person's duties with respect to the plan solely in the interests of the participants and beneficiaries; for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan; and with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

(b) *Investment prudence duties.* (1) With regard to the consideration of an investment or investment course of

³¹³ 2 U.S.C. 1501 *et seq.* (1995).

³¹⁴ Federalism, 64 FR 43255 (August 10, 1999).

action taken by a fiduciary of an employee benefit plan pursuant to the fiduciary's investment duties, the requirements of section 404(a)(1)(B) of the Act set forth in paragraph (a) of this section are satisfied if the fiduciary:

(i) Has given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio or menu with respect to which the fiduciary has investment duties; and

(ii) Has acted accordingly.

(2) For purposes of paragraph (b)(1) of this section, "appropriate consideration" shall include, but is not necessarily limited to:

(i) A determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio (or, where applicable, that portion of the plan portfolio with respect to which the fiduciary has investment duties) or menu, to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action compared to the opportunity for gain (or other return) associated with reasonably available alternatives with similar risks; and

(ii) In the case of employee benefit plans other than participant-directed individual account plans, consideration of the following factors as they relate to such portion of the portfolio:

(A) The composition of the portfolio with regard to diversification;

(B) The liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and

(C) The projected return of the portfolio relative to the funding objectives of the plan.

(3) An investment manager appointed, pursuant to the provisions of section 402(c)(3) of the Act, to manage all or part of the assets of a plan, may, for purposes of compliance with the provisions of paragraphs (b)(1) and (2) of this section, rely on, and act upon the basis of, information pertaining to the plan provided by or at the direction of the appointing fiduciary, if:

(i) Such information is provided for the stated purpose of assisting the manager in the performance of the manager's investment duties; and

(ii) The manager does not know and has no reason to know that the information is incorrect.

(4) 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 section 402(b)(1) of 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.

(c) *Investment loyalty duties.* (1) A fiduciary may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives, and may not sacrifice investment return or take on additional investment risk to promote benefits or goals unrelated to interests of the participants and beneficiaries in their retirement income or financial benefits under the plan.

(2) If a fiduciary prudently concludes that competing investments, or competing investment courses of action, equally serve the financial interests of the plan over the appropriate time horizon, the fiduciary is not prohibited from selecting the investment, or investment course of action, based on collateral benefits other than investment returns. A fiduciary may not, however, accept expected reduced returns or greater risks to secure such additional benefits.

(3) The plan fiduciary of a participant-directed individual account plan does not violate the duty of loyalty under paragraph (c)(1) of this section solely because the fiduciary takes into account participants' preferences in a manner consistent with the requirements of paragraph (b) of this section.

(d) *Proxy voting and exercise of shareholder rights.* (1) The fiduciary duty to manage plan assets that are shares of stock includes the management of shareholder rights appurtenant to those shares, such as the right to vote proxies.

(2)(i) When deciding whether to exercise shareholder rights and when exercising such rights, including the voting of proxies, fiduciaries must carry out their duties prudently and solely in the interests of the participants and beneficiaries and for the exclusive

purpose of providing benefits to participants and beneficiaries and defraying the reasonable expenses of administering the plan.

(ii) When deciding whether to exercise shareholder rights and when exercising shareholder rights, plan fiduciaries must:

(A) Act solely in accordance with the economic interest of the plan and its participants and beneficiaries, in a manner consistent with paragraph (b)(4) of this section;

(B) Consider any costs involved;

(C) Not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to any other objective;

(D) Evaluate relevant facts that form the basis for any particular proxy vote or other exercise of shareholder rights; and

(E) Exercise 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.

(iii) A fiduciary may not adopt a practice of following the recommendations of a proxy advisory firm or other service provider without a determination that such firm or service provider's proxy voting guidelines are consistent with the fiduciary's obligations described in paragraphs (d)(2)(i)(A) through (E) of this section.

(3)(i) In deciding whether to vote a proxy pursuant to paragraphs (d)(2)(i) and (ii) of this section, fiduciaries may adopt proxy voting policies providing that the authority to vote a proxy shall be exercised pursuant to specific parameters prudently designed to serve the plan's interests in providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan.

(ii) Plan fiduciaries shall periodically review proxy voting policies adopted pursuant to paragraph (d)(3)(i) of this section.

(iii) No proxy voting policies adopted pursuant to paragraph (d)(3)(i) of this section shall preclude submitting a proxy vote when the fiduciary prudently determines that the matter being voted upon is expected to have a significant effect on the value of the investment or the investment performance of the plan's portfolio (or investment performance of assets under management in the case of an investment manager) after taking into

account the costs involved, or refraining from voting when the fiduciary prudently determines that the matter being voted upon is not expected to have such an effect after taking into account the costs involved.

(4)(i)(A) The responsibility for exercising shareholder rights lies exclusively with the plan trustee except to the extent that either:

(1) The trustee is subject to the directions of a named fiduciary pursuant to ERISA section 403(a)(1); or

(2) The power to manage, acquire, or dispose of the relevant assets has been delegated by a named fiduciary to one or more investment managers pursuant to ERISA section 403(a)(2).

(B) Where the authority to manage plan assets has been delegated to an investment manager pursuant to ERISA section 403(a)(2), the investment manager has exclusive authority to vote proxies or exercise other shareholder rights appurtenant to such plan assets in accordance with this section, except to the extent the plan, trust document, or investment management agreement expressly provides that the responsible named fiduciary has reserved to itself (or to another named fiduciary so authorized by the plan document) the right to direct a plan trustee regarding the exercise or management of some or all of such shareholder rights.

(ii) An investment manager of a pooled investment vehicle that holds assets of more than one employee benefit plan may be subject to an investment policy statement that conflicts with the policy of another plan. Compliance with ERISA section 404(a)(1)(D) requires the investment manager to reconcile, insofar as possible, the conflicting policies (assuming compliance with each policy would be consistent with ERISA section 404(a)(1)(D)). In the case of proxy voting, to the extent permitted by

applicable law, the investment manager must vote (or abstain from voting) the relevant proxies to reflect such policies in proportion to each plan's economic interest in the pooled investment vehicle. Such an investment manager may, however, develop an investment policy statement consistent with Title I of ERISA and this section, and require participating plans to accept the investment manager's investment policy statement, including any proxy voting policy, before they are allowed to invest. In such cases, a fiduciary must assess whether the investment manager's investment policy statement and proxy voting policy are consistent with Title I of ERISA and this section before deciding to retain the investment manager.

(5) This section does not apply to voting, tender, and similar rights with respect to shares of stock that are passed through pursuant to the terms of an individual account plan to participants and beneficiaries with accounts holding such shares.

(e) *Definitions.* For purposes of this section:

(1) The term *investment duties* means any duties imposed upon, or assumed or undertaken by, a person in connection with the investment of plan assets which make or will make such person a fiduciary of an employee benefit plan or which are performed by such person as a fiduciary of an employee benefit plan as defined in section 3(21)(A)(i) or (ii) of the Act.

(2) The term *investment course of action* means any series or program of investments or actions related to a fiduciary's performance of the fiduciary's investment duties, and includes the selection of an investment fund as a plan investment, or in the case of an individual account plan, a designated investment alternative under the plan.

(3) The term *plan* means an employee benefit plan to which Title I of the Act applies.

(4) The term *designated investment alternative* means any investment alternative designated by the plan into which participants and beneficiaries may direct the investment of assets held in, or contributed to, their individual accounts. The term "designated investment alternative" shall not include "brokerage windows," "self directed brokerage accounts," or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan.

(f) *Severability.* If any provision of this section is held to be invalid or unenforceable by its terms, or as applied to any person or circumstance, or stayed pending further agency action, the provision shall be construed so as to continue to give the maximum effect to the provision permitted by law, unless such holding shall be one of invalidity or unenforceability, in which event the provision shall be severable from this section and shall not affect the remainder thereof.

(g) *Applicability date.* (1) Except for paragraphs (d)(2)(iii) and (d)(4)(ii) of this section, this section shall apply in its entirety to all investments made and investment courses of action taken after January 30, 2023.

(2) Paragraphs (d)(2)(iii) and (d)(4)(ii) of this section apply on December 1, 2023.

Signed at Washington, DC, this 21st day of November, 2022.

Lisa M. Gomez,

Assistant Secretary, Employee Benefits Security Administration, U.S. Department of Labor.

[FR Doc. 2022-25783 Filed 11-30-22; 8:45 am]

BILLING CODE 4510-29-P

Attachment B



Fact Sheet

U.S. Department of Labor
Employee Benefits Security Administration
November 22, 2022

Final Rule on Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights

Today, the U.S. Department of Labor released a final rule under the Employee Retirement Income Security Act (ERISA) to empower plan fiduciaries to safeguard the savings of America's workers by clarifying that fiduciaries may consider climate change and other environmental, social, and governance (ESG) factors when they make investment decisions and when they exercise shareholder rights, including voting on shareholder resolutions and board nominations.

Background

Over the last approximately 40 years, the Department has periodically considered how ERISA's fiduciary duties of prudence and loyalty apply to plan investments that promote environmental, social, or governance goals.

In its interpretive guidance during this period, the Department has consistently recognized that ERISA does not prohibit fiduciaries from making investment decisions that reflect ESG considerations, depending on the circumstances. The interpretive guidance has also recognized that the exercise of voting rights and other shareholder rights connected to shares of stock are fiduciary acts subject to ERISA's prudence and loyalty requirements.

However, differences in the tone and tenor of guidance across Administrations during these approximately 40 years have contributed to confusion among stakeholders about these investment issues.

The 2020 Rules

On November 13, 2020, the Department published a final rule, "Financial Factors in Selecting Plan Investments,"¹ which adopted amendments to ERISA's "Investment Duties"² regulation. The amendments generally required plan fiduciaries to select investments and investment courses of action based solely on consideration of "pecuniary factors," which are factors defined in the regulation.

On December 16, 2020, the Department published a related final rule, "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights,"³ which also adopted amendments to the "Investment Duties" regulation. These amendments addressed plan fiduciaries' ERISA

¹ 85 Fed. Reg. 72846.

² Originally published in 1979 and currently codified at 29 CFR 2550.404a-1.

³ 85 Fed. Reg. 81658.

obligations when voting proxies and exercising other shareholder rights in connection with plan investments in shares of stock.

These two final rules (the 2020 rules)⁴ sought to address uncertainty in these areas and respond to a perception that investment products could be marketed to ERISA fiduciaries based on goals and purported benefits that are unrelated to financial performance. The 2020 rules became effective in January 2021.

Following publication of the 2020 rules, the Department heard from a variety of stakeholders, including asset managers, labor organizations, corporate America, consumer groups, service providers, workers, and investment advisers. These stakeholders questioned whether the 2020 rules properly reflected the scope of fiduciaries' duties under ERISA to act prudently and solely in the interest of plan participants and beneficiaries. They also questioned whether the Department rushed the rulemakings and failed to adequately consider and address evidence submitted by public commenters on how ESG considerations can improve investment value and long-term investment returns for retirement investors.

The Department also heard from stakeholders that the 2020 rules and investor confusion about the rules were having a chilling effect on appropriate integration of ESG factors in investment decisions. Some stakeholders also expressed concern that under a special provision in the 2020 rules, funds would not be treated as qualified default investment alternatives (QDIAs) solely because they expressly considered climate change or other ESG factors, even if the funds were prudent based on consideration of their financial attributes alone.

President Biden's Executive Orders

Executive Order (E.O.) 13990, "Protecting Public Health and the Environment and Restoring Science to Tackle the Climate Crisis," which was signed on January 20, 2021, directed federal agencies to review regulations that:

- (1) were promulgated, issued, or adopted between January 20, 2017, and January 20, 2021, and
- (2) are or may be inconsistent with, or present obstacles to, the policies set forth in the order. Those policies included improving public health, protecting our environment, and bolstering resilience to the impacts of climate change.⁵

Section 2 of E.O. 13990 stated that for any such identified actions, the head of the relevant agency shall, as appropriate and consistent with applicable law, consider suspending, revising, or rescinding the agency action.

E.O. 14030, "Climate-Related Financial Risk," which was signed on May 20, 2021, set forth policies to mitigate climate-related financial risk as well as actions to help safeguard the financial security of America's families, businesses and workers from climate-related financial risk that

⁴ Codified at 29 CFR 2550.404a-1.

⁵ Available at www.whitehouse.gov/briefing-room/presidential-actions/2021/01/20/executive-order-protecting-public-health-and-environment-and-restoring-science-to-tackle-climate-crisis.

may threaten the life savings and pensions of America’s workers and families.⁶ Section 4 of the order directed the Department to consider publishing for notice and comment a proposed rule to suspend, revise, or rescind the 2020 rules.

Department of Labor Review of 2020 Rules and Enforcement Policy

On March 10, 2021, the Department announced it was reviewing the 2020 rules and issued an enforcement policy statement under ERISA.⁷ The statement announced that, until the publication of further guidance, the Department would not enforce the 2020 rules or otherwise pursue enforcement actions against any plan fiduciary based on a failure to comply with those final rules with respect to an investment, including a QDIA, an investment course of action, or an exercise of shareholder rights.

The 2021 Notice of Proposed Rulemaking

On October 14, 2021, the Department published a Notice of Proposed Rulemaking (NPRM) to amend the “Investment Duties” regulation. The intent of the NPRM was to address the Department’s concern that the 2020 rules created uncertainty for ERISA fiduciaries around considering climate change and other ESG factors in investment decisions.

Such uncertainty resulted in the undesirable effect of discouraging ERISA fiduciaries from such considerations, even in cases where this consideration served the plan’s financial interest. It also deterred fiduciaries from taking steps that other marketplace investors take in enhancing investment value and performance or improving investment portfolio resilience against the potential financial risks and impacts associated with climate change and other ESG factors.

The Department received approximately 900 written comments and over 20,000 petitions during the 60-day comment period.⁸ These comments and petitions came from a variety of parties, including plan sponsors and other plan fiduciaries, individual plan participants and beneficiaries, financial services companies, academics, elected government officials, trade and industry associations, and others, both supporting and opposing the NPRM.

Overview of the Final Rule

The final rule clarifies how ERISA’s fiduciary duties of prudence and loyalty apply to selecting investments and investment courses of action and exercising shareholder rights such as proxy voting.

The final rule retains the core principle that the duties of prudence and loyalty require ERISA plan fiduciaries to focus on relevant risk-return factors and not subordinate the interests of

⁶ Available at www.whitehouse.gov/briefing-room/presidential-actions/2021/05/20/executive-order-on-climate-related-financial-risk.

⁷ U.S. Department of Labor Statement Regarding Enforcement of its Final Rules on ESG Investments and Proxy Voting by Employee Benefit Plans (Mar. 10, 2021), available at www.dol.gov/sites/dolgov/files/ebsa/laws-and-regulations/laws/erisa/statement-on-enforcement-of-final-rules-on-esg-investments-and-proxy-voting.pdf.

⁸ Comments to the NPRM are available at www.dol.gov/agencies/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AC03.

participants and beneficiaries (such as by sacrificing investment returns or taking on additional investment risk) to objectives unrelated to the provision of benefits under the plan.

The final rule also reiterates a second core principle, which is that when a plan's assets include shares of stock, the fiduciary duty to manage plan assets includes the management of shareholder rights related to those shares, such as the right to vote proxies.

I. Changes to Clarify Permissibility of Consideration of ESG Factors

An important change adopted in the final rule is the addition of regulatory text clarifying that a fiduciary's duty of prudence must be based on factors that the fiduciary reasonably determines are relevant to a risk and return analysis and that such factors may include the economic effects of climate change and other ESG considerations on the particular investment or investment course of action.⁹

II. Changes to Qualified Default Investment Alternative Provisions

The final rule removes the special rules for QDIAs that applied under the 2020 rules. Under the final rule, standards applied to QDIAs are no different from those applied to other investments. When selecting a QDIA, a plan fiduciary must, among other things, focus on relevant risk and return factors and not subordinate the interests of participants and beneficiaries (such as by sacrificing investment returns or taking on additional investment risk) to objectives unrelated to the provision of benefits under the plan.

The preamble to the final rule reaffirms that, in addition to the requirements under the "Investment Duties" regulation, other standards apply to QDIAs.¹⁰

III. Changes to Clarify the Application of the Duty of Loyalty

The Tiebreaker Test

Another important change to the 2020 rules is the final rule's formulation of the "tiebreaker" standard, which permits fiduciaries to consider collateral benefits as tiebreakers in some circumstances.

The 2020 rules required that competing investments be economically indistinguishable before fiduciaries could turn to collateral factors to break a tie. It also imposed a special documentation requirement on the use of collateral factors.

The final rule replaces those provisions with a standard that instead requires the fiduciary to prudently conclude that competing investments or investment courses of action equally serve the financial interests of the plan over the appropriate time horizon. In such cases, the fiduciary is not prohibited from selecting the investment or investment course of action based on collateral benefits, meaning benefits other than investment returns.

⁹ See 29 CFR 2550.404a-1(b)(4).

¹⁰ See 29 CFR 2550.404a-5.

The final rule also removes the special documentation requirement that commenters noted created unnecessary burdens to apply the tiebreaker provision and erroneously suggested to some fiduciaries that they should be wary of considering ESG factors, even when those factors are financially relevant to the investment decision. However, the final rule maintains the longstanding principle that the fiduciary may not accept reduced returns or greater risks to secure collateral benefits.¹¹

Investment Alternatives in Participant-Directed Individual Account Plans

The final rule adds a new provision clarifying that fiduciaries do not violate their duty of loyalty solely because they take participants' non-financial preferences into account when constructing a menu of prudent investment options for participant-directed individual account plans.

This addition responds to commenters' suggestions that if accommodating participants' preferences will lead to greater participation and higher deferral rates, it could lead to greater retirement security. Thus, considering whether an investment option aligns with participants' preferences can be relevant to furthering the purposes of the plan.¹²

IV. Provisions on Shareholder Rights including Proxy Voting

Like the 2020 rules, the final rule adopts a principles-based approach to governing the exercise of shareholder rights. The final rule retains the core principle that when a plan's assets include shares of stock, the fiduciary duty to manage plan assets includes the management of shareholder rights related to those shares, such as the right to vote proxies. Like the NPRM, the final rule makes three noteworthy changes to the 2020 rules' provision on exercises of shareholder rights, including proxy voting.

First, the final rule eliminates the statement in paragraph (e)(2)(ii) of the 2020 rules that "the fiduciary duty to manage shareholder rights appurtenant to shares of stock does not require the voting of every proxy or the exercise of every shareholder right." The final rule eliminates this provision because it may be misread as suggesting that plan fiduciaries should be indifferent to the exercise of their rights as shareholders, even if the cost is minimal.

Second, the final rule removes the two "safe harbor" examples for proxy voting policies permissible under paragraphs (e)(3)(i)(A) and (B) of the 2020 rules. One of these safe harbors permitted a policy to limit voting resources to types of proposals that the fiduciary has prudently determined are substantially related to the issuer's business activities or are expected to have a material effect on the value of the investment. The other safe harbor permitted a policy of refraining from voting on proposals or types of proposals if the plan's holding in a single issuer relative to the plan's total investment assets was below a quantitative threshold.

Taken together, the Department believes the safe harbors encouraged abstention as the normal course. The Department does not believe the regulation should encourage abstention as the normal course because of the importance of prudent management of shareholder rights in enhancing the value of plan assets or protecting plan assets from risk. For this reason, the

¹¹ See 29 CFR 2550.404a-1(c)(2).

¹² See 29 CFR 2550.404a-1(c)(3).

Department is of the view that these safe harbors did not adequately protect the interests of plans and their participants and beneficiaries.

Third, the final rule eliminates specific requirements in the 2020 rules on maintaining records on proxy voting activities (paragraph (e)(2)(ii)(E) of the 2020 proxy voting rule) and monitoring obligations when using investment managers or proxy voting firms (paragraph (e)(2)(iii) of the 2020 proxy voting rule). The maintenance of records provision was widely perceived as treating proxy voting and other exercises of shareholder rights differently from other fiduciary activities. In that respect, it risked creating a misperception that proxy voting and other exercises of shareholder rights are disfavored or carry greater fiduciary obligations than other fiduciary activities.

Effective and Applicability Dates

The final rule will be effective 60 days after publication in the Federal Register. The rule will also be applicable on that date except for a delayed applicability until one year after publication for certain proxy voting provisions to allow fiduciaries and investment managers additional time to review any proxy voting policies and guidelines and make any necessary changes.

Contact Information

For questions about the final rule, contact EBSA's Office of Regulations and Interpretations at 202-693-8500.

Attachment C

Board Education on Fiduciary Duties and Corporate Engagement



LACERS
LA CITY EMPLOYEES'
RETIREMENT SYSTEM

April 25, 2023

Julie Reiser, Suzanne Dugan, and Molly Bowen

COHENMILSTEIN

Today's Presenters



Julie Reiser



Suzanne Dugan



Molly Bowen

Julie is the co-chair of Cohen Milstein's Securities Practice Group. She is known for her tenacious advocacy, creativity and understanding of complex financial and economic issues. She has been recognized as a "Titan of the Plaintiffs Bar," one of the "25 Most Influential Women in Securities Law," and "Litigator of the Week" for her role in a historic derivative settlement in the *Alphabet* shareholder litigation.

Suzanne joined Cohen Milstein after more than 20 years of service in government, including as Special Counsel for Ethics for the Office of the New York State Comptroller. For the past 11 years, she has served as outside counsel to public pension plans across the country, providing guidance on fiduciary, ethics and compliance matters. Her advice reflects the understanding of an in-house counsel combined with the broad experience developed in private practice.

Molly represents public pension funds and other institutional investors in securities class actions and shareholder derivative lawsuits. She is recognized by the legal industry for her clear judgment and unique blend of appellate and trial experience, making her an exceptional litigator.

Question

What is the origin of the following principle:

Trustees must act always in the best interest of members and beneficiaries and for their exclusive benefit, and may not sacrifice returns or take on additional risk for unrelated reasons.

Answer:

- A. This principle is from the Trump administration DOL rules
- B. This principle is from the Biden administration DOL rules
- C. Neither
- D. Both

Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights

U.S. Department of Labor 2022 Final Rule



What's a prudent fiduciary to do?

- “Process, process, process”
 - Fiduciaries are judged by the decision-making **process** they follow.
- Facts and Data
 - Do the trustees have **sufficient information** from experts, both staff and independent outside experts where appropriate.
- Rigorous Review
 - Trustees should engage in a **rigorous decision-making process** in a manner consistent with procedural prudence.
- “Document, document, document”
 - The process undertaken should be **documented** to demonstrate prudence in decision-making.
- Monitor
 - Fiduciaries have an ongoing duty to **monitor** decisions to make sure those decision remain prudent.

Non-investment Strategies

In addition to investment decisions, how can shareholders engage with the companies in which they invest to promote their long-term success and stability?

Non-investment Strategies

- Advocacy
- Proxy proposals and voting
- Derivative litigation

Advocacy

Company Engagement

Meta Platforms, Inc.

- Engaged regarding business practices that were harmful to kids and teens.

Papa John's International, Inc.

- Engaged regarding publicly reported business practices, resulting in agreement to enact new procedures to promote diversity, equity, and inclusion initiatives.

Sonic America's Drive-In Brand Properties, LLC

- Engaged regarding wage and working condition issues.

Fund Initiatives

Emerging Manager Symposium

Fall 2022

LACERS Emerging Manager Symposium is a semi-annual event for emerging investment managers interested in learning about LACERS Emerging Manager program, meeting LACERS staff and investment consultants, and understanding LACERS manager search and selection process.



Proxy Season

- Making proposals
- Voting for / against proposals
- Voting for / against directors

Proxy Season



2) Proxy Voting Policy

LACERS' Proxy Voting Policy supports sound corporate governance practices by aligning the interests of shareholders and corporations to build long-term sustainable growth in shareholder value. This policy provides LACERS' position and rationale for shareholder votes regarding corporate topics and issues to include (but not limited to) environmental and social issues, board of directors, election of the audit committee and appointment of external auditors, compensation of executives, shareholder rights and takeover defenses, capital structure, and corporate restructuring.

Proxy votes are cast by a proxy voting agent with the voting results monitored by staff and reported to the Board annually. Investment staff relies on research expertise and voting recommendations of its proxy voting agent when LACERS' Proxy Voting Policy is either silent or not directly applicable to the issue as stated on the proxy ballot.

Derivative Litigation: Starting with a Section 220 Investigation

- Shareholders have special rights to investigate whether directors and officers are fulfilling their fiduciary duties.
- Requirements:
 - Currently hold stock in the company
 - Proper purpose
 - Narrowly tailored (not a fishing expedition)

Derivative Litigation: Initiating a Lawsuit

- Shareholder can bring a lawsuit *on behalf of the company* against its board or top executives for violating their fiduciary duties.
- The goal is to remedy the harm done to the company by returning money to the company or implementing reforms that will benefit the company and its shareholders. Derivative cases are *not* designed to return money to shareholders.

Derivative Litigation: *McDonald's* Rulings Show Evolving Standards

- **April 2021:** Stockholders bring derivative lawsuit against McDonald's leadership, based on failure to address sexual harassment.
- **January 2023:** Court holds that *Caremark* standard applies to officers (not just directors) and denies Chief People Officer's motion to dismiss. Court also holds that an officer can commit a breach of the fiduciary duty of loyalty by engaging in sexual harassment, which is selfish conduct that harms the corporation.



Case Study:

In re Pinterest Derivative Litigation

Background: Cohen Milstein was lead counsel on behalf of a public pension fund in a consolidated suit alleging that the board, CEO, and CFO engaged in or tacitly approved race and sex discrimination. Resolved prior to a motion to dismiss.

Impact: Settlement included \$50 million DEI funding commitment; release of former employees from NDAs regarding facts of their mistreatment; first-ever Audit Committee responsibility for DEI reforms; Board member as co-sponsor with CEO for DEI initiatives to ensure accountability from the top; bi-annual pay equity audits; and shareholder diversity reports.



Case Study:

FirstEnergy Derivative Litigation

Background: Cohen Milstein represented a pension fund in two lawsuits in Ohio, alleging that top executives engaged in a massive political bribery scheme and the board misled investors about oversight of political spending and lobbying. Case resolved after plaintiffs defeated the motion to dismiss and the board's effort to stay the case.

Impact: Settlement included \$180 million recovery to the company (among the largest ever); departure of six directors; active board oversight of political spending and lobbying and a review of current executives; a refreshed Compensation Committee charged with establishing compensation metrics tied to ethical and legal compliance; and enhanced shareholder disclosures.





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