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Twenty-Five States Sue DOL, Challenging Final Rule on ESG Investing and Proxy Voting

[34935]

TO: ICI Members
Pension Committee
Pension Operations Advisory Committee SUBJECTS: ESG
Pension RE: Twenty-Five States Sue DOL, Challenging Final Rule on ESG Investing and Proxy Voting

On January 26, 2023, attorneys general from 25 states (joined by three additional organizations and one individual)[1] filed a lawsuit against the Department of Labor (DOL) attempting to invalidate the final rule on "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights" ("2022 Rule"), which addresses the consideration of environmental, social, and governance (ESG) factors in selecting plan investments and exercising shareholder rights.[2] The states' attorneys general filed the complaint (attached) in US District Court in the Northern District of Texas. On February 7, DOL submitted a motion alleging "forum shopping" and requesting the case to be transferred "either to the District of Columbia or another District in which a Plaintiff resides."[3]

The states claim standing to bring the lawsuit because the 2022 Rule will cause the states to lose tax revenue from retirement distributions, will harm the economic well-being of their residents, and will result in reduced investment in the fossil fuel industry, which will negatively affect the states.[4]

2022 Final Rule

The 2022 Rule amends two rules finalized at the end of the Trump Administration, "Financial Factors in Selecting Plan Investments"[5] and "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights"[6] (the "2020 Rules"). In issuing the 2022 Rule, DOL explained that the 2020 Rules "unnecessarily restrained plan fiduciaries' ability to weigh [ESG] factors when choosing investments, even when those factors would benefit plan participants financially."[7]

Although the 2022 Rule allows greater flexibility for fiduciaries to include ESG investments in plans, it retains the longstanding ERISA core principles: (1) 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, and (2) 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.

For example, the 2022 Rule deletes the "pecuniary/non-pecuniary"[8] terminology used in the 2020 Rules, based on concerns that the terminology causes confusion and a chilling effect to financially beneficial choices. Instead, the 2022 Rule includes the following language:

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. [9]

The 2022 Rule became effective on January 30, 2023, and all but two provisions also became applicable on that date.[10]

Summary of Plaintiffs' Complaint

In the complaint, the plaintiffs allege that the 2022 Rule conflicts with ERISA because it authorizes fiduciaries to consider and promote "nonpecuniary benefits" when making investment decisions, making it easier for fiduciaries to act with mixed motive. As evidence, they point to the loosening of the tie-breaker test,[11] alleging that the revised test "allows fiduciaries substantial wiggle room" and "will transform the [2020 Rule's] strict tiebreaker into something that occurs regularly, and thus authorize consideration of 'collateral benefits' … in a much broader class of cases."[12]

Second, the plaintiffs allege the 2022 Rule fails under the major questions doctrine, which refers to the Supreme Court's declaration that, if an agency seeks to decide an issue of major national significance, its action must be supported by clear congressional authorization. The complaint suggests that DOL is precluded from allowing fiduciaries to consider nonpecuniary factors in administering plan assets, explaining that "[t]he sheer magnitude of the assets that the [2022 Rule] would affect—over half of the GDP of the entire United States—suggests that courts should hesitate before finding that DOL has authority to regulate in this area for nonfinancial purposes."[13] Pointing to language that was proposed,[14] but not included in the final 2022 Rule, the plaintiffs warn that DOL may in the future require fiduciaries to consider nonpecuniary factors like climate change.

Third, the plaintiffs allege that the 2022 Rule is an arbitrary and capricious exercise of administrative power, for the following reasons:

- The 2022 Rule ignores past findings by DOL and fails to consider the danger to investors that DOL had identified in promulgating the 2020 Rule.
- DOL did not give sufficiently detailed justification for departing from the factual

findings in the 2020 Rules.
- DOL's justification of the need to cure a chill or confusion caused by the 2020 Rule do not support the changes DOL made with the 2022 Rule.
- DOL's elimination of the collateral-benefit disclosure requirement is arbitrary and capricious because rather than explain why it removed the requirement, DOL simply recites the arguments from commenters both for and against the requirement.
- DOL failed to consider issuing sub-regulatory guidance as a solution to address its concerns about the 2020 Rule.
- DOL's elimination of the documentation requirement for the tie-breaker rule is arbitrary and capricious because, although DOL claims the requirement would unduly burden fiduciaries, there is no "cognizable interest" in a fiduciary's use of the tie-breaker test. Similarly, DOL's elimination of the specific restrictions for Qualified Default Investment Alternatives (QDIAs) was arbitrary and capricious because QDIA's warrant special treatment.[15]
- The 2022 Rule is unlawful because of DOL's prejudgment, because there is evidence that DOL decided what to do before it reviewed the public comments.

The plaintiffs rely on their interpretation of a Supreme Court case, Fifth Third Bancorp v. Dudenhoeffer,[16] as support for their positions—in particular for their position that the regulation must retain the terms pecuniary/nonpecuniary.

As relief, the plaintiffs ask the court to:

- postpone the January 30, 2023 effective date of the 2022 Rule, while the lawsuit is pending.
- declare that the 2022 Rule is arbitrary and capricious and was promulgated by DOL in excess of statutory jurisdiction and authority under ERISA;
- set aside the 2022 Rule; and
- preliminarily and permanently enjoin DOL from implementing applying, or taking any action whatsoever under the 2022 Rule.

Congressional Activity

In addition to the lawsuit, there is also opposition to the 2022 Rule on the Hill. On February 7, 2023, Congressional Republicans in the House and Senate, led by Congressman Andy Barr (R-KY) and Senator Mike Braun (R-IN), introduced a Congressional Review Act (CRA) measure to nullify the 2022 Rule.[17] According to the press release, every Republican Senator and Senator Joe Manchin (D-WV) are supporting the resolution. Note that even if the resolution were to pass both Houses, for a regulation to be invalidated under the CRA, the Congressional resolution of disapproval must be either signed by the President or passed over the President's veto by two thirds of both Houses of Congress.

We also expect that Congressman Barr will reintroduce the Ensuring Sound Guidance (ESG) Act.[18] Among other things, the version of the bill from last Congress was drafted to incorporate the term and definition of "pecuniary" from the 2020 Rule into the statute. It also would have banned DOL from finalizing or enforcing the 2022 Rule.

Finally, on February 3, 2023, the Chairman of the House Financial Services Committee, Patrick McHenry (R-NC), announced the creation of a working group "to combat the threat to our capital markets posed by those on the far-left pushing environmental, social, and governance (ESG) proposals."[19] The working group, led by Oversight and Investigations Subcommittee Chairman Bill Huizenga (R-MI), will focus on SEC initiatives, but will also "coordinate Republicans' response to the ESG movement through Member education and

policy development across the Committee's jurisdiction and throughout the broader House Republican Conference."

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Notes

[1] The states include Alabama, Alaska, Arkansas, Florida, Georgia, Idaho, Indiana, Idaho, Kansas, Kentucky, Mississippi, Missouri, Montana, Nebraska, New Hampshire, North Dakota, Ohio, South Carolina, Tennessee, Texas, Utah, Virginia, West Virginia, and Wyoming. In addition to the 25 states, additional plaintiffs include Liberty Energy Inc (a publicly traded energy company), Liberty Oilfield Services LLC (a subsidiary of Liberty that sponsors a defined contribution 401(k) plan for its employees), Western Energy Alliance (a trade association representing 200 companies engaged in all aspects of environmentally responsible exploration and production of oil and natural gas), and James R. Copland (a retirement plan participant). A press release from the group on the lawsuit is available at https://www.texasattorneygeneral.gov/news/releases/paxton-sues-biden-administration-stop-it-risking-american-workers-retirements-promoting-woke-esg.

[2] For a summary of the final rule, see ICI Memorandum No. 34506, dated December 5, 2022, available at https://www.ici.org/memo34506.

[3] DOL argues that "[t]he case does not arise from any event or omission occurring in the Northern District of Texas, much less the Amarillo Division." Further, no plaintiff nor defendant resides in the district or the division. Therefore, "[a]t a minimum, should the Court determine venue is proper in the Northern District of Texas, it should nonetheless transfer this case to the Dallas, Fort Worth, Lubbock, Abilene, or San Angelo Division."

[4] Liberty Oilfield Services LLC claims standing as sponsor of an ERISA plan, claiming that under the 2022 Rule, it will lose the protections put in place by the 2020 rules, which will cause it to expend additional time and resources monitoring and reviewing recommendations from its investment advisors, without the benefit of recordkeeping requirements or clearer fiduciary duty regulations, to ensure they are focusing explicitly on pecuniary considerations and not collateral ESG factors. Liberty Energy Inc. claims standing because it will likely be harmed by decreased interest from investors and access to investment capital, noting that "increased ability to consider ESG factors under ERISA will likely move investment away from oil and gas companies like Liberty to ESG-aligned funds."

[5] For a summary, see ICI Memorandum No. 32888, dated November 3, 2020, available at https://www.ici.org/my_ici/memorandum/memo32888.

[6] For a summary, see ICI Memorandum No. 32984, dated December 15, 2020, available at https://www.ici.org/my_ici/memorandum/memo32984.

[7] See DOL press release dated November 22, 2022, available at https://www.dol.gov/newsroom/releases/ebsa/ebsa20221122. In the preamble to the proposed rule, DOL explained:

"The Department is concerned that, as stakeholders warned, uncertainty with respect to the current regulation may deter 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 often associated with climate change and other ESG factors. The Department is concerned that the [2020 Rules have] created a perception that fiduciaries are at risk if they include 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."

86 Fed. Reg. 57272, at 57275-6 (October 14, 2021).

[8] Section (c)(1) of the 2020 Rule stated that "[a] fiduciary's evaluation of an investment or investment course of action must be based only on pecuniary factors," except as provided in a narrowly drafted tie-breaker test. Section (f)(3) of the 2020 Rule defined the term "pecuniary factor" 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 established pursuant to section 402(b)(1) of ERISA." The text of the 2020 Rules did not include any ESG terminology; however, in the preamble, DOL provided its views regarding the appropriateness of considering ESG factors.

[9] Paragraph (b)(4) of the 2022 Rule.

[10] Two proxy voting provisions (both unchanged from the final rule adopted in 2020) have a delayed applicability date of one year after publication to allow fiduciaries and investment managers time to make any necessary changes to proxy voting policies and guidelines. The provisions are:

1) paragraph (d)(2)(iii), regarding the prohibition on fiduciaries' adoption of 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 as described in the rule; and

2) paragraph (d)(4)(ii), relating to investment managers of pooled investment vehicles holding assets of more than one employee benefit plan, where such participating plans may have conflicting investment policy statements.

[11] The 2020 Rule's "tiebreaker" test imposed 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 2022 Rule replaced 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. The 2022 Rule also removes the current regulation's special documentation requirement that would have applied when using the tiebreaker test, in favor of ERISA's generally applicable statutory duty to prudently document plan affairs.

[12] See pages 27–28 of the complaint.

[13] See pages 28–29 of the complaint.

[14] The rule DOL proposed in 2021 included language providing that a fiduciary's consideration of an investment's projected return "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." Proposal section (b)(2)(ii)(C), published at 86 Fed. Reg. 57272 (October 14, 2021).

[15] The 2020 Rule prohibited plans from adding or retaining any investment fund, product, or model portfolio as a QDIA, or as a component of a QDIA, if its objectives or goals or its principal investment strategies include, consider, or indicate the use of one or more non-pecuniary factors. The 2022 Rule removed this restriction, such that, under the final rule, the same standards apply to QDIAs as to selecting investments generally.

[16] 573 U.S. 409, 421 (2014). The complaint quotes the Court as saying, in the context of ERISA retirement plans, that ERISA's "'benefits' language 'must be understood to refer to . . . financial benefits (such as retirement income) . . . [and] does not cover nonpecuniary benefits like those supposed to arise from employee ownership of employer stock.'" Id. at 421 (emphasis in original).

[17] See Senator Braun's press release, dated February 7, 2023, available at https://www.braun.senate.gov/node/2200. A press release from Representative Barr, also dated February 7, 2023, is available at https://barr.house.gov/2023/2/barr-reintroduces-resolution-to-block-biden-s-politicization-of-retirement-accounts.

[18] H.R. 7151 in the 117th Congress, introduced March 18, 2022, available at https://www.congress.gov/117/bills/hr7151/BILLS-117hr7151ih.pdf.

[19] See press release dated February 3, 2023, available at https://financialservices.house.gov/news/documentsingle.aspx?DocumentID=408533.
