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DOL's Latest ESG Proposal: The More Things Change, the More They Stay the Same

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On October 14, 2021, the U.S. Department of Labor's Employee Benefits Security Administration (the "DOL") published in the *Federal Register* a new proposed regulation (the "Proposed Rules")[1] on fiduciary responsibility in selecting ERISA plan investments and exercising shareholder rights (proxy voting). The Proposed Rules reflect an effort to "warm" what the current DOL perceives as a "chilling effect" that existing regulations have had on environmental, social, and governance ("ESG")-themed investing, but they do not include major changes to core principles. Most notably, the Proposed Rules retain the rule that investment decisions and the exercise of shareholder rights must be based solely on risk and return factors (i.e., one may not sacrifice investment returns or take additional risk in support of a collateral objective), and do not offer a "safe harbor" for adding an ESG-themed fund to a 401(k) or 403(b) plan lineup.

Background

The DOL previously issued a final rule on October 30, 2020, regarding the interplay of ERISA's fiduciary standards with ESG investment considerations.[2] Although the current rule omits any express references to "ESG," its focus on "pecuniary" and "non-pecuniary" factors is widely viewed as targeting the consideration of ESG-type factors by fiduciaries when selecting ERISA plan investments.

In a separate (but related) ruling, on December 16, 2020, the DOL issued a final rule regarding the exercise of proxy voting responsibilities by ERISA plan fiduciaries, which has had a similar ESG-related effect.[3] Both current rules were effectuated as amendments to the DOL's "investment duties" regulation at 29 C.F.R. 2550.404a-1 (as would the Proposed Rules if finalized, except they would be restyled as the "investment prudence duties" regulation).

As part of a directive by the Biden administration to review Trump administration-era regulations that were inconsistent with the promotion and protection of public health and the environment, the DOL announced on March 10, 2021 that it would not enforce the current rules until it completed a review thereof and issued further guidance. The Proposed Rules represent the culmination of that review and, if finalized in their current (or substantially similar) form, could reverse some of what some perceive as the "anti-ESG" effects of the Trump-era rules.

ESG-Related Changes in the Proposed Rules

The Proposed Rules would make a number of ESG-related changes to the current investment duties regulation, including the following:

- *Acknowledges that Consideration of ESG Factors May be Permitted (or Required) as Part of Satisfying Duty of Prudence.* Like the current rule, the Proposed Rules would preserve the long-standing requirement for prudent investment and investment courses of action that a fiduciary give "appropriate consideration" to the facts and circumstances that, given the scope of the fiduciary's investment duties, the fiduciary knows (or should know) are relevant before acting accordingly. "Appropriate consideration" includes, as it does under the current rule, consideration of the projected return of the portfolio relative to the funding objectives of the plan. However, the Proposed Rules now expressly acknowledge that the consideration of projected returns "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 Proposed Rules provide, by way of example, a list of ESG-type factors that, depending on the facts and circumstances, may be material to a fiduciary's risk-return analysis, including: (i) climate change-related factors, including exposure to physical and transitional risks of climate change itself or the positive or negative effect of regulatory action to mitigate climate change; (ii) governance factors, including board composition, executive compensation, transparency and accountability, and compliance with law; and (iii) workforce practices, including diversity, inclusion, employee hiring and retention, employee training, and labor relations. In the preamble, the DOL expressed its intent that these examples clarify that ESG factors are "no different than other 'traditional' material risk-return factors" for purposes of a fiduciary's exercise of its prudent investment duty, which the DOL also believes is consistent with its prior sub-regulatory guidance.

    - Importantly, however, the Proposed Rules do preserve the current rule's language stating that a fiduciary must take into consideration the risk of loss and opportunity for gain associated with the investment (or investment course of action) compared to the opportunity for gain associated with reasonably available alternatives with similar risks. In other words, although the Proposed Rules acknowledge that ESG-type factors may in fact relate to a fiduciary's consideration of the economic benefits and projected returns of a particular investment, that consideration occurs in the context of evaluating risks and returns against other alternatives with similar risks (e.g., ESG-themed funds or investments are not considered a special or separate asset class under the Proposed Rules, which also means that there is no "safe harbor" for a fiduciary to, for example, simply add the "best" ESG-themed funds to a 401(k) or 403(b) investment fund lineup).

- *Clarifies that the Duty of Loyalty Does Not Prohibit Consideration of ESG Factors that Are Material to Investment Value*. The Proposed Rules generally preserve the current rule's recitation of ERISA's duty of loyalty. That is, a fiduciary cannot subordinate the interests of participants and beneficiaries in retirement income or financial benefits to other objectives, and may not sacrifice investment return or take on additional investment risk to promote benefits or goals unrelated to those interests.
    - However, in a significant deviation from the current rule, the Proposed Rules expressly provide that a fiduciary's evaluation of an investment (or investment course of action) must be based on risk and return factors that the fiduciary prudently determines are material to investment value, using appropriate investment horizons consistent with the plan's investment objectives and funding policies, which, depending on the facts and circumstances, *may include the ESG-factors listed above as potential material risk-return factors*.
    - The DOL notes in the preamble to the Proposed Rules that this modification is intended to confirm that consideration of an economically material ESG factor is consistent with ERISA's duty of loyalty.
    - Interestingly, in acknowledging that ESG-factors are potentially material risk-return factors, the Proposed Rules in effect impose an affirmative duty on fiduciaries to consider ESG-factors where they have a material economic impact (which, although presented as a "change," arguably follows what is and has always been required of ERISA fiduciaries – i.e., consideration of all material economic factors).

- *Eliminates the Bifurcation Between "Pecuniary" and "Non-pecuniary" Factors*. The current rule requires that ERISA fiduciaries must generally evaluate investments only on the basis of "pecuniary" factors (which are defined as factors "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…funding policy"). Only in circumstances where a fiduciary is unable to distinguish investment alternatives on the basis of pecuniary factors does the current rule permit a fiduciary to weigh "non-pecuniary" factors.[4] The Proposed Rules eliminate the "pecuniary" versus "non-pecuniary" construct, and instead provide that a fiduciary "may" (read: "should") consider *any* factor material to the risk/return analysis, including climate change and other ESG factors.
- *Broadens the Definition of a "Tie-Breaker."* The Proposed Rules appear to ease the burden of using ESG or other "collateral benefits" as a "tie-breaker" between competing investments.
    - Under the current rule, "non-pecuniary" factors could only be considered as a "tiebreaker" if the applicable investments could not be distinguished based on "pecuniary factors" alone, a very difficult standard to meet in practice. The Proposed Rules would instead allow for collateral benefits to be considered as a "tie-breaker" where competing investments "equally serve the financial interests of the plan over the appropriate time horizon"; although not entirely clear what that means, it is clear that the DOL is seeking to make the "tie-breaker" standard easier to satisfy.
    - As under the current rule, a fiduciary cannot accept reduced returns or greater risks to secure any such "collateral benefits."
    - Further, under the Proposed Rules, if the fiduciary makes an investment decision based on "collateral benefits" with respect to a designated investment alternative for an individual account plan, the "collateral benefit" characteristic must be prominently displayed in disclosure materials provided to participants and beneficiaries.
    - The Proposed Rules would also eliminate the requirement under the current rule that, where a "non-pecuniary" factor is used as a "tie-breaker," the fiduciary specifically document why it could not distinguish investment alternatives on "pecuniary" factors alone (including documentation regarding how the selected investment compared with alternative investments with regard to the "pecuniary" factors and how the chosen "non-pecuniary" factors are consistent with the interests of participants and beneficiaries in their retirement income or financial benefits under the relevant plan). The DOL believes this additional ESG-specific documentation requirement is unnecessary in light of ERISA's general prudence obligation, and that this

requirement may improperly prevent consideration of otherwise legitimate "collateral benefits" in a "tie-breaker" analysis.

- *Removes the Prohibition on Funds and Products Supporting "Non-Pecuniary" Goals as Qualified Default Investment Alternatives ("QDIAs")*. In a flat reversal from the current rule, the Proposed Rules permit a fund, product, or model portfolio that expressly considers ESG factors to be used as a QDIA as long as it is financially prudent and meets the standards set out in the DOL's QDIA regulation (29 C.F.R. 2550.404c-5). However, as noted above, the Proposed Rules do require disclosure to plan participants and beneficiaries if a designated investment alternative (including a QDIA) is selected based on a "collateral benefit" in a "tie breaker" scenario.

Key Takeaway: The Proposed Rules (if finalized) should provide ERISA fiduciaries with some comfort that they will not be penalized for appropriately considering ESG-type factors when weighing investment alternatives, where those factors are material to the risk-return analysis. Given the skepticism towards ESG-investing reflected in the current rule, fiduciaries have arguably been hesitant to consider ESG-type factors when making investment decisions. While the Proposed Rules are similar in concept to past, sub-regulatory DOL guidance, it is notable that they more explicitly acknowledge that ESG-type factors may be relevant to a fiduciary's investment analysis and could impose liability for a breach of fiduciary duty if economically material ESG factors are not appropriately considered by the plan fiduciary.

The Proposed Rules would not provide carte blanche for a fiduciary to select investments solely based on ESG factors that are unrelated to the interests of participants and beneficiaries in retirement income or financial benefits – which would violate ERISA's statutory duties of investment prudence and loyalty in any event – but should eliminate some of the burdens and uncertainty surrounding ESG-related investment decisions under the current rule. They do not, however, go so far as to label ESG-themed funds or investments as a special or separate asset class, which means that there is no "safe harbor" for a fiduciary to simply add the "best" of a selection of ESG-themed funds to a 401(k) or 403(b) investment fund lineup. Accordingly, since investment decisions are often judged after the fact with benefit of perfect hindsight, if an ESG-themed investment option underperforms its benchmark, the fiduciary will be at risk for such decision.

Proxy Voting Changes in the Proposed Rules

The Proposed Rules would also modify the current investment duties regulation as it applies to the exercise of shareholder rights (including proxy voting) in several key ways:

- *Clarifies that ESG Factors May Be Considered When Exercising Shareholder Rights*. The Proposed Rules would clarify that although a fiduciary is generally required to act “solely in accordance with the economic interest of the plan and its participants and beneficiaries” when exercising shareholder rights, the fiduciary generally may consider ESG-related factors when making such decisions in the same manner as noted above for other investment-related decisions.
- *Rescinds Statement that Voting of Every Proxy is Not Required*. The current rule specifically states that a fiduciary’s duties to manage shareholder rights does not require the voting of every proxy or the exercise of every shareholder right. The DOL, concerned that this statement could be read as broad authorization for fiduciaries to simply abstain from proxy voting (which the DOL describes as a “crucial lever” in ensuring that a plan’s interest as a shareholder is protected), proposes to delete this statement in the Proposed Rules. The preamble to the Proposed Rules does, however, acknowledge that a fiduciary may determine on a case-by-case basis that voting of a proxy may not be in a plan’s best interests (because of, for example, significant costs or efforts associated with voting).
- *Removes Voting Policy “Safe Harbors.”* The current rule permits a fiduciary to discharge its duties with respect to proxy voting by establishing (i) a policy to limit voting resources to particular types of proposals that the fiduciary has prudently determined are substantially related to the relevant issuer’s business or expected to have a material effect on the value of the investment, and/or (ii) a policy of refraining from voting on proposals or particular types of proposals when the plan’s holdings in the relevant issuer are sufficiently small. Although the DOL continues to believe that proxy voting policies can generally help fiduciaries reduce costs and compliance burdens, it fears that these “safe harbor” examples would become widely adopted, and the DOL is not convinced that the examples adequately safeguarded plan participants and beneficiaries.
- *Streamlines Monitoring Obligations for Delegated Voting Rights and Advisory Services*. The current rule provides specific monitoring obligations on plan fiduciaries who delegate proxy voting rights or utilize advisory services of proxy voting firms. The Proposed Rules instead would apply a more general “prudence and diligence” standard in the selection and monitoring of any such delegates or advisors.
- *Eliminates Recordkeeping Requirement Regarding Proxy Voting Activities*. The Proposed Rules would eliminate the requirement that fiduciaries maintain records on proxy voting activities (or other exercises of shareholder rights). The DOL

expressed its concern that this recordkeeping requirement could create a misperception that proxy voting (and other exercises of shareholder rights) are disfavored or have heightened fiduciary obligations (and therefore greater potential fiduciary liability) than other fiduciary activities. The DOL views proxy voting as a vital tool in shareholder representation (including for ERISA plan shareholders), and the Proposed Rules attempt to remove such misperception so as to not unnecessarily discourage proxy voting activity by ERISA plan fiduciaries.

Key Takeaway: Driven by a concern that the current rule has had the effect of chilling proxy voting activity by plan fiduciaries, the Proposed Rules would eliminate burdensome recordkeeping requirements and underscore that proxy voting is a key tool in managing investments in issuers that should be taken seriously by ERISA fiduciaries.

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The DOL has invited comments on all aspects of the Proposed Rules. Comments are due no later than December 13, 2021.

Although the Proposed Rules (if finalized) would swing the pendulum back in the direction of permitting (as opposed to prohibiting) ERISA fiduciary consideration of ESG factors under certain circumstances, the bedrock principles of ERISA's fiduciary duties of prudence and loyalty as applied to investment decisions generally remain unchanged – in particular, ERISA plan fiduciaries would still generally be required to base their investment decisions solely on the risk-adjusted value to plan participants and beneficiaries and in a manner so as to not subordinate their economic interests (such as by sacrificing investment returns or taking on additional risk) to unrelated goals or objectives.

We will keep you posted on any new developments in this area.

[1] *See* https://www.federalregister.gov/documents/2021/10/14/2021-22263/prudence-and-loyalty-in-selecting-plan-investments-and-exercising-shareholder-rights.

[2] For more on the current ESG rule and its history, see here and here.

[3] For more on the current proxy rule and its history, see here.

[4] Although the current rule does not expressly reference "ESG" as a "non-pecuniary" factor, the term is widely understood as targeting ESG-type concerns.

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