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The U.S. Department of Labor Issues Proposed Rule Giving Plan Fiduciaries Greater Latitude to Invest in ESG Funds

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On October 14, 2021, the U.S. Department of Labor (DOL) released a new proposed rule, ''Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights,''[1] that (again) seeks to define the extent to which a plan fiduciary may take into account Environmental, Social, and Governance (ESG) factors in investing plan assets. The proposed rule also addresses a plan fiduciary's duty to manage shareholder rights appurtenant to investments in shares of stock, such as proxy voting.

Over the past three decades, the DOL has attempted to provide guidance to plan fiduciaries as to when and how they can consider ESG factors in making investment decisions. While the tone and tenor of the DOL guidance has varied, the basic requirement – which is reiterated in the new proposed rule – is that a fiduciary must consider risk and return factors that are material to an investment's value.

The DOL in the last year of the Trump administration proposed and later finalized ESG investing rules for plan fiduciaries. In describing the prior 2020 ESG regulations, the DOL expressed concern that they created a perception that plan fiduciaries are at risk if they include any ESG factors in the financial evaluation of plan investments. In March 2021, the DOL announced that it was reexamining its 2020 ESG regulations, and that it would not enforce the 2020 ESG regulations against plan fiduciaries.[2]

PROPOSED CHANGES TO CLARIFY PERMISSIBILITY OF CONSIDERATION OF ESG FACTORS

The proposed rule adds language intended to counteract the negative perception of the use of climate change and other ESG factors in investment decisions caused by the 2020 ESG regulations, and to clarify that a fiduciary's duty of prudence may often require an evaluation of the economic effects of climate change and other ESG factors.

The proposed rule provides examples of how ESG concerns may be material to the fiduciary's risk-return analysis involved in selecting plan investments. Those include:

> **A. Climate-change related factors**: Such factors include a company's exposure to the physical risks of climate change (including the significant economic consequences on businesses as more extreme weather conditions damage physical assets, disrupt productivity and supply chains, and force adjustments to operations), and the effect of government regulations and policies to mitigate climate change.

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[1] 86 Fed. Reg. 57,272 (Oct. 14, 2021).

[2] *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).

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Specifically, plan sponsors should be aware of two types of risks associated with climate change: physical risk, and transition risk.[3] Physical risk relates to the financial impacts associated with a rise in extreme weather events and a changing climate. These risks can be especially important for long-term duration assets, and are likely to worsen as climate mitigation and adaptation efforts are ignored. In 2019, BlackRock published a report which noted that the physical risk of extreme weather patterns is underpriced in certain sectors (including the electric utility and commercial real estate sectors) and asset classes.[4] Additionally, S&P Trucost found that 60% of the companies in the S&P 500 index hold assets that were at substantial risk to the physical effects of climate change.[5]

Transition risk involves the risks that businesses face when they are dependent on fossil-fuels as governments promulgate policies and new technologies to transition to a carbon-neutral economy. Governmental regulations aimed to reduce greenhouse gas emissions may incentivize a shift from carbon-intensive investments to investments with a lower carbon footprint, and such regulations could significantly decrease the value of carbon-intensive investments. Plan sponsors may seek to address these transition risks by identifying companies and investments that have already started aligning themselves with more environmentally sustainable industries, thereby "strategically positioning themselves to succeed in the transition."[6] As more plan sponsors begin to recognize that climate risk is an investment risk, the DOL believes that "a long-term reallocation of capital" will occur that will have a positive impact on risk and return.[7] Thus, by taking climate change into account when assessing the financial risks of investments for which government climate policies will affect performance, plan sponsors can protect investment portfolios by reducing volatility and mitigating the longer term economic risks to a plan's assets.

B. Governance factors: These factors involve board composition, executive compensation, and transparency and accountability in company decision-making, as well as a company's avoidance of criminal liability and compliance with labor, employment, environmental, tax, and other applicable laws and regulations.

C. Workforce practices: Factors include a company'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.

CHANGES TO QUALIFIED DEFAULT INVESTMENT ALTERNATIVE (QDIA) PROVISIONS

The 2020 ESG regulations[8] prohibit a fund from serving as a plan's QDIA if it, or any of its component funds, has investment objectives, goals, or principal investment strategies that consider the use of non-financial factors, even if the fund is objectively economically prudent from a risk/return perspective. The proposed rule would eliminate this prohibition by providing that if a fund expressly considers climate change or other ESG factors, is financially prudent, and meets the protective standards set out in the DOL's QDIA regulation, plan fiduciaries may consider the fund as a QDIA.[9] Although the DOL has restated its position in different forms, what has remained unchanged is the principle that a fiduciary's paramount interest must be the plan's financial risk and return. The fiduciary cannot subordinate the interests of participants and beneficiaries in their retirement income to unrelated objectives, and the fiduciary may not sacrifice investment returns or take on additional investment risk to promote goals unrelated to the plan.[10]

CHANGES TO THE TIE-BREAKER TEST

The 2020 ESG regulations contain the so-called "tie-breaker" standard, which first appeared in DOL sub-regulatory guidance from the 1990s. Beginning with DOL Interpretive Bulletin 94-1, the DOL announced what is known as the "tie-breaker" standard. Under this standard, if a fiduciary has determined that two investment options effectively have the same economic risk and return profile, the fiduciary can consider "non-pecuniary" factors, such as ESG goals, to break the tie.

[3] 86 Fed. Reg. 57,290.

[4] 86 Fed. Reg. 57,290; see also BlackRock Investment Institute, *Getting Physical: Assessing Climate Risks* (2019).

[5] S&P Trucost Limited, *Understanding Climate Risk at the Asset Level: The Interplay of Transition and Physical Risk* (2019).

[6] 86 Fed. Reg. 57,290.

[7] 86 Fed. Reg. 57,290; *see also* BlackRock, *A Fundamental Reshaping of Finance*, Larry Fink's 2020 Letter to CEOs.

[8] Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72,846 (Nov. 13, 2020).

[9] 86 Fed. Reg. 57,279.

[10] DOL Interpretive Bulletin 94-1.

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The proposed rule articulates the DOL's concern that the tie-breaker standard may be interpreted too narrowly. For example, the preamble discusses the possibility that two investments may differ on a wide range of attributes, yet when considered in their totality, each can serve the financial interests of the plan equally well.[11] Although these investments are not indistinguishable, they are equally appropriate additions to the plan's portfolio. Additionally, the DOL contemplates a situation where a fiduciary may select a particular investment in order to hedge against a specific risk to the portfolio, even though the investment, when considered in isolation from the portfolio as a whole, is riskier or less likely to generate a significant return than other investments that do not serve the same hedging function. In light of this, the proposed rule would expand the tie-breaker scenario such that two investment options do not have to be indistinguishable before collateral benefits (including both ESG and non-ESG factors, such as community-based job creation) other than investment returns may be considered. Instead, the proposed rule would require fiduciaries to first establish that the two investment options ''equally serve the financial interests of the plan'' before collateral benefits are weighed. In such a case, the plan fiduciary must ensure that the collateral benefit characteristics of the fund are prominently displayed in disclosure materials to plan participants and beneficiaries.[12] If the tie-breaking characteristic of a particular investment is that it better aligns with the corporate ethos of the plan sponsor or that it improves workplace morale, then such feature must be prominently disclosed by the plan fiduciary.[13] This ensures that plan participants are sufficiently informed of the collateral factors that tipped the scale in favor of adding the investment option to the plan menu.

Although the proposed rule would not limit the collateral benefits that may be considered to break the tie, the DOL requests comments on whether more specificity should be provided. For instance, the DOL questions whether the rule should require that collateral benefits relied upon as a tie-breaker be based upon an analysis of the shared interests of the participants, beyond just their financial interests, such as the investment's potential impact on plan contribution rates or participants' jobs.

ELIMINATION OF THE FIDUCIARY DOCUMENTATION REQUIREMENT

The proposed rule also would remove the requirement in the 2020 ESG regulations for a plan fiduciary to specially document its analysis in those tie-breaker cases where the plan fiduciary has concluded that pecuniary factors alone were insufficient to be the deciding factor.[14] The DOL reasoned that this special documentation requirement is unnecessary because fiduciaries are already subject to a general prudence obligation and commonly document and maintain records about their investment selections pursuant to that obligation.[15] Further, the DOL criticizes the special documentation provisions as being too formulaic and rigid to allow fiduciaries to effectively fulfill their ERISA duty of prudence. By removing this requirement, DOL aims to remove administrative disincentives to making prudent investment decisions based on climate change or other ESG factors.

CHANGES TO PROVISIONS ON SHAREHOLDER RIGHTS/PROXY VOTING PROVISIONS

The proposed rule would make several notable changes to the 2020 ESG regulation provisions on shareholder rights, including proxy voting. Specifically, the proposed rule would remove a statement indicating that a fiduciary is not required to vote all proxies.[16]

The DOL is concerned that the statement could be misread as suggesting that plan fiduciaries should be indifferent to the important responsibility of exercising their rights as shareholders. It is the DOL's longstanding view that proxies should be voted as part of the process of managing the plan's investment in company stock unless a fiduciary prudently determines voting proxies may not be in the plan's best interest (i.e., if there are significant costs or efforts associated with voting).[17] Further, the DOL explains that when fiduciaries exercise their shareholder rights by voting proxies, they help to enhance management accountability to the shareholders that own the company.[18] Balancing these concerns, the DOL noted, however, that fiduciaries are not required to always vote proxies or engage in shareholder activism.[19] Rather, the preamble to the proposed rule encourages fiduciaries to take steps to ensure that the cost and effort associated with proxy voting is commensurate with the significance of an issue to the plan's financial interests.

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[11] 86 Fed. Reg. 57,278.

[12] 86 Fed. Reg. 57,280.

[13] 86 Fed. Reg. 57,280.

[14] 86 Fed. Reg. 57,279.

[15] 86 Fed. Reg. 57,279.

[16] 86 Fed. Reg. 57,281.

[17] Interpretive Bulletin Relating to the Exercise of Shareholder Rights and Written Statements of Investment Policy, Including Proxy Voting Policies or Guidelines, 81 Fed. Reg. 95,879 (Dec. 29, 2016). *See* 81 Fed. Reg. 95,881.

[18] 86 Fed. Reg. 57,281.

[19] 86 Fed. Reg. 57,281.

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The proposed rule would also eliminate a provision that prescribes 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).[20] This proposed change stems from the DOL's concern that the specific provision in the 2020 ESG regulations may be misinterpreted as requiring special obligations above and beyond the statutory obligations of ERISA.

In addition, the proposed rule would remove the two ''safe harbor'' examples of permissible proxy voting policies. One of these safe harbors permit a fiduciary to implement a policy limiting voting resources to particular types of proposals that the fiduciary has prudently determined will materially affect the value of the investment. The other safe harbor permits a policy of refraining from voting on certain investment choices. The DOL indicated that these safe harbors may be misconstrued as regulatory permission for plans to abstain broadly from proxy voting without properly considering their interests as shareholders.

The proposed rule would also eliminate the requirement that, when exercising shareholder rights, plan fiduciaries must maintain records on proxy voting activities. The DOL views this provision as treating proxy voting differently from other fiduciary activities, which could potentially discourage plan fiduciaries from exercising their rights, or encourage fiduciaries to over-document their efforts.

APPLICABILITY OF THE PROPOSED RULE

Plans holding stock through a registered investment company (i.e., mutual funds) would not be affected by the proposed rule because it would not apply to such funds' internal management of these underlying investments.[21] Additionally, the proposed rule expressly states that it does not apply to voting, tendering and similar rights with respect to shares of stock, pursuant to an individual account plan, that are passed through to participants and beneficiaries.[22]

USE OF PROXY ADVISORY FIRMS

The proposed rule would also prevent fiduciaries from following the recommendations of a proxy advisory firm or other service provider without first determining that such firm's proxy voting guidelines are consistent with the fiduciary's obligations under ERISA.[23] The DOL intended this provision to address specific concerns involving fiduciaries' use of proxy advisory firms and similar service providers, including the use of automatic voting mechanisms relying on proxy advisory firms.[24] The DOL invites comments on whether this provision is needed in light of the more general requirement that fiduciaries must exercise prudence in selecting and monitoring persons retained in order to exercise shareholder rights.

REFINEMENT OF PROXY VOTING POLICIES

The DOL encourages employee benefit plans to maintain an investment policy statement designed to promote the plan's purpose and its funding policy, as such activities are consistent with the fiduciary obligations set forth in §404 of ERISA.[25] Additionally, because the act of managing plan assets that are shares of corporate stock includes the voting of proxies appurtenant to those shares, the DOL considers a statement of proxy voting policy as an important part of any comprehensive statement of investment policy. In light of this, the proposed rule would require plan fiduciaries to periodically review proxy voting policies, and would prevent them from implementing such policies that would preclude a proxy vote from being submitted after a fiduciary determines that the matter being voted upon is expected to materially impact the value of the plan's investment portfolio.[26] Alternatively, the proposed rule would allow fiduciaries to refrain from voting when it is determined that the matter at issue is not expected to materially impact the plan's portfolio.

POOLED INVESTMENT VEHICLES AND INVESTMENT POLICY STATEMENTS

Where an investment manager for a pooled investment vehicle holding assets of more than one employee benefit plan is subject to conflicting investment policy statements of multiple plans, the proposed rule would require that the investment manager would reconcile the conflicting policies, assuming that compliance with each policy would be consistent with ERISA. The proposed rule also requires that the investment manager must vote (or abstain from voting) the relevant proxies to reflect the policies in a manner

[20] 86 Fed. Reg. 57,281.

[21] 86 Fed. Reg. 57,286.

[22] 86 Fed. Reg. 57,283.

[23] 86 Fed. Reg. 57,282.

[24] 86 Fed. Reg. 57,282.

[25] 86 Fed. Reg. 57,281. ERISA refers to the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406.

[26] 86 Fed. Reg. 57,282-57,283.

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that is proportionate to each plan's economic interest in the pooled investment vehicle.[27] Alternatively, the DOL suggests that the investment manager may choose to develop an investment policy statement and require participating plans to accept the investment manager's investment policy statement, including any proxy voting policy, before the plans are allowed to invest.[28] In these situations, fiduciaries must determine whether the investment manager's investment policy statement and proxy voting policy comply with ERISA before retaining the investment manager.

The proposed rule further clarifies that the responsibility for exercising shareholder rights lies exclusively with the plan trustee, except to the extent that either the trustee is a directed trustee, subject to the directions of a named fiduciary under ERISA; or the power to manage, acquire, or dispose of the relevant assets has been delegated to an investment manager pursuant to §403(a)(2) of ERISA.[29]

Plan sponsors and other stakeholders interested in submitting comments to the DOL on the proposed rule have until December 13, 2021, to do so.

The proposed rule captures the heightened awareness throughout the investment sector which acknowledges the importance of considering ESG factors to ensure healthy returns on investments. Once the DOL regulations are finalized, plan fiduciaries will have the long-awaited guidance needed to navigate these important considerations.

[27] 86 Fed. Reg. 57,283.

[28] 86 Fed. Reg. 57,283.

[29] 86 Fed. Reg. 57,283.

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