October 18, 2021

ESG and Proxy Voting: The DOL's About-Face on Trump-Era Regulations

Attorneys
Joshua A. Lichtenstein
Peter N. Rosenberg

On October 13, 2021, the U.S. Department of Labor (DOL) proposed amendments (the Proposal) to final rules released by the Trump Administration on investment selection and ESG considerations for ERISA-covered retirement plans (including 401(k) plans) and the exercise of shareholder rights, including voting proxies. The Proposal should help resolve some of the confusion and chilling effects caused by the Trump Administration's rule regarding integration of climate change and other environmental, social and governance (ESG) factors in investment decisions and responsible proxy voting by ERISA plan fiduciaries. The Proposal explicitly permits plan fiduciaries to consider climate change and other ESG factors that are material to a risk-return analysis in evaluating and selecting investments, and it addresses misconceptions about fiduciaries' responsibilities when it comes to conscientiously exercising shareholder rights to protect the interests of plan participants. As a result, the Proposal may dramatically increase the number of ERISA plans that invest in ESG-type funds or offer them to participants.

Below is an overview of the changes the Proposal would make to the DOL's existing investment duties regulation. The Proposal provides for a 60-day comment period, which will end on December 13, 2021.

Proposed Changes to the Existing Regulation

Investment Prudence Duties and ESG

Presumption to Consider Economic Effects of Climate Change/Other ESG Factors

The Proposal retains the existing prudence safe harbor for evaluating investments or investment courses of action, which requires the fiduciary to (i) give appropriate consideration to the role the investment or investment course of action plays in the plan's portfolio with respect to which the fiduciary has duties, and (ii) act accordingly. 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 to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain/return associated with the investment or investment course of action as compared to reasonably available alternatives, and

ii. 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 as those factors relate to such portion of the portfolio plan, **which 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** (bolded, underlined language is new to the Proposal).

One of the key changes in the Proposal is the explicit statement 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 ESG factors on the particular investment or investment course of action. The projected return factor directs fiduciaries to take a long-term approach to investment decision-making and portfolio construction, and the proposed addition suggests that climate change and other ESG factors may often be relevant to that analysis because the risk-return potential could be realized decades after the investment date. Moreover, as the DOL explains, the proposed language counteracts the negative perception of the use of climate change and other ESG factors in investment evaluation and selection caused by the Trump-era regulation, and it clarifies that a fiduciary's duty of prudence may often require an evaluation of the effect of climate change and/or government policy changes to address climate change on investments' risks and returns. In essence, the DOL is explicitly directing plan fiduciaries to consider that ESG issues could present material business risks or opportunities to companies, and is creating a new presumption that a prudent fiduciary should consider ESG issues when evaluating the risk and return profiles of investment opportunities.

<u>Examples of ESG Factors that Could Be Material to the Risk-Return Analysis</u>

The Proposal goes on to reaffirm that ERISA fiduciaries have broad discretion to 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. To illustrate the types of factors a fiduciary may consider, the Proposal describes how climate change-related factors, governance factors and workforce practices would all be appropriate as examples. In particular:

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 effect of Government regulations and policies to mitigate climate change;

ii. Governance factors, such as those involving board composition, executive compensation, and 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.

This new language clarifies and confirms explicitly that climate change and other ESG factors are no different than other "traditional" material risk-return factors, and that they should be regarded on an equal footing in the investment decision-making process. The examples, which are not exclusive, should help reassure fiduciaries that selecting funds that prominently incorporate ESG factors, which they have deemed to be economically advantageous for participants, would be consistent with the dictates of ERISA's duty of prudence.

Investment Loyalty Duties

<u>Elimination of "Pecuniary Factors" Definition; Integration of ESG Factors</u>

This section of the Proposal maintains the current regulation's restatement of the bedrock principle of ERISA that a fiduciary may not subordinate the interests of the participants and the beneficiaries in their retirement incomes or financial benefits under the plan to other objectives, and they may not sacrifice investment return or take on additional investment risk to promote goals or objectives unrelated to participants and beneficiaries' interests in their retirement income.

The Proposal streamlines the Trump Administration rule by eliminating the defined term "pecuniary factors", which, according to the DOL, has been described by stakeholders as being ambiguous in meaning and application. Instead, it states how 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 taking into account the funding policy of the plan established pursuant to ERISA. The weight given to any factor by a fiduciary should appropriately reflect a prudent assessment of its impact on risk-return. The Proposal integrates ESG in this section of the regulation by noting whether any particular consideration is such a factor depends on the individual facts and circumstances, and that determination may look at items like the ESG examples set forth above. While this change may not seem as impactful as the new concepts in the prudence rule, the DOL has made it clear in the preamble that this is intended to signal to fiduciaries that there are no constraints on considering ESG factors (or any other factors a fiduciary deems economically material) as long as those factors are only being considered based on their economic merits.

Tiebreaker Scenario

The Proposal also preserves the tiebreaker rule, but it makes certain modifications that would broaden the standard and better align it with the framework the DOL had adopted in sub-regulatory guidance over the years prior to the Trump-era rules. The Proposal says the tiebreaker analysis would be invoked 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, which is broader than the Trump Administration's requirement that competing investments must be indistinguishable based on consideration of risk and return to invoke the tiebreaker rule. The notion that two investments can equally serve the financial interests of a plan reflects a more holistic perspective, which acknowledges that while two investments may not be economically indistinguishable in terms of their risk-return attributes, they could still serve the overall financial interests of a plan equally well.

If this situation occurs, the Proposal says a fiduciary is not prohibited from selecting the investment, or investment course of action, based on collateral benefits. However, if the plan fiduciary makes such a selection in the case of a designated investment alternative, including a qualified default investment alternative (QDIA), for an individual account plan, 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. Furthermore, a fiduciary cannot accept expected reduced returns or greater risks by choosing to prioritize these collateral benefits instead.

The additional disclosure is meant to ensure that plan participants are given sufficient information to be aware of the collateral factor(s) the fiduciary utilized in choosing one investment option over another economically equivalent one. According to the DOL, fiduciaries can satisfy this obligation by modifying the required disclosures they provide under 29 CFR 2550.404a-5 to individual account plan participants regarding designated investment alternatives. This disclosure would be in lieu of the burdensome extra documentation requirements included in the Trump Administration's regulation, which obligated fiduciaries to disclose why pecuniary factors were not sufficient to select the investment or investment course of action; how the selected investment compares to the alternative investments with regard to composition, liquidity, and returns of the plan's portfolio; and how the chosen non-pecuniary factor or factors are consistent with the interests of participants and beneficiaries in their retirement income or financial benefits under the plan. According to the DOL, these documentation requirements are seen as another example of how the Trump-era regulations have chilled investments based on climate change or other ESG factors, notwithstanding the fact that such factors might have been directly relevant to the financial merits of the investment decision if the fiduciaries had appropriately applied the tiebreaker standard.

Removal of the Prohibition on Selecting ESG Funds or Products as a QDIA

In another key change, the Proposal also eliminates the prohibition on selecting an investment fund, product or model portfolio that includes the use of one or more non-pecuniary factors as (or as a component of) a QDIA. As the DOL explains, if a fund that expressly considers climate change or other ESG factors is financially prudent and meets the protective standards of the QDIA regulations (29 CFR § 2550.404c-5), there is no reason to foreclose plan fiduciaries from considering the fund as a QDIA.

Proxy Voting and Exercises of Shareholder Rights

The Proposal largely maintains the Trump Administration's rule on proxy voting and other shareholder rights, but it makes certain changes, as described below.

Removal of the Statement that There is No Requirement to Vote Every Proxy

The current regulation includes the statement 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 Proposal deletes this sentence out of concern that it could be misinterpreted as the DOL endorsing the idea that plan fiduciaries should be indifferent to exercising shareholder rights like voting proxies, even when doing so would incur minimal costs. The DOL reiterates its longstanding 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 determines voting proxies may not be in the plan's best interest (e.g., if there are significant costs or efforts associated with voting). Furthermore, 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. Therefore, rather than just abstaining, fiduciaries should be prudent in incurring expenses to make proxy decisions and to rely on efficient structures (e.g., proxy voting guidelines, proxy advisers/managers that act on behalf of large aggregates of investors, etc.), to the extent possible.

Removal of the Duty to Maintain Records on Proxy Voting Activities

The Proposal largely preserves the steps that fiduciaries must follow when deciding whether to exercise shareholder rights and when exercising them, including:

i. Acting solely in accordance with the economic interest of the plan and its participants and beneficiaries;

ii. Considering any costs involved;

iii. Not subordinating 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;

iv. Evaluating material facts that form the basis for any particular proxy vote or other exercise of shareholder rights; and

v. Exercising prudence and diligence in the selection and monitoring of persons, if any, selected to advise or otherwise 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.

However, the Proposal eliminates the obligation to maintain records on proxy voting activities and other exercises of shareholder rights. By including this duty, the DOL said proxy voting (and other exercises of shareholder rights) has been misconstrued as encompassing greater obligations, and thus greater liability, than other types of fiduciary activities, and as a result, it has the potential to chill fiduciaries from exercising their shareholder rights.

Removal of the Proxy Voting Policy Safe Harbors

Finally, the Proposal continues to embrace the role of proxy voting policies that have been prudently designed to serve the plan's interests and help reduce costs and compliance burden. However, it removes the two safe harbors that are in the current regulation, which include a policy of only voting on matters of deemed corporate significance and a policy of refraining from voting when the plan's holdings are minimal relative to its total investment holdings. The Proposal retains the requirement for managers of certain commingled funds to harmonize the proxy voting policies of each plan investor, so asset managers may need to adopt their own proxy voting policies to which plan sponsors can be required to consent, in lieu of needing to follow multiple polices for a single fund.

Implications

Although the DOL explains how it doesn't believe that its Proposal upends longstanding views of the agency's standards governing the selection of investments and investment courses of action or the exercise of shareholder rights, its broad endorsement of ESG factors as material risk-return considerations, in particular, signifies a sea change for the retirement and asset management industries. This Proposal may be the first time that the DOL has successfully signaled that ESG factors are meant to be viewed as on even footing with other financial factors. As a result, this Proposal may lead to an increase in the availability and utilization of ESG funds by ERISA plans, including default investment options like ESG-type target date funds. In addition, the quasi-mandate included in the Proposal may actually shift plan sponsors towards prominently featuring their consideration of ESG factors in their investment selection process. The Proposal should also make it easier for asset managers to comply with other regimes embraced in Europe (such as SFDR) and at the state level (when it comes to selecting investments for certain governmental plans). This should come as a welcome development to asset managers and retirement plan sponsors, despite the continued need for additional work by asset managers to comply with the proxy voting and shareholder rights aspect of the rule.