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Client Alert

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Department of Labor Wants to "Remove Barriers" to Consideration of ESG Factors in Investment and Proxy Voting Decisions

Series 2, 10 in 10: Series 1, Issue 6 Revisited

The U.S. Department of Labor ("DOL") recently announced a proposed rule that would reverse existing regulations promulgated less than a year ago restricting ERISA plan fiduciaries' ability to "consider climate change and other environmental, social and governance [ESG] factors when they select investments and exercise shareholder rights." According to the DOL, it's time to "remove [those] barriers."

This Client Alert is the second in a series about the Department of Labor's evolving guidance on the consideration of environmental, social, and governance ("ESG") factors by employee benefit plan fiduciaries. The first Client Alert, which addressed the Biden Administration's March 2021 announcement that the DOL would not enforce the ESG regulations promulgated near the end of the Trump Administration, is available here.

ERISA's "investment duties" regulation—29 C.F.R. § 2550.404a-1—provides guidance to ERISA plan fiduciaries about meeting their duties of prudence and loyalty when selecting plan investments and exercising shareholder rights. In November and December 2020, the DOL revised the regulation to allow fiduciaries to only consider "pecuniary" factors (except in very limited circumstances) when selecting and monitoring plan investments and voting proxies and exercising shareholder rights. These changes reversed more permissive Obama-era guidance that allowed ERISA plan fiduciaries to consider ESG factors in the exercise of their fiduciary duties. The Biden administration's proposed rule, published October 14, 2021, goes even further than the Obama-era guidance. It encourages consideration of ESG concerns through four significant

changes regarding the selection and monitoring of investments and by reviving previous guidance regarding the exercise of shareholder rights.

Selection and Monitoring of Investments

The most significant changes regarding the selection and monitoring of investments would make ESG considerations relevant again by:

- ***Eliminating the existing "pecuniary factors" requirement.*** Plan fiduciaries would no longer need to focus solely on "pecuniary factors" when evaluating investments to satisfy their duties of prudence and loyalty. While decisions would still be based on investments' financial risk and return, the proposed rule expressly acknowledges that issues of climate change and other ESG factors could bear directly on the financial risk and return of the investment (*i.e.*, ESG factors are economic in nature). Indeed, the proposed rule says that a prudent analysis may "often" require consideration of such non-financial factors.
- ***Acknowledging specific ESG factors as a material consideration in the risk-return analysis.*** When evaluating investments for an ERISA plan, a fiduciary "may consider any factor . . . material to the risk-return analysis," including (i) climate-change related factors, (ii) governance factors (such as board composition and compliance with applicable laws), and (iii) "[w]orkforce practices" (such as workforce diversity, workforce training, and labor relations).
- ***Relaxing the existing "tie-breaker" standard.*** The existing "tie-breaker" rule permits consideration of collateral benefits (*i.e.*, non-financial benefits) only when investment options are economically indistinguishable and the fiduciary has satisfied certain documentation requirements. Further, the DOL warned in the preamble of the current rule that the use of this tie-breaker test should be rare. The proposed rule, by contrast, would permit consideration of collateral benefits so long as the investments "equally serve the financial interests of the plan over the appropriate time horizon." The textual distinction may be subtle, and the tie-breaker rule survives, but the effect is to encourage more common application of tie-breaker analysis.
- ***Eliminating prohibition on ESG funds as QDIAs.*** Gone, too, would be the existing prohibition on qualified default investment alternatives ("QDIAs") that reflect "non-pecuniary" factors in their investment strategy. Fiduciaries could even select an ESG fund as a QDIA under the new "tie-breaker" standard, so long as its relevant collateral benefits are disclosed to participants.

Proxy Voting

In an exercise of addition by subtraction, the proposed rule would return proxy voting to the DOL's pre-2020 standards by removing four provisions addressing ERISA fiduciaries' exercise of shareholder rights. The most significant cut would be the relaxed duty to vote standard introduced in the 2020 regulations, which says 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 DOL wants to remove that language, pointedly saying it "could be misread as suggesting that plan fiduciaries should be indifferent to the exercise of their rights as shareholders."

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Takeaways

This is just a proposed rule, and the DOL's several specific requests for comments suggest that it understands that a fair amount of work remains to be done before the rule is finalized. The proposed rule goes further than any prior guidance, however, and if the core approach survives, the end result would be a regulation implementing the DOL's long-standing (*i.e.*, pre-2020) guidance on investment decision-making by ERISA plan fiduciaries. Moreover, the

proposed rule would supersede a regulation widely viewed as ESG-hostile. So, it would be fair to consider the new regulation as a permission slip to regularly consider ESG factors—both as economic factors and as collateral benefits—when making employee benefit plan investment decisions. That might be enough to make more plan fiduciaries open to considering ESG factors when making investment decisions.

The proposed changes to the proxy voting rules may cut the other way, revoking a permission slip for plan fiduciaries to choose which shareholder rights to exercise. While the DOL views the exercise of shareholder rights as just another part of a plan fiduciary's duties, there's little recognition that there are additional costs associated with making a cost-benefit analysis about whether to exercise every shareholder right. Some restrictions are lifted in the proposed rule, but the message is clear that fiduciaries have a duty to exercise shareholder rights unless the cost of doing so is prohibitive.

Comments on the proposed rule are due by December 13, 2021.