Updates
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DOL Proposes Expanded Use of ESG Factors in ERISA Plan Investment Decisions and Proxy Voting

The U.S. Department of Labor (DOL) published a proposed regulation on October 14, 2021, that would clarify how fiduciaries of private sector employee benefit plans should apply ERISA's fiduciary duties of prudence and loyalty when making investment decisions and exercising shareholder rights. In part, the DOL's changes to its "Investment Duties" regulation (29 C.F.R. § 2550.404a-1) would expand whether and how plan fiduciaries may consider environmental, social, and governance (ESG) factors when managing and selecting plan investments. The DOL has solicited public comments in a number of places in the proposed regulation, with comments due by December 13, 2021.

The proposed regulation follows closely on the heels of two sets of final regulations issued by the DOL late last year. The first, "Financial Factors in Selecting Plan Investments" (published November 13, 2020), adopted amendments to the Investment Duties regulation and generally required plan fiduciaries to select investments and investment courses of action based solely on consideration of "pecuniary factors." On December 16, 2020, the DOL published the second final regulation, "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights," which also adopted amendments to the Investment Duties regulation by expanding the obligations of plan fiduciaries when exercising shareholder rights, including proxy voting.

After he assumed office, President Biden signed executive orders setting policies to address climate change and to mitigate climate-related financial risk. Those included a directive in January 2021 requiring the DOL to consider proposed regulations to suspend, revise, or rescind the 2020 final regulations. Accordingly, in March 2021, the DOL confirmed that it had begun reexamining the 2020 final regulations and thus would not enforce them, pending publication of further guidance.

Providing Regulatory Support for Consideration of ESG Factors

The proposed regulation formalizes what the DOL considers a core principle under ERISA's fiduciary duties of prudence and loyalty that requires plan fiduciaries to give "appropriate consideration" to material risk-return factors without subordinating 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 plan benefits. Accordingly, when plan fiduciaries evaluate an investment or investment course of action, the proposed regulation specifies that the plan fiduciaries may consider any factor which, depending on the facts and circumstances, is material to the risk-return analysis, including "climate change-related factors." Examples given in the proposed regulation include "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."

The proposed regulation also would remove the special rule from the 2020 final regulations and earlier guidance that prohibits certain investment alternatives, including ESG funds, from being used as a qualified default investment alternative (QDIA) in individual account plans. Instead, as proposed, the same standards would apply to QDIAs as apply to other ERISA plan investments.

Clarifying the Tie-Breaker Test

The "tie-breaker" test allows plan fiduciaries to consider collateral benefits as tie-breakers among competing investments in some circumstances. The current standard imposes a requirement that the competing investments be economically indistinguishable before plan fiduciaries can turn to collateral factors, conditioned on special documentation requirements on the use of such factors. The proposed regulation, however, would replace those provisions with a standard that requires plan fiduciaries to conclude prudently that competing investments, or competing investment courses of action, equally serve the financial interests of the plan during the appropriate time horizon. In such cases, a plan fiduciary could make a selection decision based on economic or noneconomic benefits other than investment returns. The proposed change would also remove the special documentation requirements that, according to the DOL, have erroneously suggested to some plan fiduciaries that they should be wary of considering ESG factors in tie-breaker situations, even when those factors are financially material to the investment decision.

Clarifying the Exercise of Shareholder Rights

The proposed regulation would make three noteworthy changes to the Investment Duties regulation's requirements involving proxy voting and other exercises of shareholder rights, as follows:

1. **Eliminate the current 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."** What would continue to apply, according to the DOL, is its long-standing view under ERISA that proxies should be voted as part of the process of managing the plan's investment unless a plan fiduciary determines that voting may not be in the plan's best interest. That determination would require plan fiduciaries to consider several criteria. First, plan fiduciaries would need to evaluate the economic interests of the plan and its participants and beneficiaries against the costs involved in exercising the proxy. They would also need to evaluate material facts and to demonstrate prudence and diligence in selecting and monitoring those advising or assisting with exercises of shareholder rights. Overarching all of this, the evaluation process and decision cannot subordinate the financial interests of participants and beneficiaries in their retirement income or the plan's financial benefits to any other objective and cannot promote benefits or goals unrelated to those financial interests.
2. **Remove the two "safe harbor" examples for proxy voting policies.** In place of those examples, the proposed regulation would revert to general principles. Accordingly, when deciding whether to vote a proxy, plan fiduciaries would be permitted to adopt proxy voting policies that set specific parameters designed to serve the plan's interest in providing benefits and defraying reasonable plan administration expenses. The proposed regulation also includes other guidance for proxy voting policies and for allocating responsibilities among trustees, other named fiduciaries, and certain types of investment managers when exercising shareholder rights.
3. **Eliminate the Investment Duties regulation's records requirement.** Currently, when deciding whether to exercise shareholder rights and when exercising shareholder rights, plan fiduciaries must maintain records on proxy voting activities and other exercises of shareholder rights. Given the elimination of that requirement, DOL commentary directs plan fiduciaries to the generally applicable statutory duties of prudence and loyalty under ERISA for the governing record keeping standards in these areas.

The proposed regulation, by its terms, does not apply to voting, tender, and similar rights with respect to stock that, under an individual account plan, are passed through to participants and beneficiaries, such as company stock accounts in 401(k) plans. The DOL also expresses its intent in commentary that nothing in the proposed regulation "upends" the DOL's longstanding views on the standards governing the selection of investments and investment courses of action or the exercise of shareholder rights, but merely addresses new policies.

Takeaways

The proposed changes to the Investment Duties regulation represent an important chapter in the evolution of the DOL's ERISA plan investment and proxy voting guidance. There is little doubt that the proposed regulation, if finalized in its current form, would remove actual and perceived barriers to how ESG factors can be evaluated by ERISA plan fiduciaries charged with making investment decisions. The proxy voting changes would substantially retain the DOL's principles concerning a plan fiduciary's exercise of shareholder rights while addressing provisions the DOL found to be chilling proxy voting activity by ERISA plans. Interested parties are reminded of the opportunity to comment by December 13, 2021.

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