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DOL Proposes Rule Encouraging ESG & Proxy Voting, Reducing Documentation Requirements

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October 14, 2021, the Department of Labor (the "DOL") published a proposed regulation, "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights" (86 Fed. Reg. 57272, the "Proposed Rule"). The proposal would amend the DOL's investment duties regulation in 29 CFR 2550.404a-1 under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). Comments to the Proposed Rule are due on **Monday, December 13, 2021.**

The proposal follows the DOL's announcement on March 10, 2021 that it was re-examining the regulations published by the prior administration on November 13, 2020 ("Financial Factors in Selecting Plan Investments") (the "2020 ESG Rule") and on December 16, 2020 ("Fiduciary Duties Regarding Proxy Voting and Shareholder Rights") (the "2020 Proxy Rule"). In the same March 10, 2021 announcement, the DOL stated that it would not enforce the 2020 Rules.

An Executive Order issued early in the Biden administration directed agencies to review regulations that could be inconsistent with the policies of the administration related to climate change and environmental, social, and governance ("ESG") factors. According to the preamble to the Proposed Rule, the DOL met with stakeholders who reported that aspects of the 2020 ESG Rule created a chilling effect on the appropriate integration of ESG factors in investment decisions and on the exercise of shareholder rights such as proxy voting. The DOL expressed concerns that "uncertainty with respect to the current regulation may deter fiduciaries from taking steps that other marketplace investors would take in enhancing investment value and performance, or improving investment portfolio resilience against the potential financial risks and impacts often associated with climate change and

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other ESG factors." The DOL also stated that stakeholders reported that the proxy voting provisions in the 2020 Proxy Rule would "chill plan fiduciaries from playing a proper role in exercising their ownership rights as shareholders and ensuring that corporate management is properly accountable to shareholders."

The Proposed Rule would largely retain the basic framework of the investment duties regulation while reinstating guidance similar to the sub-regulatory framework that existed immediately before the 2020 Rules. For example, the Proposed Rule retains two longstanding principles. First, the duties of prudence and loyalty require ERISA plan fiduciaries to focus on material risk-return factors and not subordinate the interests of participants and beneficiaries to objectives unrelated to the provision of benefits under the plan. Second, the fiduciary act of managing plan assets includes making decisions about voting proxies and exercising shareholder rights. While the framework is the same, the Proposed Rule would include changes that seem likely to result in greater leeway for fiduciaries to include ESG investments in plans.

The Proposed Rule is discussed in more detail below.

I. Background – ESG Current Regulation and Prior Guidance

ERISA requires that fiduciaries act prudently, solely in the interest of the plan participants and beneficiaries and for the exclusive purpose of providing benefits and paying reasonable administrative expenses. Over the past 40 years, DOL has periodically issued guidance addressing the extent to which these duties under ERISA allow for socially responsible and/or ESG-based investment decisions. While the emphasis of prior guidance has shifted depending on the policy priorities of the administration in power at the time, DOL has been consistent in its position that a fiduciary cannot inappropriately sacrifice returns or take on additional risk when making investment decisions for ERISA plans and that the economic risks and returns of an investment must be the plan fiduciary's primary consideration. The 2020 ESG Rule was the first time DOL addressed ESG in regulations, rather than in sub-regulatory guidance.

II. Proposed Rule – ESG

The Proposed Rule would amend the "investment duties" regulation (29 CFR § 2550.404a-1) to include three particularly important items related to ESG investing.

A. Language to Clarify That ESG Factors May Be a Permissible Consideration

The Proposed Rule adds language to expressly state that, when considering projected returns on an investment, a fiduciary's duty of prudence "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." DOL explains, in the preamble to the Proposed Rule, that the additional language is "intended to counteract negative perception of the use of climate change and other ESG factors in the investment decisions caused by the 2020 Rules, and to clarify that a fiduciary's duty of

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prudence may often require an evaluation of the effect of climate change and/or governance policy changes to address climate change on investments' risks and returns."

The proposed change includes three examples that, depending on the facts and circumstances, may be material to a fiduciary's prudent risk-return analysis. These examples are:

- 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.
- 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.
- Workplace 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 skill; equal employment opportunity; and labor relations.

If finalized as proposed, these examples of collateral benefits could lead to greater consideration of these and other emerging factors by plan fiduciaries.

B. Qualified Default Investment Alternative ("QDIA") Permitted to Consider ESG

The Proposed Rule would apply the same fiduciary standards to the selection and monitoring of a QDIA as applied to other designated investment alternatives, including permitting consideration of ESG factors. This approach provides fiduciaries additional leeway by removing the restrictions included in the 2020 ESG Rule and 2018 sub-regulatory guidance that prohibit plans from utilizing as a QDIA a fund, product or model portfolio if its objectives or goals or its principal investment strategies include, consider, or indicate the use of one or more non-financial factors. As participants often allocate (by default or affirmative selection) substantial amounts to default investment alternatives, removing the prohibition on ESG in a plan's QDIA is significant.

C. The Tie-Breaker Test

Much of the DOL's guidance on ESG has focused on whether, when choosing among prudent investments, a fiduciary is permitted to select an alternative based on "collateral benefits" associated with that investment. The Proposed Rule reaffirms the DOL's long-standing "tie-breaker" position that fiduciaries are permitted to consider non-economic, collateral benefits when choosing among otherwise prudent investments. The DOL explains in the preamble that the change is necessary because the 2020 ESG Rule's "indistinguishable" standard could be interpreted too narrowly and appears to be chilling the consideration of ESG factors by fiduciaries making investment decisions.

Under the Proposed Rule, investments do not have to be "indistinguishable" to permit consideration of collateral objectives that favor one investment over the other. The preamble to the Proposed Rule

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explains that "two investments may differ on a wide range of attributes, yet when considered in their totality, can serve the financial interest of the plan equally well. These investments are not indistinguishable, but they are equally appropriate additions to the plan's portfolio." The preamble goes on to note that a tie-breaker trigger could also occur under the Proposed Rule's standard when a fiduciary prudently chooses an investment as a hedge against a particular portfolio risk "even though the investment, when considered in isolation from the portfolio as a whole, is riskier or less likely to generate a significant positive return than other investments that do not serve the same hedging function." In each case, the fiduciary choosing between competing investments or investment courses of action could consider collateral benefits to break the tie.

The Proposed Rule notes that it "does not place parameters on the collateral benefits that may be considered by a fiduciary to break a tie." Instead, it notes that such considerations, like any fiduciary decision, are dependent on the facts and circumstances of each particular situation. As noted above, DOL does, however, give non-exclusive examples of factors a fiduciary may consider as tie-breakers, including factors related to climate-change, governance, and workforce practices. Some of the factors DOL specifically cites include compliance with labor, employment, environmental, tax and other applicable laws and regulations, as well as diversity, inclusion, investment in training, equal employment opportunities, and labor relations. Significantly, the Proposed Rule also removes the heightened documentation requirements for a tie-breaker set forth in the 2020 ESG Rule. The approach in the Proposed Rule appears designed to give plan fiduciaries significant leeway to determine what factors are material when selecting investments.

The Proposed Rule would also permit a broader consideration of collateral benefits in choosing investment options, including the QDIA, for individual account plans. However, in situations where consideration of collateral benefits forms the basis for an investment choice, the fiduciary must disclose the specific collateral benefits it considered. It is unclear from the Proposed Rule whether those specific collateral benefits must be identified as a tie-breaker in this disclosure. Plan fiduciaries may comment to the DOL that the dividing line between core and collateral factors is not always as clear or as easy to identify as the Proposed Rule seems to contemplate, thereby making it difficult for fiduciaries to know which factors should be disclosed.

D. Other Changes

One change to the regulation likely to be welcomed by practitioners, fiduciaries, and investment analysts is the return to familiar investment concepts using terminology such as "financial interests" and "collateral benefits." The term "pecuniary" and its definition have been eliminated altogether.

E. Implications for Global Governance

The DOL's statement that pension plans may often require an evaluation of the economic effects of climate change and other ESG factors on particular investments or investment courses of action would more closely align with the evolution of consideration of ESG factors for pensions in the United Kingdom ("UK"), European Union ("EU") and other jurisdictions. In the UK, for example, required

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Statements of Investment Principles (“SIPs”) by pension plans have already been required in recent years to address financially material considerations including ESG and climate change, including a requirement that SIPs address how their asset managers’ incentives are aligned with their ESG and climate policies. UK plans are also required to provide Implementation Statements setting forth how they have acted on their SIPs, to be published online. The EU, under its Institution for Occupational Retirement Provision Directive II (“IORP II”), has similarly required that member states adopt requirements under which a pension plan should have investment policy and risk management systems to ensure that the plans invest prudently in the best long-term interest of members and beneficiaries including by taking into account the potential long-term impact of investment decisions on ESG.

The European Insurance and Occupational Pensions Authority (“EIOPA”), as another example, has opined that regulatory authorities “should use a range of supervisory techniques to assess IORP’s [i.e., a plan’s] management of ESG risks, like reviewing the ESG risk management documents and reports and challenging the IORP on its ESG risk management policy during conversation with its management”, and, further, “should encourage IORPs to publicly disclose a description of their management of ESG risks, in a transparent and comprehensible manner that allows members and beneficiaries, sponsors, other stakeholders and the public to assess the approach taken.”

As in the U.S., however, other stakeholders have expressed some concerns. PensionsEurope, for example, has stated in response to the EIOPA opinion that “the primary duty of an IORP remains to ensure good pension outcomes for their members. Any societal objectives can be adopted voluntarily, but should not be forced upon pension funds by supervisors.”

For multinational companies that will be approaching ESG from a global investment perspective, it may be worth considering how applying this new DOL guidance to U.S. plans, if finalized, will fit with ESG approaches and disclosures for its non-U.S. pension plans.

III. Background – Proxy Voting

The DOL has a long history of opining on fiduciaries’ duties concerning proxy voting. The DOL has been consistent in its view that proxy voting is a fiduciary obligation. However, as with ESG considerations, the DOL’s more granular positions have shifted over time based on the particular administration’s policy goals.

On December 16, 2020, the DOL finalized the 2020 Proxy Rule. This was the first regulatory guidance on the subject issued by the DOL. Prior to 2020, all DOL guidance on fiduciary duties with respect to proxy voting was addressed in sub-regulatory guidance. The 2020 Proxy Rule was first effective January 15, 2021 with a delayed applicability date of January 31, 2022 for certain provisions. Before the regulation was fully applicable, on March 10, 2021 the DOL announced that it was re-examining the rule and would not enforce the rule. On October 13, 2021, after engaging with a wide variety of stakeholders, the DOL announced the Proposed Rule.

IV. Proposed Rule – Proxy Voting

A. Proposed Changes

The Proposed Rule would amend the "investment duties" regulation (29 CFR § 2550.404a-1) and includes four major revisions related to the exercise of shareholder rights, such as proxy voting. In general, these revisions are consistent with DOL's pre-2020 proxy voting guidance.

i. Elimination of "No Vote" Statement in 2020 Proxy Rule

The DOL reiterated its longstanding view that proxies should be voted as part of the process of managing a plan's investments, unless a plan fiduciary determines that voting proxies may not be in the plan's best interest, such as when voting involves significant cost or effort. In order to avoid confusion or misunderstanding by plan fiduciaries that they should be indifferent to exercising shareholder rights, the Proposed Rule would eliminate the statement in the 2020 Proxy Rule 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." Interestingly, perhaps in order to avoid overemphasis on proxy voting, the DOL cautioned in the preamble that "the proposed removal of the statement, however, does not mean that fiduciaries must always vote proxies or engage in shareholder activism."

ii. Elimination of Specific Monitoring Obligations

The Proposed Rule eliminates the provision in the 2020 Proxy Rule that sets out specific monitoring obligations when the authority to vote proxies has been delegated to an investment manager or a proxy voting firm. The preamble to the Proposed Rule explains that the general prudence and loyalty duties under ERISA already impose a monitoring requirement. Furthermore, the preamble expresses the DOL's concern that by expressing specific monitoring obligations, the 2020 Proxy Rule may create an impression that there are special obligations above and beyond the statutory obligations of prudence and loyalty that generally apply to monitoring the work of service providers.

iii. Removal of "Safe Harbors"

The proposal would remove the two "safe harbor" examples for permissible proxy voting policies in the 2020 Proxy Rule. One of the safe harbors permits a proxy voting policy to limit voting resources to particular types of proposals that a fiduciary has prudently determined are substantially related to the issuer's business activities or are expected to have a material effect on the value of the investment. The other safe harbor permits a proxy voting policy of refraining from voting on proposals or particular types of proposals when the plan's holding in a single issuer relative to the plan's total investment assets is below a quantitative threshold. The DOL stated that, as a result of its outreach to stakeholders, it is not confident that the safe harbors adequately safeguard the interests of plans and their participants and beneficiaries. The DOL specifically solicits comments on the safe harbors. The DOL also expressed concern that the

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combination of the “no vote” statement and the two safe harbors in the 2020 Proxy Rule may be read as regulatory permission to broadly abstain from proxy voting without legal repercussions.

iv. Elimination of Records of Proxy Voting Activities

The Proposed Rule would also eliminate requirements in the 2020 Proxy Rule compelling plan fiduciaries to maintain certain types of records on proxy voting activities and other exercises of shareholder rights. The preamble to the Proposed Rule explains that the DOL doesn’t think it is appropriate to treat proxy voting and other exercises of shareholder rights differently from other fiduciary activities. The preamble further explains that the documentation requirement “may create a misperception that proxy voting and other exercises of shareholder rights are disfavored or carry greater fiduciary obligations, and therefore greater potential liability, than other fiduciary activities.” The DOL further states in the preamble that the general framework for ERISA is sufficient to govern the recordkeeping requirements for proxy voting.

Interestingly, concurrent with the DOL’s actions, the Securities and Exchange Commission is proposing a revamp of its Form N-PX that is intended to make it easier to track a specific mutual fund’s or investment manager’s proxy voting record including in relation to specific ESG categories such as climate change, environmental justice, human capital, and diversity. The newly machine readable forms, if implemented, might assist plan fiduciaries in reviewing, comparing, and monitoring the ESG activities of mutual funds or managers that are on or are being considered for plan line-ups. Importantly, the SEC proposal would also apply to any pension plan managed internally by the plan sponsor if the internal manager is required to file a Form 13F under the Securities Exchange Act of 1934.

B. What Remains

After the proposed eliminations, what remains are the core principles that are central to DOL’s historical guidance. When deciding whether to exercise shareholder rights and when exercising such rights, including the voting of proxies, fiduciaries must carry out their duties prudently, solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan. The proposal also retains the specific standards that a fiduciary must meet when deciding whether to exercise shareholder rights and when exercising shareholder rights. The DOL invited comments on each of these provisions, including whether the provisions are necessary and whether they may be read as creating special duties and requirements beyond what ERISA requires.

Core principles expressed in the Proposed Rule include the following:

- A fiduciary must act solely in accordance with the economic interest of the plan and its participants and beneficiaries and consider any costs involved in exercising shareholder rights.

- A fiduciary must not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to benefits or goals unrelated to those financial interests of the plan's participants and beneficiaries.
- A fiduciary must evaluate material facts that form the basis for any particular proxy vote or other exercise of shareholder rights.
- A fiduciary must exercise prudence and diligence in the selection and monitoring of persons chosen to exercise or assist with the exercise of shareholder rights.
- In deciding whether to vote a proxy, fiduciaries may adopt proxy voting policies and should periodically review such policies.
- A fiduciary should not follow its proxy voting policy if prudence dictates otherwise.

V. Conclusion and Outlook

The Proposed Rule represents an important evolution in the DOL's guidance on ESG investing and on proxy voting. Proposed changes to the ESG regulations are likely to be seen as helpful in removing perceived obstacles to ESG investing. In addition, the Proposed Rule appears to offer substantial additional leeway to fiduciaries in documenting decisions that are consistent with ERISA's duties of prudence and loyalty and also accomplish collateral objectives.

Proposed changes to the proxy voting regulation would remove provisions that are reported to chill proxy voting activity by ERISA plans while retaining the core principles previously promulgated by the DOL in both sub-regulatory guidance and in the 2020 Rules.

The DOL has requested comments on "all facets" of the Proposed Rule as well as several specific issue areas. Interested stakeholders should consider submitting comments by the Monday, December 13, 2021 deadline.

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