DOL SETS NEW TONE ON ESG INVESTING AND PROXY VOTING WITH RECENTLY PROPOSED RULE

Date: 11 November 2021

ERISA and Asset Management and Investment Funds Alert

By: Ruth E. Delaney, Robert L. Sichel, Kristina M. Zanotti

On 13 October 2021, the Department of Labor (DOL) proposed amendments (the Proposed Rule)[1] to its investment duties regulation[2] under the Employee Retirement Income Security Act of 1974, as amended (ERISA), to clarify that prudent ERISA fiduciaries may consider (and may often be required to consider) climate change and other environmental, social or governance (ESG) factors when assessing investment risks and returns. The Proposed Rule would replace final regulations implemented by the DOL in 2020 under the Trump administration (the Existing Rule).[3] The Proposed Rule reflects a significant change in tone from the Existing Rule, with a stated intent of the Proposed Rule being to combat the Existing Rule's perceived "chilling effect" on appropriate integration of climate change and other ESG factors in investment and proxy voting decisions.

THE PROPOSED RULE RETAINS CORE ERISA PRINCIPLES; PROVIDES EXAMPLES OF RELEVANT ESG FACTORS

The Proposed Rule retains the longstanding principles under ERISA that, in connection with an evaluation of plan investments, a fiduciary's duties of prudence and loyalty require the fiduciary to take into account factors that are material to an investment's risks and returns, and not to subordinate the interests of plan participants and beneficiaries to other objectives, or to sacrifice investment return or take on additional investment risk to promote goals unrelated to the plan and its participants and beneficiaries.

- *Duty of Prudence*. The Proposed Rule clarifies that, when considering projected investment returns, a fiduciary's duty of prudence may often require an evaluation of the effect of material ESG factors, including the effect of climate change, on investments' risks and returns. Further, in order to address uncertainty under the Existing Rule as to whether a fiduciary is permitted to consider ESG factors in making plan-related decisions under ERISA, new language would be added by the Proposed Rule to confirm that fiduciaries may consider any factors that are material to the risk-return analysis, including climate change and other ESG factors. The stated purpose of this new language is to clarify that ESG factors are no different than other "traditional" material risk-return factors and to remove any prejudice against considering ESG factors that might have resulted from the Existing Rule.

  In addition, to further remove any doubt surrounding appropriate consideration of these factors and to provide additional clarification, the Proposed Rule lists a number of specific (but not exclusive) examples of factors that a fiduciary may consider in evaluating an investment or investment course of action if material, including (i) climate change-related factors, (ii) governance factors, and (iii) workforce practices.

Examples of factors that may be material to a risk-return analysis		
Climate Change Related A corporation's 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 Related** 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 law and regulations	**Workforce Related** A 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

- *Duty of Loyalty.* The Proposed Rule also makes clear that consideration of an economically material ESG factor, including climate-related financial risk, is consistent with ERISA's duty of loyalty; however, consistent with longstanding DOL guidance, the Proposed Rule reiterates that ERISA fiduciaries may not sacrifice investment returns or assume greater investment risks as a means of promoting collateral social policy goals.

The Proposed Rule retains ERISA's core principle that the duties of prudence and loyalty require ERISA plan fiduciaries to focus on material risk-return factors and not to subordinate the interests of plan participants and beneficiaries (such as by sacrificing investment returns or taking on additional investment risk) to objectives unrelated to the provision of benefits under the plan.

- *Modification to "Tie-Breaker" Standard.* The Proposed Rule modifies the "tie-breaker" standard under the Existing Rule, which requires competing investments be "economically indistinguishable" before fiduciaries could turn to collateral factors as tie-breakers. Some believe that this strict standard—which also-imposes a special documentation requirement when using such factors to make an investment decision—renders the tie-breaker approach unusable. Under the Proposed Rule, this standard is replaced with a standard that requires a fiduciary to prudently conclude that competing investments or investment courses of action "equally serve the financial interests of the plan" over the appropriate time horizon—a standard that is potentially more usable—when selecting an investment based on economic or non-economic benefits other than investment returns.[4] The Proposed Rule also removes the special documentation requirements of the Existing Rule, but includes a requirement in the case of a designated investment alternative for an individual account plan, e.g., 401(k) plan, including a QDIA (as discussed below), that the collateral benefit characteristic that was considered must be prominently displayed in disclosure materials provided to participants and beneficiaries. Notably, if an ESG factor is economically material to the risk-return analysis of an investment, it should not be considered a "collateral" factor subject to the tie-breaker standard. Instead it should be considered along with "traditional" risk-return factors as discussed above.

CHANGES TO SPECIAL RULES FOR QDIAS

The Proposed Rule removes special rules for Qualified Default Investment Alternatives (QDIAs) that apply under the Existing Rule. As a result, the same standards would apply to QDIAs that apply to other investments, meaning, the same prudence and loyalty duties that apply generally to evaluating investments under ERISA would also apply to a fiduciary's evaluation and selection of designated investment alternatives from which participants select where to direct their retirement assets.

PRACTICAL IMPLICATIONS

Product Manufacturers

While some investment products, such as mutual funds and exchange-traded funds registered under the Investment Company Act of 1940, are not directly subject to ERISA, all product manufacturers should consider the general principles described in the Proposed Rule if the investment product will be marketed to ERISA investors. For example, if a fund discloses that the fund's investment performance may be adversely impacted because of the portfolio manager's consideration of ESG factors (i.e., economic returns may be sacrificed to promote collateral goals), an ERISA fiduciary such as a consultant or a plan's retirement plan investment committee may not be able to recommend or offer the investment product to plan participants or cause an ERISA plan to invest in the investment product. Conversely, if a fund's disclosure demonstrates how taking an ESG factor into account contributes to the financial returns of the investment, an ERISA fiduciary may more readily be able to invest in or offer the product. Accordingly, product manufacturers should (a) review how ESG factors are integrated into the investment process and the impact of such factors on the risk/return analysis, (b) review disclosures for any statements that might be inconsistent with the principles described in the Proposed Rule and consider whether ESG factors are actually implemented for collateral reasons (i.e., non-risk/return reasons), (c) consider whether they have the necessary tools and expertise to meet the ERISA standards, and (d) prepare to receive enhanced scrutiny regarding these matters from consultants and plan sponsors.

Investment Advisers

Investment advisers often provide advice or discretionary management services to a client's taxable and retirement accounts. Retirement accounts may include IRAs[5] or a tax-qualified retirement plan account, e.g., 401(k) plan account. In some cases, investment advisers provide advisory or discretionary services to a retirement plan, rather than to a participant in the retirement plan. For example, some advisers assist plan sponsors with selecting and monitoring a 401(k) plan's investment lineup. When an adviser provides services to an ERISA client, the adviser should consider the matters listed below under "Consultants." When an adviser provides services to an IRA, even though the IRA is generally not subject to ERISA, the adviser may want to also consider the matters listed below under "Consultants."

Consultants

Many plan sponsors rely on advice from consultants regarding investment matters, such as investment manager selection and monitoring, and plan sponsors are increasingly delegating discretionary authority to consultants to hire and terminate investment managers. In both models, the consultant should be familiar with the fiduciary standards described in the Proposed Rule when advising clients on, or selecting, investment managers and investment products that integrate ESG factors into the investment process. The Proposed Rule indicates that evaluation of an investment's risks and returns may often require consideration of the economic effects of climate change and other ESG factors. Consultants should (a) review their process for evaluating all investment managers to determine whether additional consideration of ESG factors should be included in their process (e.g., should changes be made to due diligence questionnaires); (b) consider their process for evaluating investment managers that explicitly consider ESG factors, including follow-up to determine whether the managers incorporate ESG factors into their investment process for risk/return reasons rather than as a collateral matter; (c) consider whether they have the necessary tools and expertise to evaluate investment managers; (d) review investment manager disclosures to ensure consistency with ERISA, including for individual account plans whether disclosures include any collateral ESG considerations; and (e) prepare to receive enhanced scrutiny regarding these matters from plan sponsors in RFPs and RFIs.

Plan Sponsors

Plan sponsors or retirement plan investment committees appointed by plan sponsors may have fiduciary responsibility over plan investments. If the plan sponsor works with a consultant, the plan sponsor will have co-fiduciary responsibility over the plan's investments or fiduciary responsibility to oversee the consultant. In light of the statements in the Proposed Rule that evaluation of an investment's risks and returns may often require consideration of the economic effects of ESG factors, the plan sponsor may need to consider ESG factors in connection with every defined benefit plan investment or every investment available in a participant-directed defined contribution plan investment lineup. If a plan sponsor works with a consultant, the plan sponsor also may need to perform due diligence to confirm the consultant's process properly addresses these matters (See “Consultants” above). Plan sponsors should (a) review their process for evaluating investments or hiring investment managers, particularly investments or investment managers that explicitly take ESG factors into account; (b) evaluate whether their consultants have sufficient expertise regarding ESG matters; (c) consider whether changes should be made to RFPs and RFIs used in connection with hiring consultants; and (d) consider whether they have the necessary tools and expertise to evaluate ESG matters and, if not, whether they should hire an adviser that has such expertise.

PROXY VOTING

The Proposed Rule also clarifies the application of ERISA fiduciary duties to the exercise of proxy voting and other shareholder rights. Similar to the issues discussed above, the Proposed Rule is intended, in part, to combat the chilling effect the Existing Rule has had on the consideration of material ESG factors in these processes. The Proposed Rule is also intended to emphasize the importance of a fiduciary taking shareholder rights seriously, and to instruct fiduciaries on how to conscientiously exercise those rights to protect the interests of plan participants, while making it clear that a fiduciary is not always required to vote proxies or engage in shareholder activism if such actions would not be in the plan's best interests (e.g., if there are significant costs or efforts associated with voting).

The Proposed Rule would continue to codify the principles from the Existing Rule and prior DOL guidance that the fiduciary duty to manage plan assets that are shares of stock includes the fiduciary duty to manage shareholder rights appurtenant to those assets, such as the right to vote proxies. When deciding whether to exercise, and when exercising these duties, a fiduciary must comply with ERISA's core duties of prudence and loyalty and may not subordinate the interests of plan participants and beneficiaries in receiving financial benefits to any other objective. Consequently, an ERISA fiduciary may not exercise shareholder rights in a manner that promotes benefits or goals unrelated to the financial interests of plan participants. A fiduciary must also consider any costs involved and evaluate material facts when exercising these rights.

A fiduciary must also exercise prudence and diligence when selecting and monitoring persons selected to exercise shareholder rights, such as proxy advisory firms and investment managers. A fiduciary cannot blindly follow the recommendations of a proxy advisory firm or other service provider without determining that such firm or service provider's proxy voting guidelines are consistent with ERISA and the obligations described in the Proposed Rule.

Under the Proposed Rule, plan fiduciaries may adopt, subject to periodic review, proxy voting policies providing that the authority to vote a proxy shall be exercised pursuant to specific parameters prudently designed to service the plan's interest. However, unlike in the Existing Rule, the Proposed Rule does not set up any specific type of policy as a safe harbor.

As in the Existing Rule, where authority to manage assets is delegated to an investment manager, the investment manager has the responsibility to vote proxies or exercise other shareholder rights, except to the extent those rights have been expressly reserved. The Proposed Rule would also continue the requirement for managers of pooled funds holding plan assets (which does not, for the avoidance of doubt, include funds registered under the Investment Company Act of 1940, such as mutual funds or exchange-traded funds) to reconcile conflicting proxy voting policies or require investors to accept the investment manager's policies (e.g., requiring plan investors to represent in a fund's subscription documents that a manager's adherence to its own proxy voting policies will not violate the plan's proxy voting policies). If the latter, the fiduciary of a plan investing in such a pooled fund would need to assess such policies before adopting them and investing in the fund.

The Proposed Rule would eliminate the special recordkeeping requirement for deciding whether and when to exercise shareholder rights, in order to avoid a misperception that proxy voting and the exercise of other shareholder rights are disfavored or carry greater fiduciary obligations. This change would not mean that fiduciaries should not keep such records, just that these activities should not be treated differently from other fiduciary activities.

COMMENT PERIOD

The DOL has requested comments on the Proposed Rule, which must be submitted on or before 13 December 2021.

FOOTNOTES

[1] 86 FR 57272

[2] 29 C.F.R. § 2550.404a-1. The "Investment Duties" regulation addresses the duties of prudence and loyalty in connection with selecting plan investments and the exercise of shareholder rights, including proxy voting.

[3] 85 FR 72846 and 85 FR 81658. On 10 March 2021, the DOL issued an enforcement policy statement stating that it would not enforce the Existing Rule or otherwise pursue enforcement actions against any plan fiduciary based on a failure to comply with the Existing Rule.

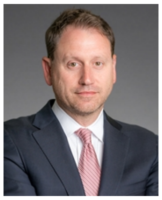
[4] The DOL specifically solicited comments on this approach.

[5] IRAs are "individual retirement accounts" as defined in Section 408(a) of the Internal Revenue Code of 1986, as amended (Code). While IRAs and service providers to IRAs are not subject to ERISA's exclusive benefit rule, Section 408 of the Code provides that an IRA must be created or organized "for the exclusive benefit" of the IRA owner.

KEY CONTACTS

RUTH E. DELANEY
PARTNER

LOS ANGELES
+1.310.552.5068
RUTH.DELANEY@KLGATES.COM



ROBERT L. SICHEL
PARTNER

NEW YORK
+1.212.536.3913
ROB.SICHEL@KLGATES.COM

