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U.S. Department of Labor Proposes ESG-Related Updates to the ERISA Investment Duties Regulation

Proposal Would Permit ERISA Pension Plan Fiduciaries to Consider Climate Change and Other ESG Factors When Selecting Investments and Exercising Shareholder Rights

SUMMARY

On October 13, 2021, the U.S. Department of Labor ("DOL") announced a proposed rulemaking to amend the Investment Duties regulation under Title I of the Employee Retirement Income Security Act of 1974 ("ERISA") that would clarify the application of ERISA's plan fiduciary duties of prudence and loyalty to selecting investments and investment courses of action, including selecting qualified default investment alternatives ("QDIAs"), and to exercising shareholder rights, including proxy voting.[1] While the proposal retains the core principle that the duties of prudence and loyalty require ERISA fiduciaries to focus on material risk-return factors, the proposal is intended to remove barriers implemented by the prior administration that the DOL believes limited fiduciaries' ability to consider climate change and other ESG matters as factors when selecting investments and exercising shareholder rights. Title I governs private pension plans.

As described in greater detail below, significant points from the proposed rule include changes to:

- Clarify the permissibility of consideration of climate change and other ESG factors, including governance and workforce factors, on particular investments or investment courses of action;
- Apply the same investment standards to QDIAs, such that otherwise qualified QDIAs may include consideration of ESG factors;
- Improve and clarify application of the "tie-breaker" test, which permits fiduciaries to consider collateral benefits as tie-breakers in some circumstances;[2] and

- Increase the likelihood of fiduciaries exercising voting and other shareholder rights while reducing associated administrative burdens.

The proposal has been anticipated since President Biden took office and follows a range of measures in the E.U. (the Sustainable Finance Disclosure Regulation, among others), the U.K. (the Occupational Pension Schemes (Climate Change Governance and Reporting) Regulations 2021, among others) and elsewhere aimed at enhancing (or mandating) pension plan consideration of climate change and other ESG factors.

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

BACKGROUND

Title I of ERISA requires U.S. private pension plan fiduciaries to act prudently and generally diversify plan investments so as to minimize the risk of large losses.[3] In addition, Title I requires fiduciaries to act solely in the interest of plan participants and beneficiaries and for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan. The DOL has recognized in various non-regulatory guidance that ERISA fiduciaries may make investment decisions that consider relevant ESG factors, including climate-related financial risks, and choose economically targeted investments in part for benefits separate from investment return.[4] Likewise, the DOL's interpretive guidance has recognized that the exercise of voting rights, as well as other shareholder rights connected to shares of stock, are fiduciary acts subject to ERISA's prudence and loyalty requirements.[5]

Under the Trump administration, on November 13, 2020, the DOL published a final rule, which adopted amendments to the Investment Duties regulation that generally require plan fiduciaries to select investments and investment courses of action based solely on consideration of "pecuniary factors."[6] The rule also included a prohibition against adding or retaining any investment fund, product or model portfolio as a QDIA if the fund, product or model portfolio reflects non-pecuniary objectives in its investment objectives or principal investment strategies.[7] On December 16, 2020, the DOL published a final rule, which also adopted amendments to the Investment Duties regulation to establish regulatory standards for the obligations of plan fiduciaries under ERISA when voting proxies and exercising other shareholder rights in connection with plan investments in shares of stock.[8]

On January 20, 2021, President Biden signed an Executive Order that directed federal agencies to review regulations promulgated, issued or adopted during the Trump administration that are inconsistent with policies to improve public health and to protect the environment.[9] On March 10, 2021, the DOL announced that it had begun a reexamination of the November and December 2020 Investment Duties rules, and that the DOL would not enforce or pursue enforcement actions against plan fiduciaries for failure to comply with those rules.[10]

Based on the DOL's recent informal outreach, the DOL notes that many stakeholders questioned whether the final rules adopted by the prior administration adequately addressed the use of ESG considerations in improving investment value and long-term investment returns. In addition, stakeholders expressed concern that funds could be excluded as investment options for QDIAs solely because such QDIAs considered climate change or other ESG factors even though the QDIAs were prudent based on consideration of their financial attributes alone.[11]

On May 20, 2021, President Biden signed an Executive Order, which included policies to mitigate climate-related financial risk and actions to help safeguard the financial security of America's families, businesses and workers from climate-related financial risk that may threaten the life savings and pensions of U.S. workers and families.[12]

OVERVIEW OF THE PROPOSED RULEMAKING

A. INVESTMENT PRUDENCE AND LOYALTY DUTIES CAN INCLUDE CONSIDERATION OF CLIMATE CHANGE AND OTHER ESG FACTORS

The DOL's Investment Duties regulation provides fiduciaries a safe harbor to satisfy their duty of prudence under ERISA. The regulation states that the safe harbor can be satisfied with respect to a particular investment or investment course of action if the fiduciary "(i) has given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved. . . and (ii) has acted accordingly."[13]

The new proposed amendments to the regulation would specify that "appropriate consideration" 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 when considering the projected return of the portfolio relative to the funding objectives of the plan. The proposal also would remove the requirement to consider only pecuniary factors and instead add a new provision that would clarify and confirm that a fiduciary may consider any factor material to the risk-return analysis, including climate change and other ESG factors. The proposed amendments include three non-exclusive examples that a fiduciary may consider in the evaluation of an investment or investment course of action if material:

1. Climate change-related factors, such as a corporation's exposure to the real and potential economic effects of climate change, including its 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;
2. 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

3. 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 skills; equal employment opportunity; and labor relations.

The proposal would also clarify that, under the ERISA fiduciary duty of loyalty, ESG considerations, including climate-related financial risk, are, in appropriate cases, risk-return factors that fiduciaries should take into account when selecting and monitoring plan investments and investment courses of action.

B. CHANGES TO THE TIE-BREAKER STANDARD

The rulemaking also proposes a change to the "tie-breaker" standard, which permits fiduciaries to consider collateral benefits in selecting a plan investment if the fiduciary concludes that competing investments equally serve the financial interests of the plan. The proposed rule would make clear that the investments do not have to be indistinguishable for collateral benefits other than investment returns to be considered once the fiduciary determines the alternative investments are equally appropriate for the plan, so long as the requirements of the proposed rule are met. These requirements include, in the case of such a collateral benefit for a designated investment alternative for an individual account plan, the prominent display of the collateral-benefit characteristic of the fund in disclosure materials. Further, the fiduciary cannot accept reduced returns or greater risks to secure the collateral-benefit. The proposed rule would also eliminate the specific documentation requirements added under the 2020 final rule, which the DOL believes created a burden specifically for investments providing collateral benefits that many perceived as targeted ESG investing.

C. CHANGES TO QUALIFIED DEFAULT INVESTMENT ALTERNATIVE PROVISIONS

The proposed rule would remove the special rule for QDIAs that was added by the prior administration and instead apply the same standards to QDIAs that would apply to other investments. According to the DOL, many stakeholders expressed concerns that funds could be excluded from treatment as a QDIA because such funds considered ESG factors, even though the funds were prudent based on the financial attributes. In its rationale, the DOL states, "[i]f a fund expressly considers climate change or other ESG factors, is financially prudent, and meets the protective standards set out in the Department's QDIA regulation…, there appears to be no reason to foreclose plan fiduciaries from considering the fund as a QDIA."[14]

D. CHANGES TO PROVISIONS ON SHAREHOLDER RIGHTS/PROXY VOTING

The rulemaking proposes four notable changes from the current regulation regarding shareholder rights and proxy voting:

1. Voting Duty: The proposed rule would eliminate the statement in the current regulation 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 supports this deletion by acknowledging that the exercise of shareholder rights is important to ensuring management accountability to the shareholders that own the company.[15] However, the DOL also notes that this does not mean fiduciaries must always vote proxies or engage in shareholder activism.

2. Monitoring Obligations: The proposed rule would eliminate a provision in the current regulation that sets out specific monitoring obligations where the authority to vote proxies or exercise shareholder rights has been delegated to an investment manager or where a proxy voting firm performs advisory services as to voting proxies. The DOL believes that the general prudence and loyalty duties under ERISA section 404(a)(1) already impose a monitoring requirement and is concerned that the specific provision in the current regulation may be read as requiring some special obligations above and beyond the statutory obligations.[16]

3. Proxy Voting Policies: The proposed rule would revise the provision of the current regulation that addresses proxy voting policies by removing the two "safe harbor" examples for proxy voting policies that would be permissible under the current regulation. The DOL stated that a statement of proxy voting policy is an important part of any comprehensive statement of investment policy but that, based on the DOL's outreach, it was not confident the existing safe harbors were necessary or helpful examples.[17]

4. Records Maintenance: The proposed rule would eliminate the current requirement that, 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.

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ENDNOTES

[1] *See* 29 CFR Part 2550.

[2] The "tie-breaker" test imposes a requirement that the competing investments be economically indistinguishable before fiduciaries can turn to collateral factors as tie-breakers, and imposes a special documentation requirement on the use of such factors.

[3] *See* 29 U.S.C. 1104; *see* 29 U.S.C. 1103(c) and 1104(a).

[4] *See, e.g.*, Interpretive Bulletin 2015-01, 80 FR 65135 (Oct. 26, 2015).

[5] *See,* e.g., Interpretive Bulletin 2016-01, 81 FR 95879 (Dec. 29, 2016).

[6] *See* 85 FR 72846 (Nov. 13, 2020).

[7] Under the DOL's QDIA regulation, investing assets in QDIAs provides liability relief to plan fiduciaries in the absence of direction from plan participants.

[8] *See* 85 FR 81658 (Dec. 16, 2020).

[9] *See* 86 FR 7037 (Jan. 25, 2021).

[10] *See* U.S. Department of Labor Statement Regarding Enforcement of its Final Rules on ESG Investments and Proxy Voting by Employee Benefit Plans (Mar. 10, 2021).

[11] *See* U.S. Department of Labor Statement Regarding Enforcement of its Final Rules on ESG Investments and Proxy Voting by Employee Benefit Plans (Mar. 10, 2021).

[12] *See* 86 FR 27967 (May 25, 2021).

[13] *See* 29 CFR Part 2550.

[14] *See id.*

[15] *See, e.g.*, Comment #262 at https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB91/00262.pdf; Comment #209 at https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB91/00209.pdf.

[16] *See* 81 FR 95882-3.

[17] *See* 81 FR 95883.

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