The DOL Pendulum Swings on ESG, but How Far Remains to Be Seen

October 15, 2021

On October 14, 2021, the U.S. Department of Labor (the "DOL") issued proposed regulations that represent the first step in meeting President Biden's directive to revise or rescind the recent Trump-era rules addressing a fiduciary's duties under Section 404 of the Employee Retirement Income Security Act of 1974, as amended ("ERISA").[1]

As a refresher, in late 2020 the Trump administration DOL issued final rules that addressed ERISA fiduciary duties with respect to (a) considering environmental, social and corporate governance ("ESG") factors when selecting investments and investment courses of action and (b) deciding whether to vote proxies and the use of proxy voting policies. The Trump-era final rules, among other things:

- provided that an ERISA fiduciary must focus solely on the plan's "pecuniary factors" (*i.e.*, financial returns and the interests of plan participants and beneficiaries in their plan benefits) in its investment decision-making process, and

- prohibited adding or retaining a qualified default investment alternative ("QDIA") that reflected non-pecuniary objectives in its investment objectives or principal investment strategies.

Although ESG was not expressly mentioned in the Trump-era final rules, the preamble to the rules discussed ESG at length in a manner viewed by many market participants as a clear signal from the DOL that it would generally disfavor the consideration of ESG factors by ERISA fiduciaries and would presume them to be non-pecuniary, except in extraordinary circumstances.

It is important to note that the DOL has not entirely reversed its course on ESG in the proposed rule. As described in greater detail below, the DOL continues to acknowledge (as it has consistently done in the past) that at the heart of an ERISA fiduciary's statutory duties is an obligation to put investment returns first. The DOL has, however,

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1 "*Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights*," 86 FR 57272 (Oct. 14, 2021), *available at* https://public-inspection.federalregister.gov/2021-22263.pdf.

softened its stance and attempted to eliminate the perceived bias against ESG by expressly acknowledging that the consideration of such factors can be taken into account in a manner that comports with ERISA's fiduciary duties of prudence and loyalty. While we do not view the proposed rule as creating a clear and open path to ESG-focused investing by ERISA plans, the proposal would take the bullseye off the back of ERISA fiduciaries who may take ESG into account by establishing such factors as no different than other traditional risk-return factors that prudent and loyal investment professionals use in their decision-making process.

The key provisions of the DOL's October 14 proposal are as follows:

A. The proposed rule clarifies when and how ESG factors can be taken into account by an ERISA plan fiduciary.

The proposed rule allows for ESG factors to be considered at two stages in the analysis.

1. *First*, a plan fiduciary can consider ESG factors in selecting an investment (or an investment course of action) when such factors are material to the risk-return analysis. ESG factors can be considered alongside other material factors and must be given appropriate weighting. ESG factors expressly listed in the proposed rule include:

- *climate change-related factors*, including exposure to the physical and transitional risks of climate change and the effect of government regulations and policies;
- *governance factors*, such as those involving board composition, executive compensation, transparency and accountability in corporate decision-making, as well as a corporation's compliance with laws and regulations; and
- *workforce practices*, including a company's progress on workforce diversity, inclusion and other drivers of employee hiring, promotion and retention; its investment in training; equal employment opportunity; and labor relations.

Notwithstanding the reference to these ESG factors, the proposed rule reiterates the long-standing requirement under ERISA that "a fiduciary may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives, and may not sacrifice investment return or take on additional investment risk to promote benefits or goals unrelated to interests of the participants and beneficiaries in their retirement income or financial benefits under the plan." Thus, even though ESG factors can be considered if they are material to investment value, the proposed rule concludes that the investment that best serves the financial interests of the plan must be selected by the fiduciary.

2. *Second*, the proposed rule reinstates the principle underpinning the "tie goes to the runner" or "all things being equal" standard that formed the basis of earlier DOL guidance. This standard allows an investment choice based on collateral benefits such as ESG factors when two investment choices equally serve the financial interests of the plan. This would rescind the current regulations' tie-breaker standard, which permits a fiduciary to take into account collateral benefits only when two investment choices are otherwise "indistinguishable" based on consideration of risk and return. The "indistinguishable" standard would appear to be rarely, if ever, applicable, and the DOL expressed the view that a collateral benefit tie-breaker should be appropriate when two investment choices differ on a wide range of attributes but are equally appropriate additions to a plan's investment portfolio. In another, related departure from the current regulations, the proposed rule does not require a plan fiduciary to specially document its analysis when it relies on collateral benefits to break the tie. The DOL notes in the preamble to the proposed rule that this requirement is not necessary "given that fiduciaries are subject to a general prudence obligation and commonly document and maintain records about their investment selections pursuant to that obligation."

B. Plan fiduciaries are no longer prohibited from choosing a QDIA that considers ESG factors if the investment alternative best serves the financial interest of the plan.

The proposed rule rescinds the current regulations' prohibition on an investment alternative serving as a "qualified default investment alternative" or "QDIA" if it, or any of its component funds, has "investment objectives or goals or its principal investment strategies include, consider, or indicate the use of non-pecuniary factors." Under the proposed rule, a fund that explicitly considers ESG factors can be a QDIA, provided that it meets the standards set forth in existing QDIA regulations. The DOL confirms in the preamble to the proposed rule that "QDIAs would continue to be subject to the same rules under the proposal as all other investments, including the prohibition against subordinating the interests of the participants and beneficiaries in their retirement income to other objectives." The proposed rule would require specific disclosure to plan participants regarding any collateral benefit characteristic of a QDIA, to the extent that a QDIA is selected on that basis.

C. The proposed rule amends the current regulations regarding proxy voting policies in two noteworthy but generally modest ways.

These amendments (a) remove two "safe harbor" examples for proxy voting policies and (b) eliminate the requirement that plan fiduciaries must maintain records on their proxy voting activities and other exercises of shareholder rights. However, the proposed regulations retain many of the existing provisions from the current regulations on proxy voting policies, including (i) the requirement that a plan fiduciary may not adopt a practice of following 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 the fiduciary's obligations set forth in the regulations; and (ii) a requirement of periodic review by plan fiduciaries of any adopted proxy voting policies.

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