STRADLEY RONON

Fiduciary Governance

October 21, 2021

*Risk&Reward*
fiduciarygovernanceblog.com
@FidGovGroup

# New DOL Proposal May Be ERISA's Zero-to-One ESG Moment

## Topline & Comment Period Deadline

A new U.S. Department of Labor (DOL) rule proposal would, if adopted, greatly accelerate ERISA fiduciaries' need to evaluate climate-related financial risk and certain other environmental, social and governance (ESG) considerations during plan investment and proxy voting decision-making. The comment period for the proposal closes on December 13, 2021.[1]

## Who is Affected?

The proposal is directly relevant to all ERISA plan sponsors (both DB and DC), investment managers, and pooled investment funds that hold "plan assets." Proxy advisory firms and product manufacturers are indirectly affected.

© 2021 Stradley Ronon Stevens & Young, LLP | www.stradley.com | Philadelphia | Washington | Chicago | New York

Information contained in this publication should not be construed as legal advice or opinion or as a substitute for the advice of counsel. The enclosed materials may have been abridged from other sources. They are provided for educational and informational purposes for the use of clients and others who may be interested in the subject matter.

### Why the DOL Proposed this Rule

The DOL has long wrestled with ESG, especially when ESG was historically associated with collateral benefits (*i.e.*, non-investment performance reasons). Formalized guidance commenced during the Clinton Administration, with each subsequent administration taking different approaches. It was during the Obama Administration when the DOL first acknowledged that an ESG factor can be material to investment performance.

The Trump Administration reaffirmed the Obama Administration's stance that an ESG factor can be material to investment performance, but its relevant rulemakings, the *Financial Factors* rule, and the 2020 proxy voting rule, expressed concern over the putative politicization of ESG investing and skepticism that certain types of ESG investing, particularly screens, was in a plan's best interest. Many believed the Trump-era rules stigmatized, and, therefore, had a chilling effect on, ESG adoption by ERISA plans.

The DOL under the Biden Administration recognized, and agreed with, the concerns that the Financial Factors and proxy voting rules had a chilling effect on ESG adoption. The DOL, in drafting the proposal, sought to enable ERISA fiduciaries to "better recognize the important role that climate change and other ESG factors can play in the evaluation and management of plan investments, while continuing to uphold fundamental fiduciary obligations." Also, considering the Administration's broader policy initiatives to address climate change risk, this new proposal fits into a larger tapestry the White House has weaved as part of its "whole-of-government" approach to climate change and other ESG issues.[2]

### How the Proposal Goes Far Beyond Other DOL Approaches to ESG

As with the *Financial Factors* rule and Obama-era guidance, the proposal emphatically reaffirms that ESG factors can be material to an investment's risk-return analysis, and in those situations, a fiduciary should consider them along with any other non-ESG material risks.[3] In doing so, the DOL fleshed out various types of ESG risks, and, in considerable detail, the multi-dimensional aspects to an ESG factor. Specifically, the proposal describes the following ESG factors that might be material:

1. "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[4] of climate change and the positive or negative effect of Government regulations and policies to mitigate climate change;[5]

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

**For more information, please contact:**

**George Michael Gerstein**
*Co-Chair, Fiduciary Governance*
202.507.5157
ggerstein@stradley.com

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 skill; equal employment opportunity; and labor relations."

We think this level of specificity by the DOL reveals an increasingly sophisticated and nuanced understanding of climate change risk. The proposal's granularity on different ESG risks will likely enhance broader understanding of these risks by fiduciaries, thus aiding adoption.

Beyond that, we think the proposal's express acknowledgment that *government action* (whether in policy or in rulemaking) may have a negative or positive material effect on plan investments could be transformational.[6] Indeed, there will be winners – and there will be losers – from government policy and rulemakings aimed at a transition to a low-carbon economy (or for some other ESG-related reason), and ERISA fiduciaries would be expected to prepare a plan's portfolio for these risks and opportunities.

1. The proposal contemplates a broad scope to government action as a potential material risk or opportunity consideration for ERISA fiduciaries. Consider the following:

2. The government action appears to include all government levels, both within the United States (federal and state) and abroad;

3. The government action need not be limited to actual regulation – a government policy, as reflected in the Biden Administration's *A Roadmap to Build a Climate-Resilient Economy*, would likely be sufficient for the fiduciary's consideration, if the policy initiative is likely to have a positive or negative effect on a particular industry, for example; and,

The government action can come from any government agency or body, such as the EPA or the Governor of California, for instance.

A government action that sets things into motion, which would trigger an ERISA fiduciary's consideration under the proposal, will likely put fiduciaries on high alert and wanting to act quickly in response.

Yet another way in which the proposal could serve as ERISA's zero-to-one ESG moment is that it appears to create a *heavy presumption in favor of ESG adoption*. Under the proposed text, a fiduciary must consider the projected return of the portfolio relative to the funding objectives of the plan, "which may often require an evaluation of the economic effects of climate change and other environmental, social, or governance factors on the particular investment…." (emphasis added).[7] Though the rule separately lists various ESG factors that *may be* considered by the fiduciary if material to the risk-return analysis,[8] the "which may often require" clause clearly reflects an intention by the DOL that various ESG factors are material, and, therefore, must be considered by a prudent ERISA fiduciary. Further lending credence to the view that the proposal goes beyond simply clarifying that ESG factors may be material, the DOL stated in the preamble, "the proposal makes clear that climate change and other ESG factors are often material and that in many instances

fiduciaries [] should consider climate change and other ESG factors in the assessment of investment risks and returns."[9]

A fourth reason this proposal is significant is the DOL's acknowledgment that "all ESG is not equal, and when it is not material to the risk/return analysis, ESG still may be a legitimate collateral benefit for consideration...."[10] Using ESG for these types "collateral benefits" is not new; in fact, it has been a means by which fiduciaries have incorporated ESG for decades.[11] But the proposal, relative to the Financial Factors rule, streamlines and broadens its usage. For example, the proposal would eliminate the special documentation requirement under the *Financial Factors* rule related to the use of collateral benefits. Moreover, the proposal expands the types of collateral benefits that may be considered.[12]

Notably, however, where a collateral benefit ESG factor is used in selecting a designated investment alternative for a participant-directed (e.g., 401(k)) plan lineup, the proposal would require that such reason/benefit "be prominently displayed in disclosure materials provided to participants and beneficiaries."[13] The DOL mentioned that this new disclosure could be added to the existing participant disclosures provided under 29 CFR Section 2550.404a-5.

### How QDIAs are Affected

There was considerable controversy over the *Financial Factors* rule's prohibition against an ERISA fiduciary selecting a "qualified default investment alternative" (QDIA) in a participant-directed plan lineup, if that fund, product or model portfolio's investment objectives, goals or principal investment strategies referenced an ESG factor that was selected for collateral benefits. The stakes are high because there is a massive amount of plan assets invested in QDIAs. The proposal eliminates this prohibition. The proposal will likely accelerate the use of ESG funds, products and model portfolios as QDIAs.

### How Pooled Investment Vehicles are Affected

The proposal retains the ability of a pooled investment fund that holds "plan assets" to require participating plans to accept the fund's investment policy statement and/or proxy voting policy, to the extent consistent with ERISA, as a condition to subscribe into the fund. This is helpful insofar as fund managers would otherwise have had to ascertain, and avoid violating, each plan investor's own investment policy statements and proxy voting policies.

### How Brokerage Windows and Self-Directed Brokerage Accounts are Affected

As with the *Financial Factors* rule, the proposal does not extend to investment funds within brokerage windows and self-directed brokerage accounts. Some plan sponsors have enabled participants to access ESG funds through these arrangements, and that practice may persist.

### How Proxy Voting and Other Shareholder Rights are Affected

ESG investing and the exercise of shareholder rights (including, but not limited to, proxy voting) often go together, which is likely why the DOL addressed them here at once. Consistent with the DOL's longstanding position, the proposal reiterates that proxy voting and the exercise of other shareholder rights on behalf of ERISA plans is fiduciary conduct, and, therefore, is subject to the fiduciary duties set forth in ERISA. The current view of the DOL, as reflected in the proposal, is that exercising shareholder rights *is important* and should not be discouraged. Yet, the DOL was quick to reaffirm its historical view "that proxies should be voted as part of the process of managing the plan's investment in company stock unless a responsible plan fiduciary determines voting proxies may not be in the plan's best interest (*e.g.*, if there are significant costs or efforts associated with voting)."[14]

© 2021 Stradley Ronon Stevens & Young, LLP

The proposal also eliminates the requirement in the 2020 proxy voting rule that there be special monitoring where the authority to exercise shareholder rights on behalf of the plan had been delegated to an investment manager or where a proxy advisory firm provides advisory services. The DOL believes that ERISA's duties of prudence and loyalty already impose a monitoring obligation, and, therefore, no special monitoring obligation with respect to shareholder rights is warranted.

The 2020 rule provided two safe harbors for fiduciaries to satisfy ERISA's fiduciary duties in determining whether to vote a proxy. Briefly, the two safe harbors were: (A) a policy to limit voting resources to particular types of proposals that the 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, and (B) a 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 that the fiduciary prudently determines, considering its percentage ownership of the issuer and other relevant factors, is sufficiently small that the matter being voted upon is not expected to have a material effect on the investment performance of the plan's portfolio (or investment performance of assets under management in the case of an investment manager).

The DOL, in the preamble to the proposal, noted that, because the safe harbors are likely to be widely adopted, it is vital that they actually safeguard the interests of the plans. The DOL is currently not confident the two safe harbors from the 2020 rule are "necessary or helpful," and, therefore, did not include them in the proposal. As noted below, however, the DOL solicits comments on whether the safe harbors should be retained.

The proposal eliminates a requirement from the 2020 rule that mandated fiduciaries to maintain records on proxy voting activities and the exercise of other shareholder rights.

The proposal retains a requirement that the fiduciary exercise prudence and diligence in the selection and monitoring of persons hired to provide research and analysis, recommendations regarding proxy votes, proxy voting administrative services, recordkeeping and other services related to shareholder rights. This is why the proposal indirectly affects proxy advisory firms.

### Some Questions to Consider

The comment period closes on December 13, 2021. The DOL is interested in feedback and has solicited comments on the proposal, including:

1. Should a final rulemaking retain the specific examples of ESG risks that may be material (*e.g.*, climate change, etc.)?

2. Is the proposal's revised language around the tie-breaker test clear and appropriate? Should a final rule provide greater specificity on which collateral benefits may be considered?

3. Should a final rule retain the enhanced documentation requirement when a plan investment option is selected for collateral benefits?

4. Should the safe harbors in the 2020 proxy voting rule be retained?

© 2021 Stradley Ronon Stevens & Young, LLP

5. Would the proposal cause plans to modify their holdings, such as in favor of mutual funds and away from individual companies, so as to avoid the proxy voting requirements set forth in the proposal?

6. Would the proposal affect how a fiduciary would manage the plan's mutual fund shares in terms of exercising shareholder rights appurtenant to the mutual fund shares?

7. Are the proposal's requirements regarding the selection and monitoring of proxy advisory firms and other service providers regarding the exercise of shareholder rights necessary and could they be read as creating special duties and requirements beyond those already existing under ERISA?

8. Should the DOL retain the specific requirement that a fiduciary may not adopt a practice of following the recommendations of a proxy advisory firm without a determination that such firm's proxy voting guidelines are consistent with the fiduciary's duties under ERISA? Do the proposal's other provisions otherwise address concerns related to fiduciaries' use of automatic voting mechanisms?

### Final Thoughts

We believe there is more to this proposal than what may initially meet the eye. The DOL is clearly trying to nudge ERISA fiduciaries into considering ESG factors in their investment and proxy voting decision-making. Should the proposal be adopted as-is, it will likely serve as an accelerant to ESG adoption by ERISA plans and plan asset vehicles. Because these consequences would be profound, plan sponsors and other fiduciaries should carefully consider whether to provide feedback and comments to the DOL in response to the proposal.

---

[1] The proposed rule would amend the "Investment Duties" regulation set forth at 29 C.F.R. Section 2550.404a-1.

[2] *See, e.g., A Roadmap to Build a Climate-Resilient Economy*, https://www.whitehouse.gov/wp-content/uploads/2021/10/Climate-Finance-Report.pdf, Executive Order 13990, "Protecting Public Health and the Environment and Restoring Science to Tackle the Climate Crisis," 86 Fed. Reg. 7037 (Jan. 25, 2021), and Executive Order 14030, "Executive Order on Climate-Related Financial Risk," 86 Fed. Reg. 27967 (May 25, 2021).

[3] Since 2015, the DOL has repeatedly asserted that ESG can be a material risk factor, and, in those situations, should be considered by an ERISA fiduciary as part of a prudent process. This holds true under the Obama, Trump and Biden Administrations. That the DOL, under both Democrats and Republicans, has acknowledged that ESG risks can be material to investment performance, strongly suggest this issue is officially off the table.

[4] The preamble to the proposal notes, "[t]ransition risk reflects the risks that carbon-dependent businesses lose profitability and market share as government policies and new technology drive the transition to a carbon-neutral economy."

[5] Per the DOL, the "imminent or proposed regulations...to reduce greenhouse gas emissions in the power sector, and other policies incentivizing a shift from carbon-intensive investments to low-carbon investments, [which] could significantly lower the value of carbon-intensive investments while raising the value of other investments."

[6] *See* George Michael Gerstein, *Climate Change Defines the Fiduciary*, Bloomberg Law, Oct. 2, 2017 ("The first major component of climate risk relates to forthcoming changes in policy and law at the international, national

© 2021 Stradley Ronon Stevens & Young, LLP

and local level."); *see also* Mercer, *Investing in a Time of Climate Change*, 2015, https://www.mercer.com/content/dam/mercer/attachments/global/investments/mercer-climate-change-report-2015.pdf.

[7] Proposed 29 C.F.R. Section 2550.404a-1(b)(2)(ii)(C).

[8] Proposed 29 C.F.R. Section 2550.404a-1(b)(4).

[9] 86 Fed. Reg. 57272, 57276 (Oct. 14, 2021).

[10] *Id*. at 57279.

[11] The analytic framework for using collateral benefits has been called the "tie-breaker" test.

[12] *Cf.* 86 Fed. Reg. at 57280 (referencing "corporate ethos" and "esprit de corps of the workforce" as collateral benefits) *with* 85 Fed. Reg. 72846, 72862 ("responding to participant demand in order to increase retirement plan savings or investments in contribution creating jobs for current or future plan participants may be consistent with the interests of participants and beneficiaries in their retirement income or financial benefits under the plan, while selecting based on which investment would bring greater personal accolades to the chief executive officer of the sponsoring employer, or solely on the basis of a fiduciary's personal policy preferences, would not.").

[13] The DOL noted in the preamble that, "[t]he essential purpose of this proposed disclosure requirement is to ensure that plan participants are given sufficient information to be aware of the collateral factor or factors that tipped the scale in favor of adding the investment option to the plan menu, as opposed to its economically equivalent peers that were not."

[14] *See also* 86 Fed. Reg. at 57281 ("Prudent fiduciaries should take steps to ensure that the cost and effort associated with voting a proxy is commensurate with the significance of an issue to the plan's financial interest.").

© 2021 Stradley Ronon Stevens & Young, LLP