Professional Perspective

DOL Proposes New ESG and Proxy Voting Rule

George Michael Gerstein, Stradley Ronon

Bloomberg Law

Read Professional Perspectives | Become a Contributor

Reproduced with permission. Published November 2021. Copyright © 2021 The Bureau of National Affairs, Inc. 800.372.1033. For further use, please contact permissions@bloombergindustry.com

DOL Proposes New ESG and Proxy Voting Rule

Contributed by George Michael Gerstein, Stradley Ronon

On October 13, 2021, the U.S. Department of Labor (DOL) unveiled a new proposal (86 Fed. Reg. 57272) related to environmental, social, and governance (ESG) investing and shareholder rights (including proxy voting). The proposal is part of a long continuum of DOL guidance and rulemaking over the years to clarify how the consideration of ESG in investment decisions and proxy voting comports with the fiduciary duties under the Employee Retirement Income Security Act of 1974 (ERISA). The Clinton, Bush, Obama, and Trump Administrations each took different approaches. Now, the DOL under the Biden Administration has issued this proposed rule, which, if adopted, would both reaffirm the importance of ESG as a consideration by ERISA fiduciaries and (as discussed below) strongly encourage the incorporation of ESG in ERISA plans and "plan asset" funds.

It is important to consider the proposal in context. It comes on the heels of the Trump-era *Financial Factors* (85 Fed. Reg. 72846) and proxy voting (85 Fed. Reg. 81658) rulemakings. Various stakeholders believed these rules stigmatized ESG and had a chilling effect on ESG's incorporation by ERISA fiduciaries. The DOL sought to address those concerns by issuing this new proposal. The proposal also fits within the Administration's broader policy initiatives to address and combat climate change risk. It is little wonder then that the DOL acted so swiftly in proposing a new ESG and proxy voting rule.

The comment period for this rule proposal closes on December 13, 2021.

The following are some of the salient takeaways:

- **The proposal reiterates that one or more ESG factors can present important investment risks and opportunities to ERISA plans**. As part of this reiteration, the proposal eliminates the "pecuniary factors" language that the *Financial Factors* rule introduced. Though it has been the DOL's position since 2015 that one or more ESG factors could be material, the proposal is the DOL's most conspicuous attempt at stating it. It is, therefore, antiquated to conflate the incorporation of ESG factors with the pursuit of non-investment performance objectives. Rather, fiduciaries may treat one or more ESG factors as material to investment risk and return, in which case the ESG factor is on equal footing as any other material factor. As part of this process, fiduciaries should remember that "ESG" is an umbrella term that encompasses myriad factors ranging from climate change risk to cybersecurity, and that not all factors necessarily need be incorporated. Fiduciaries should also consider the bases on which they determine a particular ESG factor is material to investment performance.
- **The proposal flags certain ESG factors that may be material to the risk-return analysis**. Specifically, the DOL highlighted the following ESG factors that fiduciaries should keep on their radars:

  (i) 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;

  (ii) 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

  (iii) 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.
- **The proposal potentially creates a presumption in favor of incorporating ESG factors**. Under the proposal, 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). The italicized language could be interpreted as signaling that various ESG factors are likely to be material (in the DOL's eyes), which could be just the nudge some otherwise reluctant fiduciaries may point to in deciding to incorporate ESG. Admittedly, though, the language is ambiguous as to whether that was truly the DOL's intent.

©2021 The Bureau of National Affairs, Inc.

- **The proposal streamlines the tie-breaker test for use of ESG collateral benefits**. The tie-breaker test is used when an ESG factor is used for reasons other than risk/return. The DOL has long allowed such types of investments under narrow circumstances. The *Financial Factors* rule was largely viewed as rendering the tie-breaker test virtually impossible to meet, the consequence of which was to dry up a fiduciary's appetite for utilizing ESG for any collateral benefits. The proposal also eliminates the special documentation requirement set forth in the *Financial Factors* rule for satisfying the tie-breaker test.

- **The proposal adds a new disclosure requirement for participant-directed plans**. A fiduciary's selection of an ESG fund as a designated investment alternative for collateral benefits would trigger a new disclosure requirement. Specifically, the collateral benefit characteristic would have to be disclosed to participants and beneficiaries, such as in the participant disclosures, as required under 29 C.F.R. § 2550.404a-5. This new requirement could present logistical challenges and concerns that such disclosures could amount to a new form of legal risk to plan sponsors.

- **The proposal permits the incorporation of ESG in QDIAs – whether for materiality reasons or collateral benefits**. The *Financial Factors* rule made waves when it prohibited the incorporation of ESG in "qualified default investment alternatives," if the ESG factor was being utilized for non-investment performance reasons. The proposal eliminates this prohibition, which will likely increase the use of ESG funds, products, and model portfolios as QDIAs.

- **The proposal does not extend to brokerage windows**. The inclusion of ESG funds within brokerage windows remains a viable option for plan fiduciaries; this rule proposal does not directly affect that approach.

- **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 as a condition to investing in the fund**. Thus, the proposal retains a longstanding and helpful mechanism for private investment fund sponsors to more seamlessly incorporate ESG factors into their investment strategies. With that said, the fund sponsors of funds that hold "plan assets" should confirm that their ESG/proxy voting policies comport with ERISA and applicable DOL guidance.

- **The proposal reaffirms the importance of proxy voting and the exercise of other shareholder rights**. The exercise of shareholder rights, including proxy voting, is a common method of addressing ESG risks. For some institutional investors, the ability to exercise shareholder rights with a recalcitrant board is preferable to divestment. The proposal reiterates that the exercise of shareholder rights is both fiduciary conduct under ERISA and indeed important as a general matter. The proposal, therefore, takes a different approach than the 2020 proxy voting rule, which some viewed as discouraging an ERISA fiduciary's exercise of shareholder rights. For example, the proposal removes the safe harbors and the special recordkeeping requirements in the 2020 rule.

The DOL's new ESG and proxy voting rule proposal is significant. It goes beyond merely resuscitating the Obama-era guidance. Should this proposal be adopted largely as-is by the DOL, ERISA fiduciaries will likely feel a new sense of urgency in considering ESG factors in their investment decision-making and in their exercise of shareholder rights on behalf of ERISA plans.

©2021 The Bureau of National Affairs, Inc.