DOL Proposal Signals Relaxed Rules For ESG Investing

By **Elizabeth Goldberg, Julie Stapel and Lance Dial** (October 22, 2021)

The U.S. Department of Labor on Oct. 14 published in the Federal Register a notice of proposed rulemaking on how retirement plans can make investment decisions that consider environmental, social and governance factors.[1]

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The proposed rule, if adopted in its current form, would be a significant revision of two controversial regulations adopted at the end of the Trump administration.

Those regulations were perceived by some as imposing new hurdles when considering ESG factors in making fiduciary investment decisions for retirement plans and investors subject to the Employee Retirement Income Security Act.

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The Proposed Rule Versus The 2020 Rule: How They Differ

Before delving into the specifics of the proposed rule, it is important to note that the DOL has been consistent over the many years of regulatory pingpong in affirming that plan fiduciaries must make investment decisions in accordance with ERISA's two key fiduciary duties of loyalty and prudence.

That bedrock principle has not changed in the proposed rule. As with prior DOL guidance, the variation in the proposed rule as compared to the 2020 rule is the degree to which the proposed rule supports the evaluation of ESG factors as among those that can be economically and financially material to a fiduciary's risk-return investment analysis.

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While remaining consistent with the bedrock principle, the proposed rule recognizes that ESG factors can be permissible considerations in many facts and circumstances. In fact, the proposed rule makes it clear that the factors to be considered "may often require an evaluation of the economic effects of ... [ESG] factors on the particular investment or investment course of action."

The DOL's view is reflected in five key changes.

1. De Facto Recognition of ESG as Material to Investment Risk and Return

The first key change is to an existing regulatory safe harbor under which an investment decision, if satisfied, will be deemed to be prudent. The proposed rule does this by amending the regulatory safe harbor for conduct deemed prudent to provide that appropriate investment consideration includes 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 or investment course of action.

In addition, the proposed rule specifically permits plan fiduciaries to "consider any factor in the evaluation of an investment or investment course of action that, depending on the facts and circumstances, is material to the risk-return analysis" and offers three examples of categories of factors that may be included, all of which are ESG categories:

- Climate change factors, including a corporation's "exposure to the physical and transitional risks of climate change" and the impacts of "[g]overnment regulations and policies to mitigate climate change."
- Governance factors, including "board composition, executive compensation, transparency and accountability in corporate decision-making," and "avoidance of criminal liability and compliance with ... applicable laws and regulations."
- Workplace practices, including the corporation's progress on diversity and inclusion as well as "other drivers of employee hiring, promotion and retention"; workforce skill training; equal employment opportunity; and labor relations.

This is a marked change from the 2020 rule, by stating that appropriate investment consideration may permit ESG factors, and in some circumstances, may often require an evaluation of ESG factors.

This also represents a clear departure from language in the preamble to the 2020 rule that suggested there may only be limited circumstances under which a fiduciary could consider ESG factors. The preamble discussion in the proposed rule, by contrast, highlights some of the reasons why, for example, the effects of government regulations on climate change can be expected to have an economic impact.

Similarly, the inclusion of workplace factors provides support for taking an economic view of the benefits of, for example, good labor relations.

The core of the proposed rule is still based on an evaluation of the economic effects of such factors and how such factors should be considered in the risk-return analysis, but the road is made easier for plan fiduciaries to make investments that incorporate financial ESG factors.

2. Risk-Return Test Replaces Pecuniary Factors Test, and ESG Counts

For purposes of the duty of loyalty, the proposed rule would replace the pecuniary factors standard of the 2020 rule with more general language.

The pecuniary factors standard of the 2020 rule provides that an investment will meet ERISA's duty of loyalty only if it is based on factors "expected to have a material effect on the risk and/or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives and the funding policy" — unless a limited exception applies.

The proposed rule removes the pecuniary factors test and applies a new standard that requires that a

> fiduciary's evaluation of an investment or investment course of action must be based on risk and return factors that the fiduciary prudently determines are material to

> investment value, using appropriate investment horizons consistent with the plan's investment objectives and taking into account the funding policy of the plan.

These two standards are similar.

Under both, the duty of loyalty requires decisions to be based on risk and return, appropriate time horizon and investment policy. The real change is that the proposed rule's regulatory text cross-references the above three listed categories of ESG factors, and as a result, it is expected plan fiduciaries may be more comfortable considering ESG factors as material to risk and return.

Also, in the preamble, the DOL affirms that ESG factors can be material to such risk and return.

One of the initial criticisms of the proposed rule is directed at the inclusion of ESG factors as specific examples of possible material risk-return factors, arguing that the regulation should be entirely principles-based and neutral as to specific considerations.

The argument made might be that a change to a principles-based regulation could instead represent a compromise position that may help end the regulatory back-and-forth. Yet the current administration may not view that approach as enough of a step forward from the 2020 rule changes that were viewed as having a dampening effect on the use of ESG factors.

3. Tiebreaker Test Redrafted to Be Broader and Easier

The DOL has tried to ease the application of the tiebreaker test to apply where investment courses of action "equally serve the financial interests of the plan over the appropriate time horizon," as opposed to only where investment courses of action are economically indistinguishable.

While there is little guidance in the proposed rule on how plan fiduciaries should interpret the phrase "equally serve the financial interest of the plan," it is clear that the DOL intends this to be broader in scope than the standard from the 2020 rule, which provided a tiebreaker for economically indistinguishable investments.

Given the discussion in the proposed rule and the other changes intended to remove barriers to the consideration of ESG factors in making investment decisions for ERISA plans, this change should likely also be read as intending to provide plan fiduciaries greater comfort in applying the tiebreaker test in more circumstances, especially in selecting funds for defined contribution plan investment menus.

Because of this lack of clarity, there has been some initial criticism of the proposed rule that would suggest the DOL should eliminate the tiebreaker test's "equally serve" condition and instead rely on a "prudent analysis".

On the other hand, the tiebreaker test may also provide a second bite at the apple for ESG factors. ESG factors can be used if they are material to the risk-return analysis.

But even if they are not, under the tiebreaker test, ESG factors could still be used even if not material to the risk-return analysis. This could open the door to using ESG factors that provide purely collateral benefits (e.g., for political or ideological purposes), as long as those collateral benefits do not sacrifice investment return or take on additional investment

risk to promote benefits or goals — and do not simply reflect the plan fiduciary's personal preferences.

In addition, the proposed rule would eliminate onerous documentation that was applicable to plan fiduciaries seeking to avail themselves of the tiebreaker test under the 2020 rule. Under that rule, plan fiduciaries were required to produce documentation as to why the pecuniary factors were insufficient, how the selected investment compared to other comparable investments, and how the chosen nonpecuniary factors were consistent with the interests of the plan participant and beneficiaries.

These requirements would be rescinded under the proposed rule.

However, if the tiebreaker test is used in the case of a designated investment alternative in an individual account plan, the proposed rule would impose a new disclosure requirement that fiduciaries alert participants as to the nature of the investment option by prominently displaying "the collateral-benefit characteristic of the fund, product, or model portfolio … in disclosure materials provided to participants and beneficiaries."

The preamble to the proposed rule explains that the proposal intentionally gives fiduciaries flexibility with how to meet the disclosure requirement, including that the fiduciary could use the required disclosure under Title 29 of the Code of Federal Regulations, Section 2550.404a-5.

This documentation requirement in the 2020 rule was viewed as deterring fiduciaries from using the tiebreaker exception, as it raised compliance costs by requiring an extensive paper trail. The simpler disclosure requirement should help reduce the costs and challenges of using a tiebreaker collateral factor.

There are already questions as to how this disclosure will be implemented. Given the extent to which investment disclosures in defined contribution plans are automated and standardized, the DOL may have oversimplified the challenges of articulating these factors and finding an efficient way to disclose them to participants.

The disclosure requirement also does not consider multistrategy or custom investment options that may, for example, take into account ESG factors in some but not all strategies.

More guidance could be helpful as to where or how consideration of collateral factors may be included in a plan's 404a-5 disclosure — such as in the comparative chart of investment-related information on the plan's designated investment alternatives.

For example, would specific disclosure be required — e.g., in a footnote? Or would it be sufficient to cross-reference disclosure in fact sheets and/or prospectuses for the particular investment options that are available on an internet website?

4. QDIAs Can Use ESG — and No Special Rules for Defined Contribution Plans

The proposed rule removes the bar on the use or consideration of ESG factors in qualified default investment alternatives, or QDIAs, as well as special rules that applied to defined contribution plans.

The 2020 rule limited the use of ESG factors in QDIAs and strictly prohibited a fund from being selected as the QDIA if the fund's described objective or goal or principal investment strategy included, considered or indicated the use of one or more nonpecuniary factors.

The proposed rule departs from this approach of treating QDIAs differently and instead applies the same standard to QDIAs as is applied to all other investment options — namely, that a fiduciary must focus on material risk-return factors and not subordinate the interests of plan participants and beneficiaries to objectives unrelated to the provision of benefits, subject to the tiebreaker rule.

By removing a bar on the use or consideration of ESG factors in QDIAs, the DOL has provided greater flexibility for the use of ESG-themed funds as QDIAs, or at least comfort to fiduciaries if a plan's QDIA uses ESG factors in some way or at some level — such as ESG integration at the fund or subfund level.

5. Mostly Back to Old Proxy Voting Standards

The proposed rule would remove the language on proxy voting that fiduciaries are not required to vote all proxies and would revert to the DOL's prior presumption in favor of voting proxies, unless the costs or other requirements outweigh the benefit of voting.

More specifically, the proposed rule rescinds three key requirements related to proxy voting from the 2020 rule:

- The requirement to maintain specific records of proxy voting activities, on the basis that general fiduciary standards are sufficient to cause fiduciaries to maintain appropriate records — the DOL stated there is no reason to single out proxy voting for special treatment in this regard;
- The two safe harbors that may have dissuaded fiduciaries from voting by proxy on certain issues; and
- The language stating that ERISA fiduciaries are not required to vote all proxies. The proposed rule would reinforce the long-standing principle that ERISA fiduciaries voting by proxy must act solely in the economic interests of the plan and its participants and beneficiaries, deleting the language that suggested heightened scrutiny of ESG-related proxy votes.

Thus, the DOL has largely reverted the proxy voting standard back to the previous guidance, with the change that it is now in the form of a regulation rather than an interpretive bulletin. Importantly, the proposed rule changes on proxy voting also specifically cross-reference the standards applicable to appropriate consideration, which, as noted above, include ESG factors that are relevant to the risk-return analysis.

As a practical matter, under the traditional standard, fiduciaries often find they should vote proxies unless they can determine it is not in the plan's best interest to vote — such as due to cost considerations or restrictions that may be triggered, as may be the case in voting proxies on foreign securities.

The removal of some — but not all — of the record-keeping requirements will likely be welcome relief for ERISA fiduciaries. The reference to the consideration of the revised risk-return analysis standard opens the door for a greater level of ESG consideration in proxy voting and perhaps even engagement practices.

Next Steps

Given that this is merely a proposed rule, no immediate action is required for fiduciaries. On balance, the proposed rule is generally more permissive for fiduciaries, eliminating certain record-keeping burdens under the 2020 rule and expanding the scope of permissible considerations, so plan fiduciaries should not generally need to anticipate new compliance obligations.

That said, fiduciaries who currently use ESG factors — or seek to apply ESG factors in the future — may want to consider how this proposed rule will affect current (or future anticipated) processes in order to determine whether to comment on the proposed rule — directly or through representative groups.

The DOL welcomes comments on any aspect of the proposed rule. It was notable to us that there are several specific questions and concepts raised throughout the preamble on which the DOL called out a request for comments.

For example, the DOL specifically requested comment on whether climate change risk should be considered presumptively material in the assessment of investment risks and returns. This active solicitation of comments, both generally and specifically, suggests the DOL may be testing the waters on whether to take an even more pro-ESG stance in the final version of the rule.

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[1] https://www.govinfo.gov/content/pkg/FR-2021-10-14/pdf/2021-22263.pdf.