EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION

NEW PROPOSED REGULATIONS AND USE OF ESG FACTORS IN ERISA PLANS' INVESTMENT SELECTION AND PROXY VOTING PROCESSES

For decades, the Department of Labor ("DOL") has maintained that the fiduciary of a benefit plan subject to the Employee Retirement Income Security Act ("ERISA") cannot, in pursuit of goals not germane to the plan's finances, make investment decisions that are not as economically advantageous to the plan as other available investment courses of action would be. At present, this issue arises most frequently when plans consider investment funds or strategies focused on "environmental, social and/or governance" ("ESG") factors. For example, an ESG fund intended to promote environmental sustainability might bar all investments in fossil fuel producers, even if a particular investment was otherwise attractive. If this strategy demonstrated lower returns and/or higher risk than an otherwise-comparable fund, selection of the environmental fund in lieu of the more remunerative alternative would in many cases be imprudent. In a similar vein, the DOL has also held that proxy voting rights must be exercised in the economic best interests of the plan, and may not sacrifice those interests to promote other objectives.

Since 1994, the DOL has attempted in various pieces of guidance to delineate the circumstances in which fiduciaries can take other considerations (such as ESG goals) into account without running afoul of the obligation to act for the plan's exclusive benefit. Prior to 2020, notwithstanding cautionary messages from the Trump Administration and a 2018 prohibition on ESG funds acting as qualified default investment alternatives,[1] it had been largely accepted that fiduciaries could act based on ESG considerations when:

- The ESG consideration was also a bona fide economic factor and was considered in that context (for example, a company with extensive environmental clean-up liabilities or a history of fraudulent management conduct is a less attractive investment than an otherwise-similar company without those issues); or
- All other considerations were equal, and the ESG factor acted as a "tie-breaker."

In 2020, the Trump Administration DOL issued regulations restricting ERISA plans from making investment decisions based on "non-pecuniary" factors as well as regulations regarding fiduciary responsibilities for the exercise of proxy voting rights and other shareholder rights associated with securities held by a benefit plan. While the final regulatory text omitted specific language in the Trump Administration's original regulatory proposal that expressed clear hostility toward ESG considerations, the

[1] In Field Assistance Bulletin 2018-01, the Trump Administration asserted that an ESG investment should not be designated as a qualified default investment alternative because designating a fund for this purpose that was aligned with the fiduciary's non-economic goals but not necessarily with all participants' views would call into question the fiduciary's compliance with ERISA's requirement of fiduciary loyalty. It is not clear why the Trump Administration thought that a participant's ability to freely transfer funds out of a qualified default investment alternative to another investment was not a solution to this concern, and this concern is one that the new proposed regulations reject.

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regulatory preambles continued to express a skeptical view of ESG-oriented decision making by benefit plans.[2] The final Trump regulations also:

- Imposed specific restrictions on certain actions based on "non-pecuniary" factors;
- Followed Field Assistance Bulletin 2018-01 and prohibited the selection of an ESG-themed fund as a qualified default investment alternative;
- Imposed additional analysis and documentation requirements on the exercise of proxy voting rights; and
- Imposed additional analysis and documentation requirements on a fiduciary's use of the "tie-breaker" process to make an investment decision (such as the selection of an ESG-themed fund) after reaching the conclusion that two available investments or investment courses of action could not be distinguished based on pecuniary factors. The DOL expressed skepticism that a true "tie-breaker" situation involving economically indistinguishable investments would in fact arise.

Both sets of regulations were met with intense opposition from the financial industry as well as benefit plan sponsors and fiduciaries. In particular, commentators:

- Noted the lack of any evidence that benefit plans had been engaging in problematic conduct;[3]
- Provided extensive data to challenge the Trump DOL's premise that ESG-themed investing was likely to involve sacrifices in investment performance;
- Cited widespread acknowledgment that factors which happen to be ESG factors are generally also an important part of an economic analysis;
- Identified participant interest in ESG-themed investments as a potential motivator to increase retirement savings;[4]
- Objected to the burdensome documentation rules; and
- Raised concerns that the new rules created unnecessary litigation risk by suggesting that a fiduciary's inclusion of ESG considerations (even in their pecuniary aspect) in an investment analysis or a decision to exercise voting rights could be alleged by opportunistic plaintiffs' lawyers or hostile government auditors to constitute problematic conduct.

On March 10, 2021, the Biden Administration DOL announced a temporary non-enforcement policy for the Trump regulations and indicated its intention (in keeping with a directive from President Biden) to reconsider the regulations.

The Biden DOL has now proposed new regulations. The proposed regulations would replace the Trump regulations with a framework notably more accommodating of the consideration of ESG factors as part of an

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[2] While the DOL acknowledged that an ESG factor could also be a "pecuniary" factor, its overall tone on this point was one of doubt, despite widespread sentiment to the contrary in the financial industry.
[3] Statistics indicate that the percentage of ERISA plan assets invested in ESG-themed products or taking action based on ESG goals is and historically has been quite small. This is distinct from plans taking ESG factors into account when appropriate to an economic analysis, which is in keeping with current financial industry norms.
[4] Participants and beneficiaries directing the investment of their defined contribution plan accounts under Section 404(c) of ERISA are not subject to ERISA's fiduciary standards when making investment decisions.

economic analysis, as well as allowing more liberal use of the "tie-breaker" rule. The proposed regulations would also remove language widely perceived as stating a presumption against the exercise of proxy voting rights, returning to the pre-Trump DOL position that "In general, fiduciaries should take their rights as shareholders seriously, and conscientiously exercise those rights to protect the interests of plan participants." However, the proposed regulations continue to emphasize the primacy of the plan's economic best interests. More specifically, the proposed regulations:

- Reiterate the requirement 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."
- State that plan fiduciaries, in the course of complying with the regulatory requirement to give "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…may 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." The proposed regulations add that the list of material factors may include (but are not limited to) "climate change-related factors," "governance factors" and "workplace practices."
  - The proposed regulations emphasize that "The weight given to any factor by a fiduciary should appropriately reflect a prudent assessment of its impact on risk-return," and the regulatory wording does not require the consideration of any particular factor when not warranted by the circumstances. However, the proposed regulations also assert that "appropriate consideration…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." Ultimately, this statement, along with the overall context and the preamble discussion, indicate that the DOL anticipates that at least the "E" (environmental) component of "ESG" will frequently be financially material.[5] Fiduciaries should be sure their due diligence protocols provide for engagement with ESG factors when economically warranted.
  - The proposed regulations continue to require fiduciaries to compare a particular investment or investment course of action to available alternatives. The DOL emphasized that this requirement simply reflects standard expectations for prudent analysis, and is not specific to ESG issues. The agency requested comments on whether it is necessary to state this principle, commenting that it "should be commonly understood."
- Confirm the continued permissibility of the tie-breaker approach, and broaden the language used to describe the circumstances in which it can be applied. The proposed regulations explain that "if a fiduciary prudently concludes that competing investments, or competing investment courses of action, equally serve the financial interests of the plan over the appropriate time horizon, the fiduciary is not

[5] President Biden's Executive Order 14030 regarding climate-related financial risk and an accompanying fact sheet specifically targeted the Trump regulations for revision or replacement.

prohibited from selecting the investment, or investment course of action, based on collateral benefits other than investment returns."

- The DOL explained that it had purposely used the broad description of "equally serve the financial interests of the plan" to make it clear that a fiduciary does not need to be able to demonstrate that two choices were "economically indistinguishable." The DOL noted that there might be more than one investment alternative that could be used to construct a sound investment portfolio.
- Use of the "tie-breaker" is permissible to select designated investment alternatives for a participant-directed defined contribution plan,[6] but in that case, the plan fiduciary must ensure that the relevant collateral-benefit characteristic(s) is prominently disclosed to participants. This can be done via the plan's fee disclosure notice and/or in some other reasonable fashion. The DOL noted that disclosures of this type are common in the marketplace.
- The proposed regulations eliminate the Trump regulations' specific rules on the analysis and documentation required for a "tie-breaker" determination. However, the DOL emphasized in the preamble that fiduciaries still must comply with ERISA's general requirements to conduct a prudent review and maintain appropriate documentation of that review and the reasoning behind their decision.

- Eliminate the prohibition on selecting an ESG investment (or another "collateral benefit" investment fund) as a qualified default investment alternative. Accordingly, a fiduciary would be able to select an ESG-themed fund that meets the relevant risk-return and other economic criteria to be a prudent investment and satisfies the regulatory requirements to be a qualified default investment alternative under a plan, so long as the fund's ESG characteristics are properly disclosed.
- Remove regulatory provisions that the DOL (and the benefits community) interpreted as attempting to deter fiduciaries' exercise of proxy voting rights by effectively calling for a decision to vote to be cost-justified. Although the proposed regulations do align with the Trump regulations in providing more detail around proxy voting documentation and processes than pre-regulatory guidance had offered, the proposed regulations nonetheless speak in general terms of prudent analysis and recordkeeping practices and eliminate specific requirements focused on proxy voting decisions as distinct from other types of plan management choices.
  - As under the Trump regulations, the proxy voting rules do not apply to participants or beneficiaries exercising voting rights passed through to them with respect to investments held by their plan accounts. Accordingly, a participant or beneficiary can cast a vote motivated by ESG goals, if the participant or beneficiary wishes to do so. The regulatory standards only apply to votes cast by the plan's fiduciary.[7]
  - The Trump regulations placed a heavy emphasis on the costs involved with voting, strongly implying that in most cases the advantages to the plan of voting would likely not be worth the costs. To be sure, costs had been acknowledged as a relevant consideration even in pre-regulatory

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[6] "Designated investment alternatives" are part of the "core" investment array offered to participants, and do not include investments only available through a brokerage account or similar vehicle.

[7] Shareholder rights not passed through to participants and beneficiaries must be exercised as determined by the trustee unless voting authority is reserved to a named fiduciary or delegated to an investment manager responsible for the assets.

guidance. The DOL's new preamble also agrees that, "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 interests," but then goes on to explain that, "The solution to proxy-voting costs is not total abstention, but is, instead, for the fiduciary to be prudent in incurring expenses to make proxy decisions and, wherever possible, to rely on efficient structures (e.g., proxy voting guidelines, proxy advisers/managers that act on behalf of large aggregates of investors, etc.)."

  - As the DOL's new preamble suggests, in reality, most plans' proxies are voted by their professional managers in keeping with investment policies maintained across a given strategy's client base or are passed through to participants. The process typically involves only nominal costs.

- As part of the proposed regulations' general expectation of a prudent process, fiduciaries who are deciding whether and how to exercise shareholder rights must "act solely in accordance with the economic interest of the plan and its participants and beneficiaries, in a manner consistent with" the normal regulatory rules for fiduciary conduct.
- The proposed regulations' preamble repeats the DOL's long-standing view that plan fiduciaries should establish and maintain proxy voting policies. These policies should be based on their plans' needs and ERISA's requirements, and the DOL has removed provisions of the Trump regulations that established "safe harbor" policy designs.
  - As always, the proposed regulations require that proxy voting guidelines be consistent with the fiduciary's obligations to the plan. Subject to confirming that this standard is met, fiduciaries can adopt guidelines established by plan investment managers and investment vehicles. For example, many collective investment trusts require all investors to agree to the fund's proxy voting policy. As a result, a plan can invest in a trust that imposes such a requirement only if, and for so long as, the fiduciary confirms the proxy voting policies are suitable for the plan. Fiduciaries should review fund proxy voting policies for suitability as part of pre-investment due diligence and periodic reviews.[8]
  - A plan's proxy voting policies cannot prohibit the plan from submitting a proxy if "the matter being voted upon is expected to have a material effect on the value of the investment or the investment performance" of the portion of the plan's portfolio under the fiduciary's management, nor may the policies prohibit the plan from refraining from voting when no material effect is expected. In both cases, the fiduciary should take into account the costs of voting.

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[8] Collective investment trusts are considered "plan assets" vehicles, meaning that their managers are fiduciaries of the investing plans and subject to ERISA's fiduciary duties. In contrast, mutual funds are not subject to ERISA. However, a mutual fund's proxy voting strategy may still be a relevant consideration for a fiduciary deciding whether to invest in or remain invested in a mutual fund. As with any factor, the importance of proxy voting will depend on the circumstances. If a mutual fund or collective investment trust invests primarily in debt securities, for example, the issue is much less likely to arise than in connection with a fund making equity investments in public companies. In most cases, a fund's performance and cost characteristics are likely to be much more important than proxy voting, particularly since proxy voting practices presumably would be reflected in the fund's performance to the extent relevant.

  - As noted above, the DOL has removed two "safe harbor" examples of proxy voting policies created by the Trump regulations that were widely viewed as skewing the analysis against the exercise of voting rights, stating that it does not believe the safe harbors are necessary or helpful. The agency has requested comments on the issue.
- While the proposed regulations remove Trump regulatory provisions calling for special monitoring requirements when proxy voting authority has been delegated, the DOL's preamble explains that the removal reflects the DOL's view that it was unnecessary and inappropriate to single out vendors offering these services for special oversight. Like all plan vendors, proxy voting services and investment professionals making proxy voting recommendations still must be prudently selected and provide their services at a reasonable price.
- Likewise, although specific record retention requirements for proxy votes would be removed by the proposed regulations, plan fiduciaries should maintain appropriate records in order to demonstrate their proper fulfillment of their duties.

Next Steps

Congress may consider legislation intended to make it easier for plan fiduciaries to accommodate interest in ESG strategies. In the meantime, however, plan fiduciaries should adhere to the long-standing principle that benefit plans must be managed in the financial best interests of plan participants, and that these financial interests cannot be subordinated to other goals. In furtherance of this standard, fiduciaries should:

- As always, prudently investigate and periodically review selected investments and vendors, and document the analysis underlying investment and vendor selection/retention decisions as well as other plan management choices.
- Review their current investment policy statements, proxy voting protocols and related documentation for alignment with ERISA and the principles underlying the proposed regulations as well as with the plan's current investment strategies and long-term goals, bearing in mind that the regulations are still only proposed regulations.
- Set up a schedule to revisit investment policy statements, proxy voting protocols and related documentation at intervals going forward, not only in case of legal changes, but in case the plan's financial needs change, investment strategies or best practices evolve, or other factors make a revision to these documents appropriate.
- Periodically review the vendors providing investment management and proxy voting services, to ensure that they remain well-qualified, cost-effective, and suitable to the plan's investment needs.
- Make sure that a system is in place to confirm that investment managers and any other vendors responsible for proxy voting services are voting as required by the plan's proxy voting protocols and that appropriate records are being kept.
- For participant-directed defined contribution plans, confirm that any ESG funds or any other investments that were (or might be perceived as having been) chosen on the basis of "collateral benefit" factors are providing proper disclosure.

- Particularly in light of the new regulations' "proposed" status, be sure to discuss the risks and rules with counsel before making decisions based on ESG "collateral benefits" factors.
- Notwithstanding the prior bullet, confirm that investment professionals will consider ESG factors when those factors (notwithstanding their ESG status) are appropriate to the economic analysis.

If you have any questions regarding this LEGALcurrents, please contact any member of the Employee Benefits and Executive Compensation group at 585.232.6500, 716.853.1616, or visit www.hselaw.com.