More ESGcitement From the DOL – New Proposed Investment/Proxy ERISA Regulations

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The U.S. Department of Labor (the "DOL") on October 14, 2021, released a new Proposed Regulation (the "Proposed Regulation") generally relating to the prudence and loyalty duties under the fiduciary rules of the Employee Retirement Income Security Act of 1974 ("ERISA") and to the voting of proxies. The Proposed Regulation is the latest attempt to address the appropriateness of the consideration of environmental, social and governance ("ESG") factors in connection with investment-related decisions by fiduciaries of employee benefit plans that are subject to ERISA ("Plans").

While the Proposed Regulation does not expressly mention ESG factors, it is nevertheless driven by ESG considerations. The Proposed Regulation would reframe certain aspects of the existing newly amended ERISA regulations to bring them more in-line with the current administration's approach to ESG generally.

Since 1994, the DOL under various presidential administrations has published guidance (referred to as "sub-regulatory authority"), regarding economically targeted investments, the precursor to recent years' ESG factors. The DOL's view, as exemplified in such guidance, reflects a pendulum, as sub-regulatory authority has been tailored to be consistent with the varied agendas of each presidential administration.

The previous administration released a proposed regulation on June 23, 2020 and a subsequent final regulation on Octo ber 30, 2020 (the "2020 Proposed Prudence Regulation" and the "Existing Prudence Regulation ," respectively), directly addressed by the Proposed Regulation. The previous administration also released a proposed regulation on August 31, 2020 and subsequent final regulations on December 11, 2020 (the "2020 Proposed Proxy Regulation" and the "Existing Proxy Regulation ," respectively). Many regarded these efforts as an attempt to address that administration's concerns about the growth in ESG and other collateral considerations. While the Existing Prudence Regulation and Existing Proxy Regulation (together, the "Existing Regulations") reflect the previous administration's view that a fiduciary's consideration of ESG factors should be minimal, the preamble to the Proposed Regulation (the "2021 Proposed Regulation Preamble") may possibly be read to go so far as to affirmatively consider ESG factors to be appropriate considerations when selecting and monitoring Plan investments.

Our May 2020 OnPoint, ERISA's Social Goals? ESG Considerations Under ERISA, traces the development of the DOL's ESG-related authority over the years and contains other general background regarding ESG considerations under ERISA. In addition, the Existing Prudence Regulation is further discussed in our November 2020 OnPoint, An ESGplanation of ERISA's New Regulation on Social Investing and the Existing Proxy Regulation is addressed in our December 2020 OnPoint, Voting on Principle – ERISA Proxy Regulation Finalized.

The Trump administration's decision to memorialize its approach in regulatory language (rather than continuing the swings of successive iterations of sub-regulatory advice) has now apparently pushed the Biden administration to propose a regulatory amendment in an effort to move to a more ESG-friendly approach. Indeed, the 2021 Proposed Regulation Preamble goes so far as to suggest that ESG factors may be appropriate considerations when selecting and monitoring Plan investments. Additionally, the Proposed Regulation would allow for elimination of the stringent documentation requirements set forth in the Existing Regulations.

This latest effort is subject to all applicable notice-and-comment requirements (as was the case for the Existing Regulations). With rules now enshrined in the regulations themselves, the pendulum now, as an expected result of the issuance of the Existing Regulations, will no longer swing so easily – but, as the Proposed Regulation shows, may nevertheless indeed continue to swing.

DISCUSSION

I. Overview

During the last 30 years, the DOL has issued guidance regarding ERISA's fiduciary duties in respect of Plan investments that promote objectives such as furthering environmental, social or public policy goals. The DOL has consistently indicated that ERISA does not necessarily prohibit fiduciaries from making investment decisions that reflect ESG considerations. Still the DOL has cautioned fiduciaries that they could not subordinate the interests of plans to further ESG goals. In this regard, the operative language of this Proposed Regulation is quite clear that a "fiduciary may not . . . accept reduced returns or greater risks to secure [collateral benefits]." The DOL also has been clear that the exercise of voting rights as well as other shareholder rights connected to shares of stock are fiduciary acts subject to ERISA's fiduciary requirements.

Over the years, the debate has focused to a significant extent on (i) the extent to which ESG (and similar collateral) factors may be used to support a position that a given investment is in the best economic interests of the Plan and (ii) the circumstances in which a Plan fiduciary may choose an investment that utilizes ESG factors as a "tie-breaker" when comparing otherwise substantially identical investment propositions. Differences in the tone and tenor of the DOL's guidance in different administrations has created confusion about these investment issues and could well be described as giving rise to an unhelpful "regulatory game of ping pong."

To continue the metaphor, the Trump administration's Existing Prudence Regulation, however, arguably converted the decades'-long game of table-tennis into one of tennis: the move to abandon sub-regulatory guidance in favor of actual regulatory language effectively moved the game to a larger playing surface. In particular, a final regulation by its very nature has greater legal significance and permanence. Unlike sub-regulatory guidance, final regulations require formal notice and comment. Whether or not any Biden administration's effort to amend the Existing Prudence Regulation will be the final say on the matter remains to be seen.

The Proposed Regulation does not use the term "ESG." Nevertheless, the 2021 Proposed Regulation Preamble mentions ESG some 346 times (and mentions "climate change" some 129 times). Thus, even though the title of the Proposed Regulation is fairly neutral, it would appear as in the case with the Existing Prudence Regulation that it is designed to serve a specific policy objective. In this case, the policy objective squares with President Biden's two earlier Executive Orders regarding climate change, released in January 2021 and May 2021[1] (the latter specifically directing the DOL to "consider publishing . . . for notice and comment a proposed rule to suspend, revise, or rescind

[1] Exec. Order No. 13990, Protecting Public Health and the Environment and Restoring Science to Tackle the Climate Crisis (available at: https://www.federalregister.gov/documents/2021/01/25/2021-01765/protecting-public-health-and-the-environment-and-restoring-science-to-tackle-the-climate-crisis) and Exec. Order No. 14040, Climate-Related Financial Risk (available at: https://www.federalregister.gov/documents/2021/05/25/2021-11168/climate-related-financial-risk).

the [Existing Regulations]") and a DOL March 2021 enforcement policy[2] indicating the DOL would not enforce the Existing Regulations pending the DOL's reconsideration of them.

Features of the Proposed Exemption: ESG

- **Explicit Recognition of the Potential Financial Impact of "Climate Change and Other ESG Factors.**" The Proposed Regulation would retain the core principle that ERISA Plan fiduciaries must focus on material risk-return factors and can never subordinate the interests of participants and beneficiaries under the plan. However, the Proposed Regulation would address the concern that the Existing Regulations created uncertainty and may "have the undesirable effect of discouraging ERISA fiduciaries' consideration of climate change and other ESG factors in investment decisions[,]" even in cases when it is in the financial interest of plans to take such considerations into account. Accordingly, the Proposed Regulation would make clear that ESG factors can (and in some cases must) be considered in connection with a fiduciary's investment analysis. Indeed, the Proposed Regulation expressly confirms the DOL's view that such considerations can be "financially material."

- **Specific Examples of ESG Factors that May Be Material to a Fiduciary's Risk Return Analysis.** The Proposed Regulation would include three non-exclusive sets of examples of ESG factors that may be material to a fiduciary's risk/return analysis relating to (i) climate change, (ii) corporate governance, including board composition, executive compensation, transparency and accountability in corporate decision-making and good corporate behavior, such as avoiding criminal liability and compliance with labor, employment, environmental, tax and other laws and (iii) workforce factors, including workforce diversity and inclusion, investment in training, equal employment opportunity and labor relations.

- **Elimination of Express Restriction on ESG-themed "Qualified Default Investment Alternatives" ("QDIAs").** The Proposed Regulation would eliminate the Existing Prudence Regulation's prohibition on using ESG factors or investments as components for QDIAs. The 2021 Proposed Regulation Preamble states that "there appears to be no apparent reason to foreclose plan fiduciaries from considering [such investment alternatives] as a QDIA."

- **Less Restrictive "Tie-Breaker" Rule.** In determining whether a fiduciary may select an investment based on collateral considerations, the Proposed Regulation would move away from the "economically indistinguishable" standard included in the Existing Prudence Regulation in favor of a standard that looks to whether a fiduciary prudently concludes that competing investments or competing investment courses of action "equally serve the financial interests of the Plan over the relevant time horizon." The DOL in the preamble to the Existing Prudence Regulation (the "Existing Prudence Regulation Preamble") indicated that it had been skeptical that a tie-breaker scenario was anything more than theoretical. The Biden administration's DOL conversely signaled that it believes tie-breakers may be more broadly appropriate and has a more accepting view of factors that might be considered in determining whether competing investments or investment courses of action might serve a Plan's interests equally.

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[2] U.S. Dept. of Labor News Release, U.S. Department of Labor Statement Regarding Enforcement of Final Rules on ESG Investments and Proxy Voting by Employee Benefit Plans (available at: https://www.dol.gov/sites/dolgov/files/ebsa/laws-and-regulations/laws/erisa/statement-on-enforcement-of-final-rules-on-esg-investments-and-proxy-voting.pdf).

- **Elimination of Some Documentation Requirements**. The Proposed Regulation would eliminate the Existing Prudence Regulation's special documentation requirement when a tie-breaker analysis is used.

- **Addition of New Documentation Requirements**. The Proposed Regulation, however, would add a new disclosure requirement. Where a tie-breaker analysis is used in selecting a "designated investment alternative" (including a qualified default investment alternative, or "QDIA") in a participant directed defined contribution plan like a 401(k) plan, the "collateral-benefit characteristic of the fund, product or model portfolio" would have to be disclosed to plan participants to so that they have "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."

Main Features of the Proposed Exemption: Proxy Voting

- **Reverts to Prudence, Eliminates Special Call Outs on Monitoring and Documentation Requirements, Eliminates Safe Harbors**. The Proposed Regulation would eliminate the Existing Proxy Regulation's statement that ERISA "does not require the voting of every proxy or the exercise of every shareholder right," eliminate what many regarded as an enhanced proxy monitoring requirements fo r plans with respect to investment managers and proxy advisory firms they engage and eliminate the two safe-harbors, which allowed fiduciaries to limit the circumstances when they would exercise their voting rights.

- **Revokes Special Documentation Requirement**. The Existing Prudence Regulation requires that when deciding whether to exercise shareholder rights and when exercising shareholder rights, fiduciaries must maintain records on proxy voting activities and other shareholder rights. The Proposed Regulation would remove this requirement out of concern that it could be regarded as imposing greater fiduciary obligations than would otherwise apply with respect to other fiduciary decisions.

- **Changes Designed to Avoid Confusion; Avoid Disincentive to Exercise Ownership Rights**. The DOL indicated the rule changes in the Proposed Regulation were made because, based on stakeholder feedback, they were concerned the Existing Regulations caused confusion and likely would chill fiduciaries' exercise of their ownership rights.

Timing

- The comment period runs for 60 days after publication in the Federal Register (12/13/2021). The DOL indicates that commenters are free to express views not only on the provisions of the proposal, but on any issues germane to the subject matter of the proposal.

- The 2020 Proposed Prudence Regulation received almost 9,000 comments. It would not be surprising to anticipate that the Proposed Regulation will generate similar interest by stakeholders.

II. General Background

Under ERISA, a Plan fiduciary has a duty to act prudently and solely in the best interests of Plan participants and beneficiaries. The duty of prudence requires fiduciaries to act with "the care, skill, prudence and diligence of a prudent person acting in a like capacity and familiar with such matters." The duty of prudence requires diversifying

investments to minimize the risk of large losses and acting in accordance with the proper Plan documents. The duty of loyalty requires Plan fiduciaries to act "for the exclusive purpose of providing benefits to participants and beneficiaries." The Existing Prudence Regulation expressed concerns that ESG considerations arguably could raise issues under the duty of loyalty that other pecuniary considerations might not raise.

The DOL's interpretations over the course of various administrations have been consistent on the fundamental point that a fiduciary may not subrogate a Plan's investment returns to accommodate ESG (or other) benefits, and ESG factors may not overtake financial considerations or be utilized at the expense of other cost indicators, such as rate of return. However, successive administrations have disagreed as to the extent to which ESG (and similar collateral) factors may be used to support a Plan fiduciary's decision to invest Plan assets.

A concept that emerged early is generally that it may be possible to use ESG-type factors as a kind of "tie-breaker," so to speak, so that collateral factors may indeed be considered when all other factors between two or more investment choices are effectively equivalent. Thus, in Interpretive Bulletin 94-1, the DOL permitted the consideration of collateral benefits in tie-breaker scenarios, such as where other financial factors were not dispositive. In 2008, DOL guidance under a Republican administration more firmly restricted investment decisions based on factors "other than the economic interest in the plan" and emphasized that tie-breakers only exist when alternatives are "truly equal" from both a quantitative and qualitative perspective. In 2015, the pendulum swung again, as, DOL guidance under a Democratic administration emphasized that ESG considerations are "proper components of the fiduciary's primary analysis."

III. The Existing Regulations

Overview

The DOL under the Trump administration seemed frustrated with the vagaries surrounding ESG in the ERISA context. In the Existing Prudence Regulation Preamble, the DOL said:

> As ESG investing has increased, it has engendered important and substantial questions with numerous observers identifying a lack of precision and consistency in the marketplace with respect to defining ESG investments and strategies, as well as shortcomings in the rigor of the prudence and loyalty analysis by some participating in the ESG investment marketplace. There is no consensus about what constitutes a genuine "ESG" investment, and ESG rating systems are often vague and inconsistent, despite featuring prominently in marketing efforts. . . . In part, the confusion stems from the fact that, from its beginning, the ESG investing movement has had multiple goals, both pecuniary and non-pecuniary. Moreover, ESG funds often come with higher fees, because additional investigation and monitoring are necessary to assess an investment from an ESG perspective.

It may not be surprising then, that the DOL in the Existing Prudence Regulation Preamble exhibited significant skepticism of ESG's place in an ERISA fiduciary's investment considerations, stating, for example, that:

> The purpose of this action is [to] separate the legitimate use of risk-return factors from inappropriate investments that sacrifice investment return, increase costs, or assume additional investment risk to promote non-pecuniary benefits or objectives. . . . The Department . . . cautions fiduciaries against too hastily concluding that ESG-themed funds may be selected based on pecuniary factors or are not distinguishable based on pecuniary factors . . . .

In the course of finalizing the Existing Regulations, the DOL softened its proposed approach to ESG from the initial proposal, even ultimately deleting all express references to ESG. Nevertheless, the Existing Regulations still effectively significantly limit the ability for ESG factors to be utilized. For example, the DOL expressed concerns in the Existing Prudence Regulation Preamble that ESG investing could result in "lack of precision and consistency in the marketplace with respect to defining ESG investments and strategies, as well as shortcomings in th e rigor of the prudence and loyalty analysis by some participating in the ESG investment marketplace." Similarly, regarding proxy voting, the DOL expressed in the preamble to the Existing Proxy Regulation (the "Existing Proxy Regulation Preamble") that there was a "general concern that responsible fiduciaries might be accepting investment managers' proxy voting policies without sufficient review as to whether those policies comply with ERISA and, if so, whether the investment managers were complying with those policies."

ESG as a Pecuniary Factor

The Existing Prudence Regulation belies a fair degree of skepticism that fiduciaries would be able to justify that ESG factors could drive favorable economic performance for Plans. Indeed, the tenor of the Existing Prudence Regulation Preamble suggested that the use of ESG factors could even be harmful to Plans from a pecuniary perspective. The DOL's approach seems to have been premised, in part, on the uncertainties associated with measuring ESG impacts. The DOL wondered, for example, whether generally accepted investment theories had yet evolved to support the consideration of ESG factors as affirmatively positive.

Nevertheless, the Existing Prudence Regulation did not foreclose the possibility that ESG coul d have a place in a Plan fiduciary's analysis on investment decisions. It just requires that in order to take ESG into account, fiduciaries would first determine that a consideration of ESG factors would be demonstrably helpful to the Plan's pecuniary interests. For example, in the preamble to the 2020 Proposed Prudence Regulation (the "2020 Proposed Prudence Regulation Preamble"), the DOL noted that "there are certain instances where environmental considerations will present an economic business risk," such as " a company's improper disposal of hazardous waste, [which] would likely implicate business risks and opportunities, litigation exposure, and regulatory obligations" and "dysfunctional corporate governance," or other factors that, in each case, would be material economic considerations generally accepted investment theories (referred to therein as "Pecuniary ESG Factors"). Nevertheless, the Existing Prudence Regulation is arguably consistent with the proposition that even where solid Pecuniary ESG F actors exist, they must be considered alongside other relevant economic considerations to evaluate the risk and return and the weight given should reflect a prudent assessment of their impact on risk and return.

ESG as a Tie-Breaker

One of the issues that has accompanied the decades' long game of regulatory ping-pong has been the extent to which (if any) a fiduciary could consider ESG and other collateral factors as sort of a tie-breaker between equivalent investment options. Under this effectively "no harm, no foul" approach, proponents had argued that a Plan would not suffer any detriment if all things are effectively equal between two competing investment options and a fiduciary chose the investment option that furthers ESG or other collateral goals. Th e DOL acknowledged (in the 2020 Proposed Prudence Regulation Preamble) that two investments could be economically indistinguishable. But it also called out the fact that it was skeptical that the existence of a so-called "tie-breaker" scenario could be anything more than a theoretical possibility: "the [DOL] expects that true ties rarely, if ever, occur."

Nevertheless, the DOL's view was that fiduciaries will rarely "consider two investment funds, looking only at one objective measure, and find the same target risk-return profile or benchmark, the same fee structure, the same performance history, same investment strategy, but a different underlying asset composition." The DOL later noted

(in the Existing Prudence Regulation Preamble) that "there was disagreement among commenters as to whether true ties actually occur" and that "the tie-breaker test should be simplified and focus on situations where the fiduciary is unable to distinguish investment alternatives on the basis of pecuniary factors alone, rather than demanding that investments be identical in each and every respect before the tie-breaker provision would be available."

ESG in Funds Used as QDIAs

The Existing Prudence Regulation also provides that QDIAs require special treatment and expressly provides that a fund, product or portfolio may be part of a QDIA if its investment objectives or goals or its principal investment strategies include, consider or indicate the use of one or more non-pecuniary factors. The Existing Prudence Regulation Preamble makes clear that "the special rule for QDIAs is not focused on whether an investment…applies any particular 'E', 'S', or 'G' factors in operation[,]" but focuses on whether any given factor is "pecuniary or non-pecuniary in nature, and that the selection of ESG funds is not per se prudent or imprudent." This disqualification is potentially significantly important as a practical matter, to the extent that participants and beneficiaries under participant-directed Plans simply leave their accounts invested in QDIAs without making affirmative investment decisions to reallocate to other investment alternatives.

Documentation and Other Support

The Existing Prudence Regulation includes a documentation requirement for decisions based on non-pecuniary factors intended to constitute tie-breakers, with the DOL intending to provide a "safeguard against the risk that fiduciaries will improperly find economic equivalence and make decisions based on non-pecuniary factors without a proper analysis and evaluation."

Generally, if Plan fiduciaries use non-pecuniary ESG factors, under the Existing Prudence Regulation they must document (i) why pecuniary factors were not sufficient to select the investment or investment course of action; (ii) how the investment compares to the alternative investments with regard to (A) the composition of the portfolio with regard to diversification, (B) the liquidity and current return of the portfolio relative to anticipated cash flow requirements of the Plan and (C) the projected return of the portfolio relative to the funding objectives of the Plan and (iii) how the chosen non-pecuniary factor or factors are consistent with the interests of the participants and beneficiaries in their retirement income or financial benefits under the Plan.

Proxy Voting

Under the Existing Proxy Regulation released on December 11, 2020, the DOL addressed fiduciary duties of prudence and loyalty with respect to the exercise of shareholder rights, including proxy voting, the use of written proxy voting policies and guidelines and the selection and monitoring of proxy advisory firms. The Existing Proxy Regulation provides that ERISA does not require the voting of every proxy, but rather that fiduciaries must act prudently and solely in the interest of Plan participants when deciding whether and how to vote. The DOL indicated that fiduciaries could satisfy this standard by adopting voting policies and parameters prudently designed to serve the Plan's economic interest. The Existing Proxy Regulation includes two safe harbors, one based on limiting voting to proposals related to the issuer's business activity or are expected to have a material effect on the investment's value and another based on voting only if the Plan's interest in the issuer is above a certain percentage of the Plan's total assets.

As in the case with the Existing Prudence Regulation, the DOL's effort with respect to proxy voting under the Existing Proxy Regulation may be characterized as addressing at least three particular areas of concern: (i) some Plan

fiduciaries have considered incorporating non-pecuniary factors into proxy decisions, (ii) fiduciaries have misunderstood the DOL's existing sub-regulatory guidance and (iii) Plans may be over-relying on proxy firms without ensuring that their recommendations are in the economic interests of the Plan. It may have appeared to some that the DOL's efforts under the Trump administration were an attempt to thwart a fiduciary's use of Plan assets to advance political or social justice issues, including ESG issues, through proxy resolutions that are not "solely in accordance with the economic interests of the plan and its participants and beneficiaries." In this regard, the DOL in the Existing Proxy Regulation Preamble cautions fiduciaries against "overly expansive" interpretations of the Plan's "economic interests" such as "vague or speculative notions that proxy voting may promote a theoretical benefit to the global economy that might redound, outside the plan, to the benefit of Plan participants . . . ."

The DOL indicated in the Existing Proxy Regulation that the fiduciary would need to include an evaluation of the costs as well as benefits involved in a proxy vote, including "expenditures for organizing proxy materials; analyzing portfolio companies and the matters to be voted on; determining how the votes should be cast; and submitting proxy votes to be counted." These expenditures also included extraordinary costs relating to particular proxies, including those of foreign issuers, and "[o]pportunity costs in connection with proxy voting . . . such as foregone earnings from recalling securities on loan or if, as a condition of submitting a proxy vote, the plan will be prohibited from selling the underlying shares until after the shareholder meeting."

Status of the Existing Regulations

As noted above, on January 12, 2021, President Biden issued Executive Order 13990 "Protecting Public Health and the Environment and Restoring Science to Tackle the Climate Crisis,"[3] which provides a non-exclusive list of agency actions, including the Existing Regulations, that are to be further reviewed. On March 10, 2021, the DOL followed with the issuance of a nonenforcement policy regarding the Existing Regulations (the "Nonenforcement Policy").[4] Under the Nonenforcement Policy, pending further guidance, the Existing Regulations will not be enforced by the DOL, and no actions will be taken by the DOL against Plan fiduciaries based on a failure to comply with the Existing Regulations. However, in our experience, there remains concern regarding the Existing Regulations among fiduciaries, and therefore managers and other fund sponsors, in that (i) the Existing Regulations are presently still in effect and (ii) the nonenforcement policy does not foreclose participants and beneficiaries from bringing causes of action or other claims based upon the Existing Regulations.

IV. The Proposed Regulation

Overview

The 2021 Proposed Regulation Preamble expresses concerns regarding the Existing Regulations, stating that "the current regulation has created a perception that fiduciaries are at risk if they include any ESG factors in the financial evaluation of plan investments," and that, unlike the Existing Regulations, the Proposed Regulation would make clear

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[3] Exec. Order No. 13990, Protecting Public Health and the Environment and Restoring Science to Tackle the Climate Crisis (available at: https://www.federalregister.gov/documents/2021/01/25/2021-01765/protecting-public-health-and-the-environment-and-restoring-science-to-tackle-the-climate-crisis).

[4] U.S. Dept. of Labor News Release, U.S. Department of Labor Statement Regarding Enforcement of Final Rules on ESG Investments and Proxy Voting by Employee Benefit Plans (available at: https://www.dol.gov/sites/dolgov/files/ebsa/laws-and-regulations/laws/erisa/statement-on-enforcement-of-final-rules-on-esg-investments-and-proxy-voting.pdf).

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 and investment risks and returns."

Indeed, the 2021 Proposed Regulation Preamble also expresses concern that the uncertainty surrounding the Existing Regulations act as a deterring factor that would cause it to act more ESG-adverse than other marketplace investors, by creating a perception that fiduciaries are "at risk if they include any ESG factors in the financial evaluation of Plan investments." The 2021 Proposed Regulation Preamble further provides that failure to consider ESG factors may "hamper fiduciaries as they attempt to discharge their responsibilities prudently and solely in the interest of Plan participants and beneficiaries."

General Scope

In keeping with Biden administration priorities, it is perhaps not a surprise that the DOL uses examples that focus on environmental (the "E" in "ESG") factors. The Proposed Regulation would expressly permit fiduciaries to consider "[c]limate 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."

However, the 2021 Proposed Regulation Preamble and the operative proposed language would also make clear that:

"governance factors, such as those involving board composition, executive compensation, and transparency and accountability in corporation 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" may be considered by a fiduciary; and

"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" may also be considered by a fiduciary.

The 2021 Proposed Regulation Preamble notes that "[t]he list of examples . . . is not exclusive" and that "the Department solicits comments on whether other or fewer examples would be helpful to avoid regulatory bias." Commenters may wish to consider if and how they may wish to address this invitation.

ESG and Financial Analysis

The Proposed Regulation would allow ESG factors to be considered in connection with a fiduciary's investment analysis. The 2021 Proposed Regulation Preamble notes that "consideration of the projected return of the portfolio relative to the funding objectives of the Plan may often require an evaluation of the economic effects of climate change and other ESG factors" and that a fiduciary's calculus "may often require an evaluation of the effect of climate change and/or government policy changes to address climate change on investments' risks and returns" and that "climate-related financial risk[s]…are, in appropriate cases, risk-return factors that fiduciaries should take into account when selecting and monitoring plan investments and investment courses of action."

While the Proposed Regulation, like the Existing Prudence Regulation, does not expressly mention ESG (though the preambles of both make extensive references to ESG), the Proposed Regulation, unlike the Existing Prudence Regulation, also does not use words "pecuniary" and "non-pecuniary." More generally, the DOL's view on the

relationship between ESG factors and the duty of prudence has (maybe not surprisingly) taken a turn from its view under the Trump administration.

In particular, the 2021 Proposed Regulation Preamble provides that ESG factors could be financially material to a Plan and expresses concerns that the Existing Prudence Regulation discourages Plan fiduciaries from considering such factors, with a "chilling effect on appropriate integration of material climate change and other ESG factors in investment decisions."

Indeed, the Proposed Regulation would appear to go so far as to provide expressly that consideration of ESG factors is consistent with the fiduciary duty of prudence and that a fiduciary would be permitted to consider any factor material to the risk-return analysis, including ESG factors. Particularly, ESG factors would be able to be part of a risk-return analysis and they would be treated no differently from other "traditional" material risk-return factors. The DOL wants to counter concerns that "fiduciaries are at risk if they include any ESG factors in the financial evaluation of plan investments." Thus, ESG factors could be appropriate "even though the investment, when considered in isolation from the portfolio as a whole, is riskier or less likely to generate a significant positive return than other investments that do not serve the same hedging function."

Some may be reading the Proposed Regulation's operative language as requiring fiduciaries to consider certain ESG and ESG-type factors when making their investment and investment-related decisions. While it remains to be seen how the DOL will endeavor to finalize the Proposed Regulation, such an approach would seem to be in stark contrast to the approach taken thus far under ERISA, as the DOL generally has never mandated with specifics what a fiduciary must consider in pursuing the fiduciary's prudence obligations.[5] Competing policy objectives may well be at play here, with those favoring a more expansive use of ESG factors to advance a climate-based agenda confronting the very real legal safeguards imposed by ERISA in connection with Plans' economic returns.

Tie-Breaker Scenarios

The Biden administration's DOL has a more favorable approach to the tie-breaker rationale than the DOL of the Trump administration. Thus, the Proposed Regulation would move away from the Existing Prudence Regulation's insistence that economically "indistinguishable" alternatives form the basis for invoking a tie-breaker. The 2021 Proposed Regulation Preamble indicates that where "a fiduciary prudently concludes that competing investments or competing investment courses of action equally serve the financial interests of the [P]lan over the relevant time horizon, the fiduciary is not prohibited from selecting the investment, or investment course of action, based on collateral benefits other than investment returns." Expanding still further flexibility offered by certain prior DOL authority, one example given by the 2021 Proposed Regulation Preamble of potentially permissible collateral considerations is where there is a characteristic that "aligns with the corporate ethos of the Plan sponsor or that . . . improves the esprit de corps of the workforce."

As was the case under the Existing Prudence Regulation, investment alternatives must be reviewed based on risk and return factors in order for the door to be open to using ESG factors as tie-breakers. However, in the case of the Proposed Regulation, a tie-breaker would be permissible as long as both alternatives "equally serve the financial interests of the plan over the appropriate time horizon." This softening of the DOL's view under the Biden

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[5] But cf., e.g., Burgess, "$41 Billion Pension Fund Settles Australian Climate Change Lawsuit" (Bloomberg Green, Nov. 1, 2020 (updated Nov. 2, 2020)) (reporting on the settlement of a claim brought in the case of *McVeigh v. Retail Employees Superannuation Trust* against an Australian pension fund to the general effect that the fund was not sufficiently protecting retirement savings against the impact of rising world temperatures).

administration regarding the efficacy of a tie-breaker analysis may well be a fundamental aspect of the evolution of the DOL's thinking as a practical matter, as Plan fiduciaries would be less compelled to show that a consideration of ESG factors would be likely to affect investment returns favorably. This impact may be especially critical if, as suggested by the 2020 Proposed Prudence Regulation Preamble, generally accepted investment principles do not yet support the conclusion that considering ESG factors is likely to increase investment returns.

QDIAs

The Existing Prudence Regulation prohibits the use of ESG factors or investments as components for QDIAs. The Proposed Regulation would not go so far as requiring the use of ESG factors, but instead provides that the general obligations of fiduciaries under ERISA and the QDIA rules specifically should govern the selection of QDIAs. The DOL opines in this regard that such general obligations could include the consideration of other investments, which would include ESG factors. For example, the 2021 Proposed Regulation Preamble rejects the notion that QDIA selection warrants special treatment, providing that "[i]f a fund expressly considers climate change or other ESG factors, is financially prudent, and meets the protective standards set out in the Department's QDIA regulation, . . .there appears to be no reason to foreclose plan fiduciaries from considering the fund as a QDIA." In contrast, the Existing Regulations provides that QDIAs "warrant special treatment because they are unique arrangements under ERISA that help ensure retirement savings for plan participants who have not provided affirmative investment directions for their individual accounts."

Removal of Existing Documentation Requirements: New Disclosure Requirements.

The Proposed Regulation would eliminate the Existing Proxy Regulation's unique specific documentation requirements applicable to tie-breakers, which the DOL believes "singled out and created burdens specifically for investments providing collateral benefits, which many perceived as targeting ESG investing." The DOL believes that the special documentation requirement is also unnecessary due to Plan fiduciaries' general prudence obligations and common documentations and record-keeping requirements. Specifically, the DOL believes that maintaining those special documentation requirements could have a "chilling effect on the use of the tie-breaker provision more generally, including when ESG is not under consideration."

The Proposed Regulation would, however, add a disclosure requirement that the "collateral-benefit characteristic of the fund, product or model portfolio must be prominently displayed in disclosure materials provided to participants" 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."

Proxy Voting

The promulgation of the Existing Proxy Regulation was arguably an effort by the Trump administration to curtail what it believed was pervasive activist voting by Plans on collateral considerations. The Proposed Regulation would eliminate the Existing Proxy Regulation's statement that ERISA "does not require the voting of every proxy or the exercise of every shareholder right." The 2021 Proposed Regulation Preamble indicates, however, that this "does not mean that fiduciaries must always vote proxies or engage in shareholder activism." Instead, the DOL suggests that general prudence considerations govern the analysis.

The Proposed Regulation would require periodic review of proxy-voting policies and would preserve increased flexibility to determine whether to vote on a particular matter by offering a blanket exception to policies in the case

that the Plan fiduciary otherwise determines the material effect of the voting subject. The Proposed Regulation would also revise monitoring requirements by ERISA Plan fiduciaries when the authority to vote proxies has been delegated to an investment manager or a proxy voting firm. The 2021 Proposed Regulation Preamble notes that the Existing Proxy Regulation's language could be interpreted as "requiring some special obligations above and beyond the statutory obligations of prudence and loyalty that generally apply to monitoring the work of service providers," and the Proposed Regulation would reject that approach in favor or a general prudence analysis.

The Proposed Regulation would provide that a pooled investment vehicle with more than one Plan's assets must vote in proportion to each Plan's economic interest in the pooled investment vehicle. Plan fiduciaries generally would be required prior to investing to accept the investment manager's investment policy statement and to assess whether the policy statement is compatible with ERISA.

The Existing Proxy Regulation requires that when deciding whether to exercise shareholder rights and when exercising those shareholder rights, fiduciaries must maintain records on proxy voting activities and other shareholder rights. The Proposed Regulation would remove this requirement out of concern that it creates a "misperception that proxy voting and other exercises of shareholder rights are disfavored or carry greater fiduciary obligations, and therefore greater potential liability, than other fiduciary activities." Accordingly, the Proposed Rule would provide for increased flexibility with regards to voting by allowing principles of prudence to guide the analysis after a fiduciary's consideration of the costs and the benefits.

This portion of the Proposed Regulation would also eliminate extensive monitoring requirements and clarify that there are no additional obligations for purposes of ESG considerations outside of prudence and loyalty. Other changes would include removal of current safe harbors, revisions to proxy-voting policies to increase flexibility, proportionate consideration in the case of pooled investment vehicles and revisions to documentation requirements.

CONCLUSION

While the Proposed Regulation would alter the ESG landscape under ERISA, it would not change the fundamental precept that, to quote the 2021 Proposed Regulation Preamble, "a fiduciary may not . . . accept reduced returns or greater risks" to secure collateral benefits. Indeed, the Proposed Regulation, as it must, would work within the confines of ERISA's statutory language. A key point here, however, consistently with the manner in which sub-regulatory advice has ebbed and flowed over the years, is that the approach of the Proposed Regulation (together with the discussion in the 2021 Proposed Regulation Preamble itself) differs starkly from the approach of the Existing Prudence Regulation as to tone, nuance and details. In particular, the Proposed Regulation would result in significant changes to the treatment of ESG factors as it pertains to Plan fiduciaries' decision-making process, the manner in which ESG fits into the prudence/loyalty analysis generally, the relevance and treatment of ESG factors as possible tie-breakers and any documentation requirements relating to the consideration of ESG factors.

There is also some potential subtle, or maybe not so subtle, impact on the markets for investment capital. For example, it remains to be seen how the flow from the Existing Regulations to the Proposed Regulation (and, presumably, the Proposed Regulation as eventually finalized) will affect the manner in which disclosures for investment funds will address ESG going forward where Plans may be investors. Will there be less discussion of downside risk as a result of ESG considerations and more discussion of hoped-for upside? Additionally, fund sponsors and money managers operating in the global arena would possibly need to find ways to harmonize their practices under ERISA with those under various non-U.S. regimes, which may be much more focused on taking into account ESG with less emphasis on showing that the consideration of ESG factors is beneficial financially.

In addition, global managers with ERISA and non-ERISA clients may continue to struggle to some extent with harmonizing ERISA and other international regimes, even with a more ESG-friendly DOL. In this regard, while the DOL's ESG-related stance has clearly softened, there still may be a significant disconnect between ERISA's general posture regarding the primary focus on investment returns, on the one hand, and a more evident desire under various non-U.S. initiatives to accomplish social goals through investing, on the other.

Regardless of where the Proposed Regulation lands under the Biden administration, fund sponsors and money managers may be somewhat circumspect in their efforts to proceed under what becomes the new rules. Inevitably, the pendulum will swing again, even if the swing requires yet another change to the ERISA regulations, and investment firms may want to protect themselves against having to redesign their ESG-related approaches from the ground up at each successive swing. While the Proposed Regulation seems likely to be finalized, any finalized version may not be the last regulatory or sub-regulatory change, as the pendulum could continue to swing, and the requirements set forth in the Existing Regulations may arise in future guidance. The ping-pong game of successive releases of sub-regulatory guidance would seem still to be afoot, albeit now shifting to the proverbial center tennis court of the world of actual regulations.

At the end of the day, the basic ERISA construct continues to be that financial considerations must be paramount regarding investments. That fundamental directive will remain absent a statutory change. Operating within those rules, the Trump administration leveled a difficult one-two punch directed at ESG, by (i) expressing skepticism regarding the practical efficacy of the tie-breaking rationale and (ii) simultaneously casting aspersions on the notion that presently ESG consideration can be shown to be a financial positive. The Biden administration now proposes to parry away both of these blows by (i) validating the notion of ESG factors as legitimate tie-breakers and (ii) bolstering the notion that considering ESG factors can have a favorable impact on investment returns. The song may remain the same – it's just that different cover bands play the same tune differently.

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