Paul | Weiss

CLIENT MEMORANDUM

October 18, 2021

Department of Labor Proposes Rule to Remove Barriers to Considering ESG Factors in Plan Management

This client alert, part of a series focused on ESG disclosure and regulatory developments, should be read together with our ESG Lexicon, available here, which provides definitions of some of the key terms used in ESG reports, disclosures and regulations.

Key Takeaways

- On October 14, 2021, the Department of Labor (the "DOL") published a proposed rule titled "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights" in the Federal Register (the "Proposal"). The Proposal proposes amendments to the DOL's "investment duties" regulation (the "Current Regulation") under Title I of the U.S. Employee Retirement Income Security Act of 1974, as amended ("ERISA"), which regulates certain duties applicable to fiduciaries of employee benefit plans subject to ERISA ("ERISA Plans").

- The Proposal attempts to address several stakeholder concerns with the Current Regulation, including the Current Regulation's perceived bias against ESG investing and voting proxies. To this end, while the Proposal largely confirms the Current Regulation's emphasis on protecting the economic interests of ERISA Plan participants and beneficiaries, the Proposal also clarifies that ESG factors may often be appropriate considerations for ERISA Plan fiduciaries when making investment or proxy voting decisions on behalf of ERISA Plans. In addition, the Proposal would streamline recordkeeping requirements for ERISA Plan fiduciaries relying on ESG factors when making investment decisions.

Background

The Current Regulation was finalized in late 2020 as an attempt to bring clarity and finality to decades of DOL guidance on the propriety of considering ESG factors when making investment decisions on behalf ERISA Plans (such as the decision to include an investment alternative on a 401(k) plan or to cause an ERISA Plan to invest in an ESG-oriented alternative investment) or voting proxies held by such ERISA Plans. The Current Regulation generally requires ERISA Plan fiduciaries to consider only so-called "pecuniary factors" when making such decisions, and prohibits ERISA Plan fiduciaries from subordinating the economic interests of ERISA Plans in order to serve unrelated, ESG-oriented goals. Under the Current Regulation, ESG factors are permissible considerations for ERISA Plan fiduciaries only when they themselves constitute "pecuniary factors" or, in extremely limited circumstances, when they can serve in a "tie-breaking" role.

After the Current Regulation was published, stakeholders continued to express concern that the Current Regulation effectively discouraged ERISA Plan fiduciaries from considering ESG factors even when permitted by the Current Regulation, and created additional uncertainty on when and whether ERISA Plan fiduciaries could vote proxies on behalf of ERISA Plans. Accordingly, on March 10, 2021, the DOL announced that it had begun a reexamination of the Current Regulation, and pending its review, it would not enforce the Current Regulation or otherwise pursue enforcement actions against any ERISA Plan fiduciary based on a failure to comply with the Current Regulation; see our prior client alert here. This review is part of President Biden's broader agenda to address the growing physical and transitional risks posed by climate change on the U.S. economy, which included a direction to the DOL to consider suspending, revising or rescinding the Current Regulation; see here for President Biden's Executive Order announcing this agenda, as well as our prior client alert here.

The Proposal's Key Changes to the Current Regulation

The Proposal would largely preserve the Current Regulation's central instruction that ERISA Plan fiduciaries, when exercising discretion over ERISA Plan assets (including voting proxies), must remain focused on the economic interests of the ERISA Plan and on its participants and beneficiaries. This means that ERISA Plan fiduciaries generally may not sacrifice investment return or take on additional investment risk to promote benefits or goals unrelated to the economic interests of the ERISA Plan's participants and beneficiaries.

However, the Proposal would address various stakeholder concerns about the Current Regulation's perceived bias against consideration of ESG factors when making investment decisions on behalf of ERISA Plans. First, the Proposal would clarify that ESG factors can, in some circumstances, themselves be material to an ERISA Plan fiduciary's risk/return analysis. Indeed, given the role some ESG factors can be expected to play in long-term economic trends (e.g., given the direct effects of climate change or governmental responses thereto), the Proposal suggests that, in some circumstances, ERISA Plan fiduciaries *should* consider ESG factors when making investment or proxy-voting decisions on behalf of ERISA Plans.

The Proposal would also somewhat expand the circumstances in which ESG factors may serve in a "tie-breaking" role. Under the Current Regulation, ERISA Plan fiduciaries may only consider "pecuniary factors" when making investment decisions on behalf of ERISA Plans, which are factors expected to have a material effect on the risk and/or return of an investment, based on appropriate investment horizons consistent with an ERISA Plan's investment objectives and funding policy. If ESG factors do not themselves constitute "pecuniary factors" when deciding between two investment alternatives or investment courses of action, then the ERISA Plan fiduciary evaluating the alternatives or courses of action may not take ESG factors into account, under the Current Regulation—except in a limited "tie-breaking" role. Further, if an ERISA Plan fiduciary proposes to rely on ESG factors in such a "tie-breaking" role, the Current Regulation requires the ERISA Plan fiduciary to carefully document its decision-making process.

Under the Proposal, the DOL acknowledges that investment alternatives or investment courses of action may be essentially equivalent when considered in their totality (rather than strictly in terms of risk/return), because they serve the economic interests of an ERISA Plan equally well. Accordingly, the Proposal would remove the Current Regulation's stricter "pecuniary factors" standard, which could in turn increase the role that ESG factors could play in "breaking ties" between investment alternative or investment courses of action. In addition, the Proposal would remove the Current Regulation's documentation requirements; under the Proposal, ERISA Plan fiduciaries would be expected to document their consideration of ESG factors like they would any other risk/return factors.

The Proposal would also permit ERISA Plan fiduciaries to select ESG-oriented investments as an ERISA Plan's "qualified default investment alternative," or "QDIA." QDIAs are investment alternatives for individual account plans (such as 401(k) plans) that serve as the "default" investment for participants who have not otherwise made elections for the investment of their retirement contributions. The Current Regulation prohibits ERISA Plan fiduciaries from choosing an ESG-oriented investment as a QDIA, since participants do not necessarily make the decision to promote ESG factors by having their contributions invested in a QDIA. The Proposal would eliminate this prohibition, provided that an ERISA Plan clearly discloses the ESG-based considerations behind any decision to include the investment alternative as a QDIA (this disclosure requirement also applies to any other investment alternative that is selected specifically for ESG-related reasons).

Finally, the Proposal would somewhat liberalize the circumstances in which ERISA Plan fiduciaries may vote proxies on behalf of ERISA Plans. While acknowledging that voting proxies (along with exercising other rights appurtenant to securities owned by an ERISA Plan) is subject to ERISA's general fiduciary duties, the Current Regulation emphasizes that, in some circumstances, researching and voting proxies on matters that are not clearly relevant to the economic interests of an ERISA Plan may constitute an imprudent use of an ERISA Plan's resources. Accordingly, the Current Regulation requires ERISA Plan fiduciaries to specifically document their proxy-voting decisions and provides two complementary "safe harbors" designed to streamline proxy voting decisions.

The Proposal would remove the Current Regulation's documentation requirements for proxy voting, deferring again to the understanding that ERISA Plan fiduciaries generally document their decision-making in the ordinary course. In addition, the Proposal would remove the Current Regulation's "safe harbors" as unduly prescriptive and as treating the decision *not* to vote proxies on behalf of ERISA Plans as subject to a different standard than voting such proxies.

The DOL invites comments on all facets of the Proposal, and any issues germane to the subject matter of the Proposal, during the 60-day period beginning October 14, 2021, and ending December 13, 2021.

Implications

The Proposal clarifies that ERISA fiduciaries are permitted to make ESG-related investments and consider ESG factors in making investment decisions; and that doing such will not necessarily conflict with the fiduciary duties owed to ERISA plan participants and beneficiaries. This clarification may bring comfort to ERISA Plan fiduciaries who acknowledge climate change and other ESG factors as being material to investment decision making and will provide such fiduciaries with clarity on the legal standards associated with integrating climate and other ESG considerations when making investment decisions. Additionally, as ESG factors increasingly emerge into enterprise risk factors, the Proposal makes it clear that ERISA Plan fiduciaries are permitted to participate, when operating prudently and in the best interest of ERISA Plan participants and beneficiaries, in proxy voting matters involving ESG factors. ESG factors when material to the investment can, and most likely will, impact the risk profile and potential returns of such investment. Further, as we anticipate increased regulatory engagement with respect to ESG matters, and as we continue to witness the impact of climate change, social inequities and the heightened focus on other ESG matters both domestically and internationally—the consideration, and materiality, of ESG matters with respect to investment decisions will likely become more and more imperative and commonplace across the investment spectrum and within ERISA Plans.

* * *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Andrew L. Gaines
+1 212-373-3339
againes@paulweiss.com

Jean M. McLoughlin
+1 212-373-3135
jmcloughlin@paulweiss.com

Jake Glazeski
+1 212-373-3131
jglazeski@paulweiss.com

David Curran
+1-212-373-2558
dcurran@paulweiss.com

ESG Associate Reco Charity and Sustainability & ESG Advisory Practice Director Madhuri Pavamani contributed to this Client Memorandum.