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DOL proposes to warm the climate for ESG investing

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The Department of Labor (DOL) proposes to clarify when ERISA plan fiduciaries can consider environmental, social and governance (ESG) factors in investment selection and proxy voting. The proposal would maintain the requirement for fiduciaries to focus on factors material to a risk-return analysis but, unlike the current rule, would make clear that this evaluation may include ESG factors — including climate-change risks. A more flexible tiebreaker standard would apply to consideration of collateral benefits, but with new disclosures for defined contribution (DC) plans. The proposal would lift the restrictions on investments that incorporate nonpecuniary factors from being considered qualified default investment alternatives (QDIAs). DOL also proposes to remove the current rule's proxy-voting policy safe harbors and cumbersome written documentation requirements. Comments on the proposal are due Dec. 13.

Investment selection and monitoring

After President Biden issued an executive order directing federal agencies to review regulations inconsistent with his climate-change agenda, DOL last spring announced that it wouldn't enforce controversial 2020 rules on investment selection and proxy voting. A later executive order specifically directed DOL to reevaluate these rules.

The current investment-selection rule — which provides a safe harbor for prudent investment selection — doesn't prohibit consideration of ESG factors when selecting investments. However, the rule explicitly requires a fiduciary to base investment decisions only on "pecuniary factors" that the fiduciary prudently determines will have a material effect on an investment's risk and return.

Informal stakeholder feedback indicates that the rule has had a "chilling effect" on consideration of ESG factors by ERISA fiduciaries: Many stakeholders believe ESG considerations wouldn't qualify as

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pecuniary factors and could therefore only be considered, if at all, under the current rule's rigid tiebreaker standard. As a result, DOL believes the rule may deter ERISA fiduciaries from considering factors that non-ERISA investors are using to enhance the value and performance of their investments or to anticipate market impacts of climate change.

ESG factors may be material to risk and return

To counter negative perceptions about the use of ESG factors in investment decisions, the proposal would dispose of the pecuniary factors wording and add language supporting consideration of ESG factors material to an investment's risk and return. DOL frames this change as a clarification grounded in the agency's prior nonregulatory guidance.

- **Elimination of pecuniary factors terminology.** One of the most visible components of the proposal is the removal of the term "pecuniary factors." However, the proposal would retain the same concept that an investment course of action must be based on risk and return factors material to investment value, but clarify that ESG factors are often material. The weight a fiduciary gives to an ESG factor (or any other factor) should reflect its effect on risk and return.
- **List of material ESG factors.** The proposal would allow fiduciaries to consider any factor, including both ESG and non-ESG factors, material to the risk-return of an investment, without having to satisfy the tiebreaker standard. The proposal lists three examples of ESG factors that DOL views as likely to be appropriate:
  - Climate-change factors, such as exposure to the real and potential economic effects of climate change, including its physical and transitional risks and the positive or negative effect of government regulations and policies to mitigate climate change
  - Governance factors, such as board composition, executive compensation, transparency and accountability in decision-making, avoidance of criminal liability, and compliance with applicable laws
  - Workforce practices, including diversity, inclusion, and other drivers of employee hiring, promotion, and retention; workforce training; equal employment opportunity; and labor relations
- **Climate change and plan funding considerations.** The proposal indicates that fiduciaries may need to consider ESG factors when evaluating an investment's projected return relative to the plan's funding objectives. DOL says that businesses are already feeling the economic effects of climate change due to extreme weather events, and government regulations to address climate change are likely to affect investments in carbon-intensive industries. In the preamble, DOL singles out climate-change factors as particularly relevant to the projected returns of defined benefit (DB) plan portfolios, given the longer-term nature of their benefit obligations. However, this concept also seems relevant to the selection of DC plan investment options.

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Elimination of QDIA restrictions on collateral benefits

Fiduciaries don't have to choose a QDIA as their plan's default investment, but most do so because of the associated fiduciary liability relief these products provide. The current rule makes any investment that considers collateral benefits as part of its investment objectives ineligible for QDIA status, regardless of a fiduciary's reasons for selecting the investment. The proposal would eliminate this restriction.

This aspect of the proposal may raise concerns for fiduciaries who have already changed their QDIA offerings in response to the current rule, which requires fiduciaries to comply with that restriction by May 1, 2022. If DOL is now saying fiduciaries in some cases may need to choose investments that consider ESG factors, do fiduciaries who changed their QDIA offerings to comply with the current rule need to reevaluate that decision? Additional guidance would be helpful.

Relaxation of tiebreaker standard

Under both the current rule and the proposal, fiduciaries may use collateral factors that aren't material to risk or return as tiebreakers in certain instances but may never settle for lower returns or accept increased risk. However, the current rule allows fiduciaries to break ties using collateral goals only when competing investments are indistinguishable based on risk-return characteristics. The proposal would loosen the tiebreaker standard to apply to investments that equally serve the plan's financial interests. The proposal doesn't restrict the types of collateral benefits that fiduciaries may consider.

Disclosure of collateral factors. A new participant disclosure requirement would apply to DC plan investment options selected using the tiebreaker standard. The collateral-benefit characteristic of the investment that led to its selection would need to be prominently disclosed to participants. DOL believes plans could readily incorporate this statement into existing participant investment disclosures. The proposal is unclear whether a generalized disclosure of collateral factors in a fund prospectus would suffice or whether fiduciaries would have to provide a separate disclosure highlighting the specific collateral factors that influenced the fund's selection.

Lifting documentation requirements. The proposal would eliminate the burdensome documentation requirements that apply under the current rule's tiebreaker standard. Instead, fiduciaries would document these decisions following the same prudence obligation that applies to all investment decisions.

Proxy voting

DOL continues to view the exercise of shareholder rights, such as proxy voting, as a fiduciary act. Accordingly, both the current and proposed rules require fiduciaries to exercise shareholder rights solely in accordance with the plan's economic interests. However, where the current rule seemingly discourages considering ESG factors when exercising these rights, the proposal allows consideration of all factors — including ESG factors — the fiduciary prudently determines are material to the value of the plan's investments. The proposal would align the role of ESG factors in proxy-voting decisions with the consideration of ESG factors as part of investment selection.

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Encouraging exercise of shareholder rights

The proposal would also rescind several provisions of the current rule that seem to encourage fiduciaries to abstain from exercising shareholder rights:

- **Exercise of shareholder rights when in plan's best interest.** The proposal would remove a provision of the current rule that says ERISA fiduciaries don't have to vote every proxy or exercise every shareholder right. DOL encourages proxy voting unless a fiduciary determines doing so is not in the plan's best interest, such as when the costs are excessive in light of the plan's financial interests. DOL also encourages plan fiduciaries to rely on efficient structures for exercising shareholder rights, including the use of advisors or managers.
- **No special documentation.** The proposal would eliminate the current requirement for fiduciaries to maintain records on proxy voting and exercises of shareholder rights. Proxy voting would instead be subject to the same record-keeping standards that apply to other fiduciary decisions.
- **No special monitoring.** The proposal would remove the current rule's special monitoring obligations when fiduciaries have delegated proxy-voting authority or retained a third party to advise on proxy voting. Again, ERISA's general fiduciary standards apply in these situations.
- **Proxy-voting safe harbors eliminated.** The proposal would also remove the current rule's two safe harbor proxy-voting policies, which stakeholders indicated could encourage abstention from proxy voting.

Partisan divide on ESG and prospects for final regulation

Congressional Democrats offered legislation (HR 3887 and S 1762) earlier this year that would have a result similar to the proposed rule's changes. At the same time, congressional Republicans have ramped up their criticism of the proposed rule and the broader ESG movement, including scrutinizing President Biden's nominee to lead the DOL's Employee Benefits Security Administration. ESG-related legislation doesn't have much chance of success in the current Congress, given the ongoing partisan divide over ESG issues, despite the investment industry's embrace of ESG factors in decision-making.

The proposal also puts DOL in the unusual position of working to amend regulations just finalized within the last year. To support this regulatory action, the proposal's preamble is carefully crafted to identify inconsistencies between the current regulation and the agency's previous nonregulatory guidance, as well as to begin building a record of stakeholder feedback suggesting deficiencies in the process of adopting the current rule. As DOL seeks additional support for this regulatory action, public comments from interested stakeholders will be critical.

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Request for comments

Comments are due Dec. 13. DOL welcomes feedback on all aspects of the proposal and related issues, but is asking for comments on several specific issues, including:

- Whether the regulation should include language on how an investment compares to reasonably available alternatives
- Whether the regulation should include other examples of material factors or fewer examples
- Whether, in light of a growing body of research, fiduciaries should consider climate-change risks as presumptively material to risk-return assessments
- Whether fiduciaries should proactively solicit participants' ESG preferences
- Whether the reformulated tiebreaker standard is sufficiently clear and appropriate, or whether other approaches might better reflect plan practices
- Whether more specific parameters on collateral benefits would be helpful
- Whether participant disclosures about collateral benefit decisions are helpful and, if so, how to best implement the disclosures
- Whether proxy-voting safe harbors would be useful
- Whether the monitoring requirements for delegated proxy voting or the use of proxy-voting advisors are necessary or create special duties beyond ERISA's requirements, and whether the prudence requirement for using a proxy advisor is necessary

Related resources

Non-Mercer resources

- Proposed regulations, Prudence and loyalty in selecting plan investments and exercising shareholder rights (Federal Register, Oct. 14, 2021)
- Press release (DOL, Oct. 13, 2021)

Mercer Law & Policy resources

- Biden, lawmakers seek to reverse Trump-era ESG investing, proxy rules (May 25, 2021)
- DOL issues nonenforcement policy for investment, proxy rules (March 10, 2021)

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- DOL final proxy-voting rule less stringent than proposed (Feb. 22, 2021)
- DOL finalizes rule on selecting plan investments (Dec. 3, 2020)

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