EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION

DEPARTMENT OF LABOR ISSUES REPLACEMENT FINAL REGULATIONS REGARDING PROXY VOTING AND "ESG" INVESTING BY BENEFIT PLANS

The Department of Labor ("DOL") has finalized investment oversight and proxy voting regulations that will replace regulations on those topics issued by the Trump Administration. The new final regulations are the latest in a multi-decade effort to establish usable parameters for the consideration of what are now commonly termed "ESG" (environmental, social and governance) factors by benefit plan fiduciaries in the process of making investment and proxy voting decisions.

The Employee Retirement Income Security Act ("ERISA") requires benefit plan fiduciaries to act prudently and for the exclusive purpose of providing benefits to plan participants and beneficiaries. Accordingly, the DOL has always maintained that fiduciaries must make investment decisions that are in the best economic interests of the plan, and cannot sacrifice investment returns or take on additional risk in the pursuit of other goals. Nonetheless, the DOL also has long permitted fiduciaries to use non-financial considerations as a "tie-breaker" when deciding between two financially acceptable courses of action. For example, a union plan might favor an investment that is expected to promote union jobs over an economically equivalent opportunity that is not expected to have that sort of effect. However, while these underlying principles generally have remained consistent through various agency pronouncements over the years since the first Interpretive Bulletin in 1994, the DOL has struggled to articulate more detailed standards for benefit plan fiduciaries faced with ESG questions.

In 2020, the Trump Administration proposed regulations that attempted to make it more difficult for plan fiduciaries to act on ESG concerns. While the proposal acknowledged that in some cases, an ESG factor would be a legitimate part of an economic analysis, the bulk of the regulatory discussion reflected hostility to ESG investing. A subsequent set of proposed regulations addressed concerns about shareholder activism, strongly suggesting that plans should be restrictive in their approach to exercising their proxy voting rights when those proxies are subject to voting by plan fiduciaries rather than individual participants voting with respect to their own accounts.[1] In taking this stance, the proposal departed from a long-standing DOL position that plans generally should seek to exercise voting rights. While the Trump proposal acknowledged that proxies should be voted if voting was expected to be economically beneficial to the plan, the proposal required fiduciaries to document their findings that this standard was met, and overall implied a switch from a presumption in favor of voting to a presumption against voting.

[1] Participants voting proxies for their own individual accounts can vote (or abstain) based on whatever factors they consider relevant, and are not subject to fiduciary duties.

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The proposed regulations met with strongly negative reactions from benefit plan practitioners and the financial industry. While the financial efficacy of funds with overt ESG classifications remains a matter of debate, there is a strong consensus that a number of factors which also happen to be ESG factors often need to be taken into account as part of a prudent financial analysis because of their economic impact. For example, financial professionals generally agree that the risks and likely return of an investment in a fossil-fuel company should be analyzed in light of current social pressures towards clean energy, increasing legal restrictions (for example, in Europe) on the use of fossil fuels, and the risk of environmental liability. Fiduciaries and the financial industry also raised strong objections to the anticipated administrative burden and liability risks presented by the proposed changes to the "tie-breaker" and proxy voting rules. Commenters asserted that the overarching requirement that ERISA plans be invested in their participants' economic best interests constituted adequate protection against inappropriate pursuit of ESG goals, and cited statistics demonstrating a lack of any meaningful efforts by private-sector benefit plans to prioritize ESG investing or voting.

In the wake of the negative comments, the Trump Administration removed anti-ESG references from the text of the official regulations, and softened a number of other provisions before finalizing the rules in late 2020.[2] However, the overall tone of the regulations and the preambles reflected continued antipathy towards any benefit plan involvement with ESG analysis or activity, and skepticism of the role of proxy voting in a plan's investment strategy. The DOL also set a high standard for determining that two investments qualify as sufficiently economically identical to allow use of "non-pecuniary" factors as a tie-breaker, and imposed additional analysis and documentation requirements should a tie-breaker situation arise. In addition, the regulations banned the use of an ESG-themed investment fund as a plan's qualified default investment alternative. The final regulations were highly unpopular, and the Biden Administration announced a non-enforcement policy pending re-examination of the issues.

In late 2021, the Biden Administration issued new proposed regulations (see our LEGALcurrents at https://hselaw.com/news-and-information/legalcurrents/new-proposed-regulations-and-use-of-esg-factors-in-erisa-plans-investment-selection-and-proxy-voting-processes/ for details). The new proposal largely reverted to the pre-Trump position on proxy voting, indicating an expectation that fiduciaries will generally find it prudent and cost-effective to vote proxies when they have the right to do so. The new proposal also swung the regulatory pendulum in favor of facilitating ESG-oriented investment decisions, so long as the benefit plan is not adversely affected from an economic standpoint.

The regulations have now been finalized. The finalization comes after a number of months of increasing political controversy over the role of ESG factors in pension decisions by state governments (which are not subject to ERISA or DOL rules), and in the midst of Biden Administration efforts to support environmentally sustainable investments. The regulations themselves, however, continue to underline the

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[2] Additional background on the Trump regulations is available in our LEGALcurrents on the ESG regulations at https://hselaw.com/news-and-information/legalcurrents/department-of-labor-finalizes-regulations-on-erisa-plan-investments-in-esg-socially-conscious-funds/ and our LEGALcurrents on the proxy voting regulations at https://hselaw.com/news-and-information/legalcurrents/final-regulation-on-proxy-voting-and-exercise-of-other-shareholder-rights-by-erisa-plans/.

primacy of economic factors for investments by private-sector benefit plans subject to ERISA. The regulations reiterate the DOL's longstanding view that ERISA prohibits subordination of the plan's economic interests to other factors.

Indeed, the DOL softened provisions in the 2021 proposed regulations that addressed when ESG factors should be taken into account due to those factors' economic impact. Specifically, the DOL removed a statement that an economic analysis "may often require" ESG consideration in favor of saying that "Risk and return factors may include the economic effects of climate change and other environmental, social, or governance factors on the particular investment or investment course of action." The DOL explained that, "The modified version of the proposed language is intended to make it clear that climate change and other ESG factors may be relevant in a risk-return analysis of an investment and do not need to be treated differently than other relevant investment factors, without causing a perception that the DOL favors such factors in any or all cases." The DOL also removed specific examples that included ESG factors in a financial analysis.

Still, the final regulations retain the 2021 proposal's more lenient standards for assessing when other goals can be taken into account to break a tie between two investment courses of action that would each serve the plan's economic interests. In particular, the final regulations remove the restrictions and additional documentation requirements that the Trump Administration's rules would have imposed on use of this "tie-breaker" analysis, and simply require that the two potential choices equally serve the financial interests of the plan, without requiring the two choices to be economically indistinguishable before fiduciaries can consider other factors as tie-breakers. The final regulations even eliminate a requirement from the proposed regulations that would have required disclosure to participants in a participant-directed plan that a tie-breaker analysis had been applied. Thus, as was the case under the pre-Trump rules, fiduciaries' use of other factors as a tie-breaker between two economically appropriate investments will be able to take place behind the scenes. This does not, of course, change fiduciaries' obligations to act prudently in deciding when and how to use a tie-breaker or their obligation to maintain appropriate documentation of their decisions.

The final regulations also drop the Trump-era prohibition on use of an ESG-themed investment as a qualified default investment alternative ("QDIA"). A fiduciary that believes an ESG-themed investment would be a prudent and appropriate QDIA for its plan may establish that investment as the QDIA. As with any QDIA, a participant who does not want to invest in the QDIA can file a contrary election.

For those fiduciaries who have received participant requests to add investment options that focus on one or more ESG factors (e.g., funds which avoid investments that do not meet certain environmental sustainability benchmarks, or market themselves as favoring "fair trade" policies, or as adhering to particular religious or moral restrictions), the DOL included an express statement clarifying that fiduciaries do not breach their obligation of loyalty merely because they take participant preferences into account. However, the DOL also noted, "At the same time, however, plan fiduciaries may not add imprudent investment options to menus just because participants request or would prefer them." In other words, the duty of prudence must be satisfied independently of participant preferences.

Conversely, the final regulations do not require fiduciaries to make options available simply because participants are interested in having the options, even if those options are prudent. The DOL explained that given the difficulties in soliciting and evaluating participant preferences and the potential conflicts between participant preferences and fiduciaries' assessment of the prudence of a given option, "the final rule declines to mandate that fiduciaries factor participants' preferences into their evaluation, selection, and retention of designated investment alternatives, and declines to mandate a uniform methodology for determining such preferences; the final rule, instead, leaves these questions to be decided by plan fiduciaries considering the facts and circumstances of their plan and participant population." Ultimately, regardless of whether the array includes one or more ESG-oriented options, fiduciaries of participant-directed plans should ensure that the plan's investment array satisfies the requirements established under Section 404(c) of ERISA to provide participants with an adequately diversified set of choices, and should be sure they have provided participants with all required disclosures.

The final regulations also are consistent with the proposed regulations in terms of restating the DOL's pre-Trump expectation that plans will generally vote proxies and otherwise exercise shareholder rights, and that fiduciaries doing so will act consistently with their obligation to prioritize the economic interests of the plan. The special documentation and analysis requirements applicable to proxy voting activities under the Trump regulations, as well as controversial provisions regarding "safe harbor" policies on whether and when to vote proxies that were widely viewed as discouraging voting, have been removed. However, the final regulations do require fiduciaries to make a thoughtful decision about their proxy voting policies and any policies imposed by collective investment vehicles holding plan assets. To the extent a plan engages one or more vendors to assist with evaluating and exercising shareholder rights, plan fiduciaries must prudently select and oversee the vendor, in keeping with ERISA's requirements for the selection and oversight of any plan vendor. As with any plan decision, decisions relating to shareholder rights should be appropriately documented in the fiduciaries' records.

Overall, the final regulations largely revert to pre-Trump standards, but have been designed to ensure that fiduciaries feel confident that they can pursue economically prudent ESG investment and proxy voting strategies when they consider it appropriate to do so. Given the overall consistency between the pre-Trump and Biden rules, most plans should already be operating in compliance with the final regulations' requirements. However, this is a good opportunity for fiduciaries to check in with their investment professionals and confirm that their investment and proxy voting arrangements take this newest guidance into account. This is particularly important with respect to the final regulations' requirements for proxy voting policies in the case of those plans which do not pass all proxy voting rights through to participants, since the DOL has provided additional details about its expectations in this regard. The new regulations generally take effect 60 days after publication in the Federal Register, although the DOL provided for a delayed effective date (one year after publication) for some of the proxy voting provisions.

If you have any questions regarding this LEGALcurrents, please contact any member of the Employee Benefits and Executive Compensation group at 585.232.6500, 716.853.1316, or visit www.hselaw.com.