DON'T CALL IT ESG:
THE DEPARTMENT OF LABOR'S NEW FINANCIAL FACTORS REGULATIONS AND THEIR IMPACT ON ESG INVESTING AND ERISA FIDUCIARY DUTIES MORE BROADLY

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OVERVIEW OF TODAY'S MATERIALS

- ESG Basics and Overview
- Department of Labor's New "Financial Factors" Regulation (Don't Call It ESG)
  - Pecuniary Factors
  - Non-Pecuniary Factors as Tie-Breakers
  - Application of Regulation to Defined Contribution Plans
- Department of Labor's (Very) New Proxy Voting Regulation (Don't Call It ESG Either)
- ESG Enforcement Initiatives
- What Happens Next?

ESG BASICS AND OVERVIEW

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"ESG"

Environmental, Social, and (Corporate) Governance factors and considerations

E

Environmental

- Climate Change
- Biodiversity
- Natural Resources
- Carbon Emission
- Air and Water Pollution

S

Social

- Health and Safety
- Labor Standards
- Product Liability
- Privacy and Data Security

G

Governance

- Diversity and Inclusion
- Transparency
- Board Independence
- Ownership and Ethics
- Executive Compensations

ESG Considerations and ERISA Fiduciary Duty

- The use of ESG factors in investment decision-making can implicate ERISA's fiduciary duties.
  - ERISA Section 404(a)(1) provides that a fiduciary shall discharge his or her duties with respect to a plan solely in the interest of the participants and:
    - (A) for the exclusive purpose of (i) providing benefits to participants; and (ii) defraying reasonable expenses; and
    - (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use.
- The key issue is how ESG factors fit within the fiduciary's obligation to act prudently and solely in the interest of plan participants.
  - For example, the DOL has warned against violations of the duty of loyalty: 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 non-pecuniary benefits or goals."

ESG Considerations and ERISA Fiduciary Duty

- The DOL has issued interpretative guidance over the last 20 to 25 years that can feel like watching a ping-pong match.
- The key difference between Democratic and Republican administrations is the extent to which the DOL believes that ESG factors are (a) part of the economic consideration of an investment (i.e., a "pecuniary factor," using the newer terminology) or (b) collateral to the economic considerations and instead reflect public policy or political objectives (i.e., a "non-pecuniary factor")

ESG PROPOSED REGULATION – HISTORY

Clinton Administration

Interpretive Bulletin 94-1

- "ETIs" are subject to the same standards as any other investment.
- If an ETI can meet prudence requirements, a fiduciary can elect to invest in an ETI.

Bush Administration

Interpretive Bulletin 2008-01

- "ERISA's plain text does not permit fiduciaries to make investment decisions on the basis of any factor other than the economic interest of the plan."
- ETI could be a tiebreaker in the case of two identical investments.

Obama Administration

Interpretive Bulletins 2015-01 and 2016-01

- ESG may be a proper component of the economic merits of an investment.
- ESG factors are not "inherently suspect or in need of special scrutiny."

Trump Administration

Field Assistance Bulletin 2018-1

- Did not repeal IB 2015-01, but signaled a shift in tone and focus.
- "Fiduciaries must not too readily treat ESG factors as economically relevant to the particular investment."

Executive Order Promoting Energy Infrastructure and Economic Growth

- "It is the policy of the United States to promote private investment in the Nation's energy infrastructure."
- Ordered DOL to review plan investments in the energy sectors.

New Proposed Regulations Amending 29 C.F.R. Section 404a-1

- Adds new standards around reviews of investments, including the use of ESG factors.
- Adds a new section on proxy voting.

Why the DOL Focus on ESG?

- There is increasing market interest in ESG and increasing ERISA plan interest in ESG.
  - For example, the Proposed Rule generated more than 8,700 comments.
  - In the preamble to the Final Rule, the DOL cited data on the growth of ESG investing, such as "the assets invested is sustainable funds was nearly four times larger in 2019 than in 2018."
- Corporations have adopted ESG principles for corporate investments and have looked to their ERISA plans to do so as well.

DEPARTMENT OF LABOR'S NEW "FINANCIAL FACTORS" REGULATION (DON'T CALL IT ESG)

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New DOL "Financial Factors" Regulation

- On October 30, 2020, the DOL issued a Final Rule titled "Financial Factors in Selecting Plan Investments."
- The DOL described the Rule as "codifying a regulatory structure" and "establishing clear regulatory guideposts" in order "to confirm that ERISA requires plan fiduciaries to select investments . . . based solely on financial considerations."
- The Rule is effective January 12, 2021, with a later effective date of April 30, 2022 for application of provision applicable to QDIAs (discussed below).

Key Change from the Proposal: “Don’t Call It ESG”

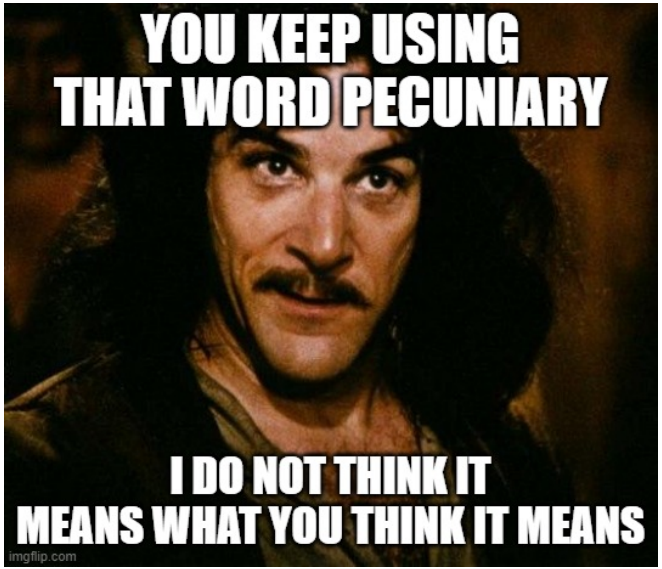
- But while understood as the ESG rule, the DOL removed the words “environmental,” “social,” and “governance” from the Final Rule.
  - Instead, the standard is now that the duty of loyalty prohibits the consideration of “non-pecuniary” factors, unless an exception applies.
  - Specifically: a plan fiduciary’s evaluation of an investment or investment course of action must be based only on “pecuniary” factors, subject to two limited exceptions (discussed shortly).
  - This is important because it moves away from the presumption implied by the Proposed Rule, that a factor labeled as ESG is necessarily non-pecuniary.

New Standard—Only "Pecuniary" Factors

- According to the DOL, this pecuniary standard reflects "fundamental" duty of loyalty principles:
  - that a fiduciary's evaluation of investment must be focused solely on economic considerations;
  - that a fiduciary not subordinate the interests of the plan to other objectives; and
  - that a fiduciary not sacrifice investment return or take on additional investment risk to promote noneconomic benefits or goals.
- Note that while the pecuniary factors standard interprets the duty of loyalty, the Rule also contained a small tweak to the DOL's prudence safe harbor.

What is a Pecuniary Factor?

- So what does pecuniary mean?
- The term "pecuniary factor" is defined as a factor that a fiduciary prudently determines is expected to have a material effect on the risk and/or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives.



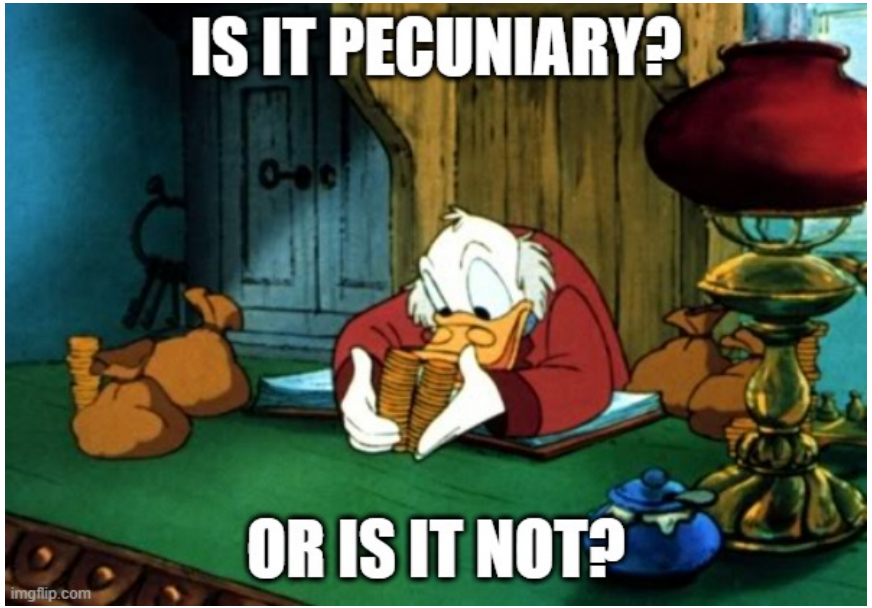
"Pecuniary" Broken Down

- **"Prudently determines"** – The Final Rule provides a standard for plan fiduciary determinations of whether a factor is "pecuniary" and it is the ERISA prudence standard.
  - As compared to the proposal, which did not provide a standard, the Final Rule is intended to incorporate more flexibility by adopting a "reasonableness standard of care," recognizing that these judgments will necessarily involve forward-looking expectations.
- **"Material effect"** – The Final Rule retains the "material effect" language from the proposal.
  - In so doing, the DOL said that it believes fiduciaries and investment managers are generally familiar with this concept from its use in connection with both ERISA and federal securities laws.
- **"Appropriate investment horizons"** – This requirement is intended to be sufficiently flexible to permit a plan fiduciary to determine the appropriate time horizon for the particular plan, and also appears intended to Rule out making judgments based on periods that would extend beyond when participants would be receiving their benefits.

Can ESG Be Pecuniary?

- Can ESG factors be "pecuniary"?
  - Lots of academic and industry literature says yes. Arguments include:
    - Selecting securities without considering ESG may be risky
    - Asset managers may improve outcomes by considering ESG risks and opportunities
    - ESG consideration is a common feature of sophisticated investment review
- The Final Rule acknowledges this point of view and in the preamble the DOL agreed that ESG "could be pecuniary in nature and that, in such cases, fiduciaries properly could consider the factors as part of their investment analysis."
  - For example, the DOL acknowledges that ESG facts can "present an economic business risk or opportunity."

So What's Pecuniary? And How Do You Prove It?



- Fiduciaries may need to work with consultants and advisors to develop tools and metrics to demonstrate the material economic effect of various factors.
- How determinations of pecuniary status are made and judged is likely an aspect of the Rule that will be affected by the change in administration.

When Non-Pecuniary Factors Are Permitted

- The Final Rule sets out two exceptions that would permit consideration of non-pecuniary factors.
  - First, a new "tie-breaker" usage: a fiduciary can apply non-pecuniary factors (and make a decision based on such non-pecuniary factors) when the fiduciary is unable to distinguish among investment alternatives on the basis of pecuniary factors alone.
  - Second, a fiduciary can add investment options to a participant-directed individual account plan that "produces collateral benefits or is otherwise viewed as socially desirable," i.e., ESG-themed funds (but not as a QDIA).

Tie-Breaker Elements

- To rely on this exception, the fiduciary is required to document:
  - Why pecuniary factors were not sufficient to break the tie,
  - How the selected investment compares to the other comparable investments with regard to the prudence factors enumerated in the regulation, and
  - How the chosen non-pecuniary factors are consistent with the interests of the plan participants and beneficiaries in their retirement income or financial benefits under the plan.
- But the DOL cautioned that non-pecuniary factors should be relatively uncommon.

Exception (of Sorts) for Defined Contribution Plans

- A fiduciary can add investment options to a participant-directed individual account plan that "produces collateral benefits or is otherwise viewed as socially desirable," i.e., ESG-themed funds.
- But such option still needs to satisfy the pecuniary standard (use only pecuniary factors) or the tie-breaker test.

> (2). . . a fiduciary is not prohibited from considering or including an investment fund, product, or model portfolio as a designated investment alternative solely because [it] promotes, seeks, or supports one or more non-pecuniary goals, provided that:
>
> (i) The fiduciary satisfies the requirements of paragraphs (a) and (c) of this section . . . ; and
> (ii) [The fund is not a QDIA or component of a QDIA]

ESG-Themed Funds Can Be Added to a 401(K) Plan

- So what does this mean? According to the DOL:
  - DC plans are not subject to stricter rules for the use of ESG.
  - "Fiduciaries are indeed permitted to add, to platforms or menus, designated investment alternatives that may produce collateral benefits or otherwise are viewed by some as socially desirable."
  - In other words, a 401(k) plan can have an ESG-themed fund in the lineup. There is no bar on funds that have "one or more environmental, social, corporate governance, or similarly oriented assessments or judgments in their investment mandates, or that include these parameters in the fund name."
  - "Nothing in the final rule precludes a fiduciary from looking into certain types of investment alternatives in light of participant demand for those types of investments."

But, Pecuniary Test Does Not Go Away

- *But:*
  - The DOL views this as a limited exception, which applies only if the alternatives can be justified "**solely on the basis of pecuniary factors**" (or the tie-breaker test).
  - For example, the DOL opines that choosing investments with expected reduced returns or greater risks to secure non-pecuniary benefits would not meet this standard (and instructs fiduciaries to review prospectuses and other disclosure documents to see if they include statements).
  - Also, the fiduciary must still satisfy prudence and loyalty standards.

Qualified Default Investment Alternatives (QDIA)

- However, this exception does not apply to QDIAs.
- A QDIA cannot be a fund whose investment objectives "include, consider, or indicate the use of one or more non-pecuniary factors."
- While this is probably no one's idea of perfectly clear, we view this as clarifying as compared to the Proposed Rule, which seemed to call into question whether even *pecuniary* ESG factors could be considered in any aspect of a QDIA's structure.
- We believe the Final Rule would allow use of *pecuniary* ESG factors in a QDIA.

Another Exception: Brokerage Windows

- The Final Rule affirmed that—consistent with earlier DOL guidance—the investment options within brokerage windows are generally not designated investment options, and thus are not subject to the same fiduciary duties related to the selection of investment options.
  - In theory then, the pecuniary analysis required of designated investment options is not required of a fund option in a brokerage window, including ESG-themed funds.

Bigger Impact: Other "Non-Pecuniary" Factors?

- An open question is whether—and how—the Final Rule will regulate investment decision-making outside of the ESG context.
- A possible view is that in order to comply with the duty of loyalty, all investment decision-making must be "pecuniary" or within one of the two noted exceptions.
- So what could be possible non-pecuniary factors (outside the ESG context)?

DOL Identified as Likely Not Pecuniary

- Increasing contributions or participant employment
- Strengthening plan sponsor
- Participant interest
- Benefits to the world economy

DOL Did Not Address: Unclear if These Could Require Pecuniary Test

- Sector investing (could depend upon the reason)
- Long term horizons not tied to immediate performance (such as liability hedging)

DOL Identified as Possibly Pecuniary

- Manager reputation or brand
- Proprietary funds and services

But non-pecuniary factors can still be elements of tie-breaker test. For example, the DOL identified increased contributions and participant interest as permissible factors to use in tie-breaker test.

Is Pecuniary is the New Prudent?

- An open question is how much the New Rule will broadly impact fiduciary duty standard. For example:
  - Should plan fiduciaries seek to make investment decisions that are not only prudent and loyal, but based on pecuniary factors?
  - Should plan fiduciaries seek to document that investment decisions are based on pecuniary factors?

DEPARTMENT OF LABOR'S (VERY) NEW PROXY VOTING REGULATION (DON'T CALL IT ESG EITHER)

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New Proxy Voting Regulation

- On Friday, December 11 (yes, six days ago, so please be kind to us), the DOL released a final regulation titled "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights."
- Like the Financial Factors regulation, this Rule was on a fast track—proposed on September 4, 2020, receiving 300 substantive comments (and 6700 in response to petitions).

Proxy Voting Regulation

- Guidance dating back to the 1980s provided that voting proxy is a fiduciary act.
- As noted above, the "ping pong" series of guidance further addressed whether/how "non-economic" interests can be taken into account when voting proxies.
- The Final Rule confirms and clarifies that the fiduciary duty to manage shareholder rights does not require voting on each and every shareholder right.
- The Proposed Rule then embarked on a detailed discussion of how a fiduciary should evaluate *whether* to vote a proxy or not.
  - In some respects, this process seemed more involved than the process for deciding *how* to vote the proxy.
- Happily, for plan fiduciaries, the Final Rule takes more of a "safe harbor" approach that would allow fiduciaries to adopt proxy voting policies and procedures meeting certain conditions and be considered to have satisfied their obligations.

Proxy Voting Regulation

- The regulation sets forth the conditions that policies and procedures must meet to satisfy the safe harbor.
  - Only vote when the vote is prudently determined to be substantially related to the issuer's business or expected to have a material effect on the value of the investment.
  - Don't vote when the plan's holding in a single issuer relative to a plan's total investment assets is below a quantitative threshold.
  - All subject to a "prudence override," pursuant to which a fiduciary cannot be precluded from voting the proxy when voting would have a material effect upon the value of the investment after taking into account the costs involved or refraining from voting when voting the proxy would have NOT have a material effect taking into account the costs involved.
- The regulation had additional clarifying guidance on mutual fund proxy voting (both within the mutual fund and proxy voting on mutual fund matters) and pooled fund proxy voting.

Proxy Voting Regulation

- The effective date of this regulation is 60 days from publication in the Federal Register, which, as of the date we had to finalize these slides, had not been determined.
- There were certain provisions, however, for which compliance is not required under January 31, 2022.

ESG ENFORCEMENT INITIATIVE

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DOL ESG Enforcement

- Along with the two regulations, the DOL has been conducting enforcement examinations on the use of ESG factors and proxy voting.
  - These investigations are being conducted out of multiple DOL regional offices.
  - The document requests indicate that the DOL is examining whether, and how, fiduciaries are making investment decisions or voting proxies, based on ESG considerations.
  - Both plan fiduciaries and fiduciary service providers are targets.
  - The DOL has reportedly identified investigatory targets based upon media reports of plan ESG usage and analysis of 5500 data.

DOL ESG Enforcement

Sample Document Requests	
All investment policies or guidelines currently in effect for the Plan, specifically including, but not limited to, any policies or guidelines concerning the use of ESG factors (or any similar factors) in making investment decisions or in selecting investment funds for inclusion in the Plan's fund lineup, or monitoring the performance of Plan investments or funds.	All documents relating to the fiduciaries' use or consideration of ESG factors (or any similar factors) in connection with any investment decisions made by the Plan, selection of investment funds for inclusion in the Plan's fund lineup, or monitoring the performance of Plan investments or funds.
Documents sufficient to show the names, addresses, and responsibilities of all persons or entities with responsibility for making investment decisions, or providing investment advisory or consulting services, that take into account ESG factors in connection with the Plan's investments.	Documents sufficient to identify any investment holdings or transactions which were based in whole or part on the consideration of ESG factors (or any similar factors).
Any statements furnished to the participants of the Plan related to the Plan's or Plan fund's use of ESG factors (or any similar factors).	Asset listings or portfolio statements for any investment holdings included in the Plan's portfolio in whole or part based on the consideration of ESG factors (or any similar factors).

WHAT HAPPENS NEXT?

Impact of Biden Administration?

- Unless the Democrats gain control of the Senate in January 2021, it is unlikely that either Final Rule would be withdrawn under the Congressional Review Act (which permits Congress to disapprove a regulation).
  - On the other hand, a Biden Administration would likely want to stake out a different interpretation and so may amend the Final Rules at a later date.
- With regard to enforcement: it is likely that a Biden Administration will stop, or de-emphasize, the existing ESG investigations (and may even issue a non-enforcement policy on the Rules).
- But one open question is whether there a risk of private litigation under the Rules?
- Finally, there is movement on the Hill on these topics.

What to do next?

- Now the final regulations, under the standards established by the current administration and case law, can be cited in enforcement actions and litigation.
- For this reason, ERISA plan fiduciaries (including managers of plan assets pooled investment vehicles) and managers of investment funds marketed to ERISA plans should review the new regulations to ascertain whether their current practices are consistent with a "pecuniary factors only" standard or fit into one of the exceptions and to evaluate proxy voting requirements against the new requirements.
- Consider broader implications:
  - Will all fiduciary investment decisions need to be confirmed to be pecuniary?
  - Should fiduciaries describe decision-making as pecuniary (such as investment minutes)?
  - How will proxy voting policies and procedures need to change?

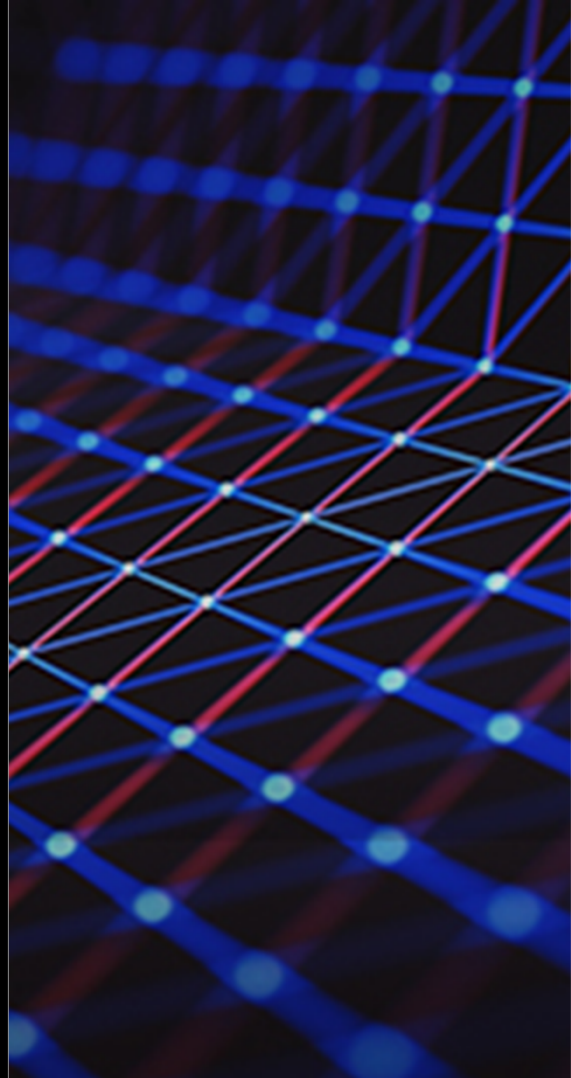
ANY QUESTIONS?

CORONAVIRUS COVID-19 RESOURCES

We have formed a multidisciplinary **Coronavirus/COVID-19 Task Force** to help guide clients through the broad scope of legal issues brought on by this public health challenge.

To help keep you on top of developments as they unfold, we also have launched a resource page on our website at **www.morganlewis.com/topics/coronavirus-covid-19**

If you would like to receive a daily digest of all new updates to the page, please visit the resource page to **subscribe** using the purple "Stay Up to Date" button.



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Liz advises clients on ERISA matters with a focus on fiduciary responsibility provisions, prohibited transaction rules and exemptions, and the management of employee benefit plan assets. She negotiates investment-related agreements on behalf of plans and financial services providers; designs, implements, and administers employee benefit plans; and counsels clients on DOL investigations, plan fiduciary governance structures, ERISA reporting and disclosure obligations, ERISA litigation, and general benefit plan compliance considerations. Liz's work experience includes several years at the DOL's Office of the Solicitor.

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Julie provides effective and practical solutions to clients' complex ERISA issues. She proficiently steers plan sponsors and investment managers through ERISA's fiduciary and prohibited transaction rules, and negotiates virtually every type of investment related agreement with employee benefit plans. Julie uses exceptional communication and interpersonal skills to advise clients on a wide range of ERISA topics, including effective fiduciary governance, risk management and the application of environmental, social, and governance (ESG) factors in plan investment decision-making.

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

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Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong*
Houston
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New York
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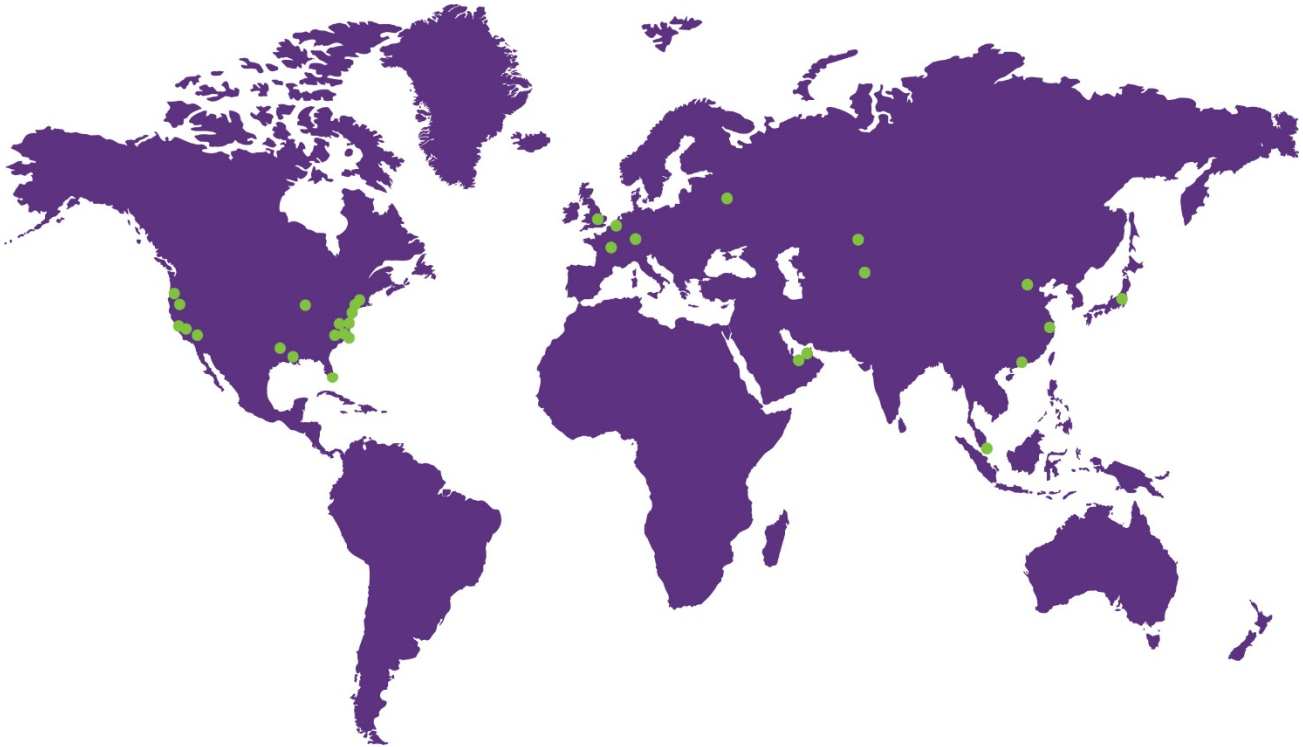

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