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Morgan Lewis

Agenda

- **ESG Basics and Overview**
- **Summary of Proposed Rule**
- **What Happens Next?**

ESG BASICS AND OVERVIEW

"ESG"

Environmental, Social, and (Corporate) Governance Factors and Considerations

E

Environmental

Climate Change	Energy Use
Biodiversity	Water Use
Natural Resources	Hazardous Waste
Carbon Emission	Air and Water Pollution

S

Social

Health and Safety	Working Conditions
Labor Standards	Compensation and Benefits
Product Liability	Internal Pay Equity
Privacy and Data Security	Child and Forced Labor
Employee Opportunity	Corporate Giving and Philanthropy
Diversity and Inclusion	Supplier Practices

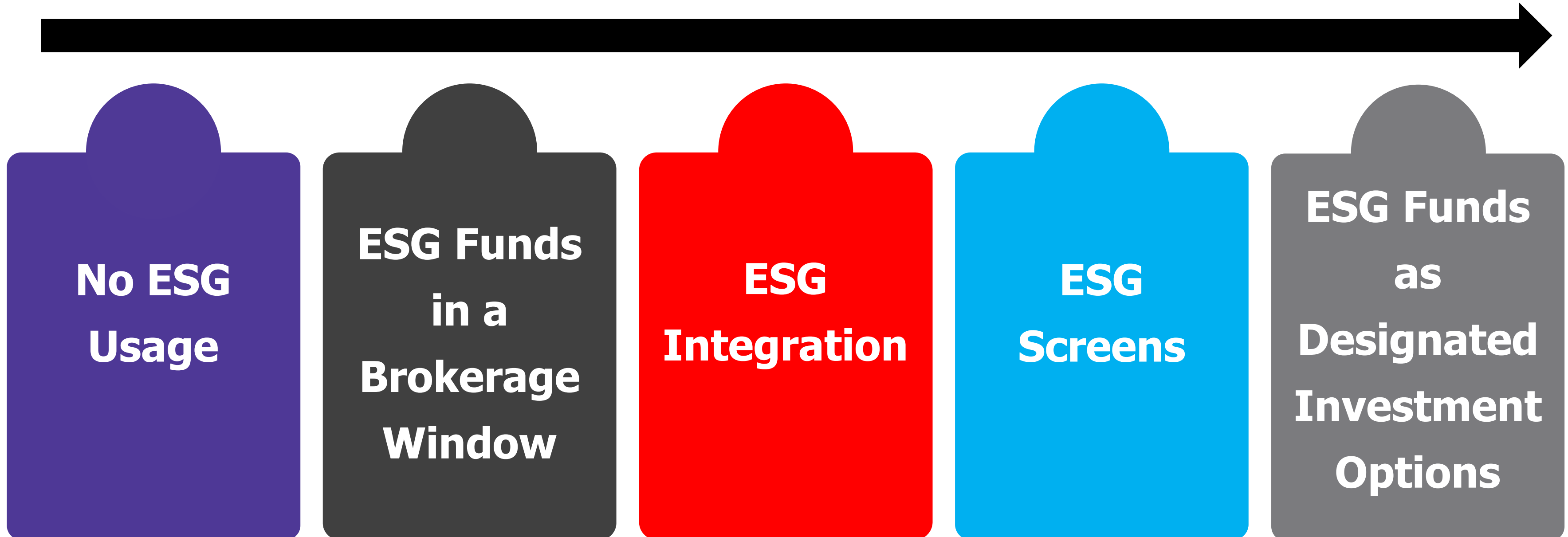
G

Governance

Diversity and Inclusion	Shareholder Rights
Transparency	Enterprise Risk Management
Board Independence	Audit Oversight
Ownership and Ethics	Disclosure and Reporting
Executive Compensation	Privacy and Cybersecurity

Spectrum of How ERISA Plans Might Use ESG

From Least Utilization to Most



ESG DOL Regulatory 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

Regulation Amending 29 C.F.R. Section 404a-1 (2020 Rule)

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

Biden-Harris Administration

Proposed Regulation Amending 29 C.F.R. Section 404a-1 (Proposed Rule)

- Proposes to amend 2020 standards around reviews of investments, including the use of ESG factors.
- Proposes to amend section on proxy voting.

DOL consistent view: A "fiduciary may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits . . . to other objectives."

The key difference is the extent to which the DOL believes that ESG factors are:

(a) part of the economic consideration of an investment or

(b) collateral to the economic considerations and instead reflect public policy or political objectives.

Trump Era: Reexamination of ESG and Proxy Voting

"Financial Factors in Selecting Plan Investments" (2020 Rule)

- Fiduciaries may consider only "pecuniary factors," which are factors expected to have a material effect on the risk and/or return of an investment based on appropriate investment horizons and the plan's objectives and funding policy.
- Lots of anti-ESG statements in the Preamble, including skepticism that ESG could be pecuniary.
- QDIAs could not use ESG integration.

"Fiduciary Duties Regarding Proxy Voting and Shareholder Rights"

- 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.

Along with the two regulations, in 2020 the DOL conducted enforcement examinations on the use of ESG factors and proxy voting, which added to the chilling effect on ESG usage.

SUMMARY OF PROPOSED RULE

DOL New Proposed Rule: Both ESG Neutral and Pro-ESG

- On October 13, the DOL released a Notice of Proposed Rulemaking on "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights" (Proposed Rule).
  - Overall, the Proposed Rule signals a more permissive regulatory environment for fiduciaries considering ESG factors when making investment decisions and voting proxies on behalf of plans.
  - Represents a significant shift in DOL policy.
  - It also provides some (but likely not enough) clarity for how ESG can be used without violating ERISA.
- The comment period is open for 60 days from the date of publication in the *Federal Register*, putting the comment deadline in mid-December.

Elements of the Proposed Rule

Prudence Safe Harbor

Investment decision is prudent if fiduciary has given "appropriate consideration" to facts and circumstances relevant to the investment and acted accordingly.

Duty of Loyalty

A fiduciary may not subordinate the interests of the participants in their retirement income or financial benefits under the plan to other objectives, and may not sacrifice investment return or take on additional risk to promote benefits or goals unrelated to interests in their retirement income or financial benefits under the plan.

A fiduciary's evaluation must be based on risk and return factors that are prudently determined to be material to investment value, using appropriate investment horizons consistent with the plan's investment objectives and taking into account the funding policy of the plan.

Tie Breaker That Permits Fiduciary to Select Investment Based on Collateral Benefits

Proxy Voting Rules

Five Key Changes from 2020 Rules to 2021 Proposed Rule

- **ESG Endorsement.** For the DOL safe harbor for prudent investments, ESG factors that are material to risk and return may be considered, and in some cases, may *need* to be considered.
- **Pecuniary Factors Now Risk-Return Test (and ESG Counts).** For purposes of the duty of loyalty, replaces the pecuniary factors standard with a more generic requirement that factors be based on "risk-return." This new standard is similar and continues to require decisions on risk and return, investment horizon, and investment policy. But the DOL gives examples in the regulation that seem to endorse ESG as per se material.
- **Tie-Breaker Could Now Allow Collateral ESG.** Retains a tie-breaker test, but new version appears to open the door to consideration of collateral benefits.
- **QDIAs Can Use ESG (and No Special Rules for DC Plans).** Removes bar on the use or consideration of ESG factors in QDIAs. The Proposal also removes special rules for DC plans.
- **Mostly Back to Old Proxy Voting.** Removes the language on proxy voting that fiduciaries need not, and in some cases should not, vote on all proxies and reverts to traditional view that decisions around proxy voting are fiduciary in nature.

Key Change 1: ESG May Be Considered and May *Need* to Be Considered as Part of Safe Harbor for Prudent Investments

Section of Regulation	2020 Rule	Proposed Rule	Takeaway
§2550.404a-1(b) Safe Harbor to Satisfy the Duty of Prudence	For safe harbor compliance, investment decision is prudent if fiduciary has given "appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved" and acted accordingly.	Adds that as part of the safe harbor, "appropriate investment consideration ... may often require an evaluation of the economic effects of climate change" and other ESG factors. Adds that a "fiduciary may consider any factor in the evaluation of an investment or investment course of action that, depending on the facts and circumstances, is material to the risk-return analysis, which might include" specific E, S, and G examples.	This clarifies that in order to satisfy the existing DOL safe harbor for prudent decision-making, ESG factors that are material to risk and return may be considered and "may often require" an evaluation of ESG. Though these changes are to the safe harbor, they reflect a marked change from the 2020 Rule.

Key Change 2: Pecuniary Factors Test Replaced with Similar Risk/Return Standard (and ESG Can Be Material)

Section of Regulation	2020 Rule	Proposed Rule	Takeaway
§2550.404a-1(c) Duty of Loyalty Standard	To satisfy the duty of loyalty, investment decisions must not promote "non-pecuniary" goals. A "pecuniary" factor is one "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 and the funding policy…"	Removes the pecuniary factors test but replaces it with a similar standard under which investments must be based on factors of performance, risk, investment policy, time horizon, and funding. The new test is a "fiduciary's evaluation of an investment or investment course of action must be based on risk and return factors that the fiduciary prudently determines are material to investment value, using appropriate investment horizons consistent with the plan's investment objectives and taking into account the funding policy of the plan." However, the regulation then adds reference to the three examples of E, S, and G factors. Because of this incorporation, the DOL's view is that ESG factors may be material to risk and return.	On the one hand, the new "risk return" standard is not far from the old pecuniary factors standard. The core of the regulations is still based on an evaluation of performance, risk, investment policy, time horizon, and funding. But the real change is that the regulatory text incorporates the three examples of ESG usage in a manner that suggests a view that ESG factors may be material to risk and return. The road is made easier for plan fiduciaries to make investments that incorporate financial ESG factors.

Key Change 3: New Version of Tie-Breaker Test That Allows for Consideration of Collateral Benefits

Section of Regulation	2020 Rule	Proposed Rule	Takeaway
§2550.404a-1(c) Duty of Loyalty Standard – Tie-Breaker Test	If a decision can't be made based on pecuniary factors, the decision must pass a tie-breaker test that requires two alternative investment courses of action to be "economically indistinguishable" and requires substantial analysis and documentation.	Retains the tie-breaker test but under the Proposed Rule, tie-breaker is to allow consideration of "collateral benefits other than investment returns." Under this tie-breaker test, fiduciary can consider such collateral factors that "equally serve the financial interests of the plan over the appropriate time horizon." Also removes documentation that was applicable to plan fiduciaries seeking to avail themselves of the tie-breaker test under the 2020 Rule (although there is a documentation requirement for DC plan investment lineups).	It is clear that the DOL intends this to be broader in scope than standard from the 2020 Rule. This could open the door to using ESG that is purely collateral (e.g., for political purposes and unrelated to risk-return) so long as it serves plan financial interests. However, it is not clear how fiduciaries should interpret "equally serve the financial interest of the plan."

Key Change 4: DC Investment Lineups and QDIAs Not Subject to Special Restrictions

Section of Regulation	2020 Rule	Proposed Rule	Takeaway
§2550.404a-1(d) – QDIAs and DC Plans	Limited the use of ESG in QDIAs, and strictly prohibited QDIA funds with nonpecuniary investment objectives or strategies. Suggested special standards applicable to the selection of DC plan investment options.	ESG factors and considerations apply to QDIAs as they apply to all other investment contexts. No special treatment of DC plan lineups.	Should provide greater flexibility to use specifically ESG-themed funds as QDIAs, or at least comfort to fiduciaries if a plan's QDIA uses ESG factors in some way or at some level (such as ESG integration at the fund or sub-fund level). Selection of ESG funds for DC plan lineups not subject to special scrutiny (but see before on special disclosure for tie-breakers).

Key Change 5: Reversion to More Traditional Proxy Voting Rules

Section of Regulation	2020 Rule	Proposed Rule	Takeaway
§2550.404a-1(e) – now §2550.404a-1(d) Proxy Voting	Changed the proxy voting standard to provide that fiduciaries need not, and in some cases should not, vote on all proxy issues. Imposed recordkeeping requirements on fiduciaries when they did exercise their proxy vote.	Removes the language stating that ERISA fiduciaries are not required to vote all proxies. The Proposed Rule would reinforce the long-standing principle that ERISA fiduciaries voting by proxy must act "solely in the economic interests of the plan and its participants and beneficiaries," deleting the language that suggested heightened scrutiny of ESG-related proxy votes. Acknowledges that ESG factors can be considered in proxy voting and shareholder rights (does so by cross-referencing the ESG standards applicable to "appropriate consideration," which, as noted above, include ESG factors that are relevant to the risk-return analysis). Eases recordkeeping requirements.	The DOL has reverted the proxy voting standard back to the DOL's traditional view. As a practical matter, under the traditional standard, fiduciaries often find they should vote proxies unless they can determine it is not in the plan's best interest to vote (such as due to cost or complexity). Eliminates some recordkeeping requirements.

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WHAT HAPPENS NEXT?

Additional Observations

- One of the initial criticisms of the Proposed Rule is directed at the inclusion of ESG factors as specific examples of possible material risk-return factors.
  - This critique argues that the regulation should be entirely principles-based and neutral as to specific considerations.
- With regard to the tie-breaker test, there are already questions as to how this disclosure will be implemented.
  - Given the extent to which investment disclosures in DC plans are automated and standardized, the DOL may have oversimplified the challenges of articulating these factors and finding an efficient way to disclose them to participants.
  - More guidance could be helpful as to where or how consideration of collateral factors may be included in a plan’s 404a-5 disclosure.

Open Questions and Considerations

- **How will fiduciaries actually implement these standards?**
  - Is "material to the risk-return analysis" really any easier to implement than "pecuniary"?
  - How will fiduciaries evaluate the ESG characteristics of various products and services?
- **Does the DOL want to go even further in endorsing ESG?**
  - Some of the items on which they have specifically sought comments might suggest this.
  - But are there limits on what you can do without statutory changes?
- **Will fiduciaries actually feel there is enough clarity to rely on the tie-breaker test?**
- **In general, will fiduciaries worry that the ground will shift again if there is a new Republican administration inaugurated in January 2025?**
  - In other words, are we still playing ping-pong?
  - If so, will that discourage investment in implementing these standards?

Next Steps

- Given that this is merely a Proposed Rule, no immediate action is required for fiduciaries.
- On balance, the Proposed Rule is generally more permissive for fiduciaries, so fiduciaries should not generally need to anticipate new compliance obligations regarding investment decisions and proxy voting.
- That said, fiduciaries who currently use ESG factors (or seek to apply ESG factors in the future) may want to consider how this Proposed Rule will affect current (or future anticipated) processes in order to determine whether to comment on the Proposed Rule (directly or through representative groups).

Specific Questions Identified for Comments

The DOL is seeking comments on the entire Proposed Rule, but specifically identified several questions for comments.

Is it necessary to clarify that "facts and circumstances relevant to an investment" include considering expected return on alternative investments? (86 Fed. Reg. 57277)	Should there be parameters around what factors can be considered as "collateral benefits"? (86 Fed. Reg. 57277)	Compliance costs (86 Fed. Reg. 57277)
Should there be fewer examples of potentially material ESG factors? (86 Fed. Reg. 57277)	Did Biden's Executive Order prevent plans from incurring sunk costs of complying with the 2020 Rule? (86 Fed. Reg. 57277)	Impact of the 2020 Rule on "integration of climate change and other ESG factors in investment decisions." (86 Fed. Reg. 57277)
Feedback on the new tie breaker standard, and how to operationalize. (86 Fed. Reg. 57277)	Should certain ESG factors be considered presumptively material? Specifically asked about climate change. (86 Fed. Reg. 57277)	Feedback on "impact, legality and appropriateness under ERISA of requiring that fiduciaries proactively solicit climate change and other ESG preferences." (86 Fed. Reg. 57277)

QUESTIONS?

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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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Our Global Reach

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Middle East
North America

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Pittsburgh
Princeton
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Singapore*
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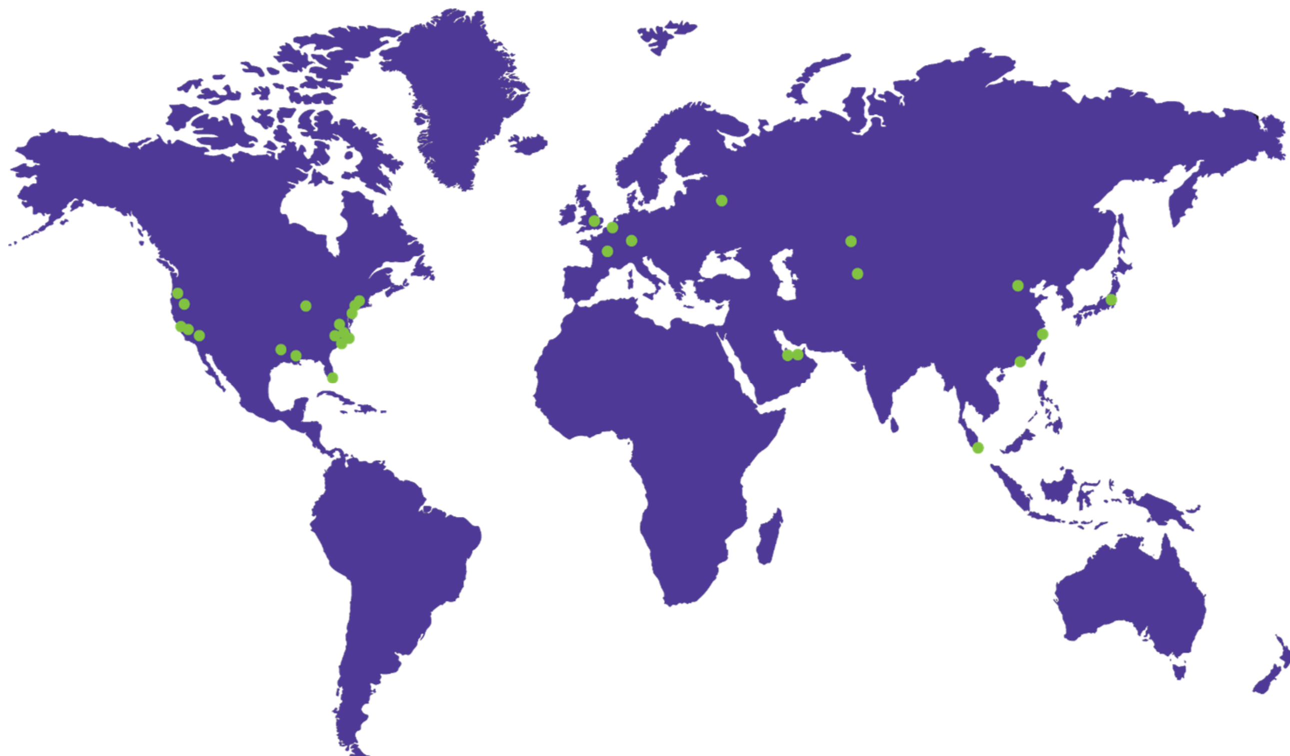

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