ERISA Alert

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DOL's ESG and Proxy Voting Proposal—Impact on ERISA Fiduciaries and Private Fund Managers

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On October 13, 2021, the U.S. Department of Labor (DOL) issued a proposed regulation that would, if adopted, amend existing regulations, adopted in 2020, relating to environmental, social and corporate governance (ESG) considerations in investment and proxy voting decisions for ERISA fiduciaries.

Highlights for ERISA Fiduciaries and Private Fund Managers

If the proposed regulation is adopted in final format:

- All ERISA fiduciaries, including private fund managers managing "plan assets" funds and other accounts:
  - MUST continue to make investment decisions and vote proxies based solely on financial considerations, except in very limited circumstances (which was required even prior to the existing regulations).
  - MUST evaluate the economic impact of ESG factors when considering investments.
  - MUST vote proxies based on the proxy voting policies of investing ERISA plans unless the plans have agreed to accept the manager's proxy voting policies.
  - MUST review their investment and proxy voting policies and other offering materials for compliance with the proposed regulation.
  - MAY face enhanced risk of fiduciary breach claims for either: (i) failing to properly evaluate ESG factors or (ii) justifying ESG investment decisions/proxy voting as pecuniary when, in fact, they are nonpecuniary.
- Non-ERISA fiduciaries such as private fund managers of hedge and private equity funds with less than 25% "benefit plan investor" participation:
  - SHOULD review their investment and proxy voting policies and other offering materials for compatibility with the proposed regulation to the extent raising capital from clients which are subject to ERISA's fiduciary standards (e.g., ERISA retirement plans).

Contact Information

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- Although such a manager is not directly subject to the proposed regulation, an ERISA plan investing in such a fund will need to make its own investment decision, which now could include the underlying manager's ESG policies.

– SHOULD NOT represent that its investment products are suitable for an ERISA investor or are otherwise consistent with the proposed regulation.

Background

The existing regulations reflect the Trump administration DOL's concern that ERISA fiduciaries would use nonpecuniary considerations when investing plan assets in violation of the "exclusive purpose rule" under ERISA. In particular, the DOL was especially concerned that an investment may sacrifice performance, forgo opportunity or take on additional risk to achieve ESG objectives. In short, the Trump administration DOL asserted that ERISA fiduciaries must never sacrifice investment returns, take on additional risk or pay higher fees to promote non-pecuniary benefits or goals.

Although the existing regulations were effectively a formalization of the DOL's prior pronouncements on ESG, the tone of the preamble made it clear that the Trump administration DOL was very skeptical that ESG should play any factor in an ERISA fiduciary's investment decision process or proxy voting decisions. Because of this perception, some were concerned that ERISA fiduciaries were placed in an untenable situation where they could never consider ESG factors in investment decisions, even if they presented legitimate risks.

Proposed Regulation

The proposed regulation is designed to reflect the Biden administration's view that climate change and other ESG factors may (and perhaps should always be) a part of an ERISA fiduciary's decision making process. In the news release relating to the proposed regulation, Acting Assistant Secretary for the Employee Benefits Security Administration Ali Khawar said, "The proposed rule announced today will bolster the resilience of workers' retirement savings and pensions by removing the artificial impediments – and chilling effect on environmental, social and governance investments – caused by the prior administration's rules." He went on to say, "A principal idea underlying the proposal is that climate change and other ESG factors can be financially material and when they are, considering them will inevitably lead to better long-term risk-adjusted returns, protecting the retirement savings of America's workers."

With this background in mind, the proposed regulation, if adopted, would amend the existing regulations as follows:

- Eliminate the prohibition on investment funds serving as qualified default investment alternatives for 401k plans if they consider ESG matters.
- Specifically provide that, as part of its investment prudence duties, an ERISA fiduciary may consider any factor in the evaluation of an investment that is material to the risk-return analysis, including: (i) climate change related factors such as a corporation's exposure to the real and potential economic effects of climate change including exposure to the physical and transitional risk of climate change and the positive or negative effect of Government regulations and policies to mitigate climate change; (ii) governance factors such as board composition, compliance with

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labor, employment, environmental, tax and other applicable laws and (iii) workforce practices such as diversity and inclusion.

- Provide that appropriate considerations of the projected return of a portfolio relative to the funding objectives of a plan may require an evaluation of the economic effects of climate change and other environmental, social or governance factors on the particular investment or investment course of action.
- Eliminates the need to specifically document the reason for using the so-called "tie-breaker rule" (e.g., if all things are otherwise equal, then nonpecuniary factors may be used in making investment decisions). The proposed regulation also broadens the application of the tie-breaker rule such that a fiduciary may use nonpecuniary factors to select among investment options when the fiduciary prudently concludes that the options "equally serve the financial interests of the plan."
- Reestablish the DOL's long standing policies that proxy voting is part of an ERISA fiduciary's duties and eliminate various provisions of the existing regulations that may have chilled a plan fiduciary from exercising its rights as a shareholder. In particular, the proposed regulation:
- Eliminates the language in the existing regulations that ERISA does not require voting of every proxy. This elimination does not suggest, however, that an ERISA fiduciary must always vote, but rather must decide what is in the best interest of the plan.
- Eliminates specific monitoring obligations where shareholder rights have been delegated to other parties such as investment managers.
- Eliminates special requirements that would have required plan fiduciaries to maintain records on proxy voting activities.
- Specifically provides that an investment manager of a pooled investment vehicle, which includes "plan assets," such as a hedge fund with significant ERISA investor participation, that holds assets of more than one benefit plan may be subject to an investment policy statement of one client plan, which conflicts with another client plan. The proposed regulation would require the investment manager to reconcile, if possible, the conflicting policies. In addition, in the case of proxy voting, the investment manager must vote (or abstain from voting) the relevant proxies to reflect such policies in proportion to each plan's economic interest in the pooled vehicle. (Needless to say, administering this requirement could be burdensome. Fortunately, the proposed regulation permits an investment manager to establish their own policies and require investment plans to accept such policies as a condition of investing.)

Effective Date

The proposed regulation will generally be effective sixty days following its publication in the Federal Register.

Impact on ERISA Fiduciaries and Private Fund Managers

On the surface, the proposed regulation would not change existing law or the ERISA fiduciary standard, which requires fiduciaries to act with complete and undivided loyalty to plan participants and beneficiaries. The U.S. Supreme Court has held in the

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context of ERISA retirement plans that this standard must be understood to refer to financial rather than nonpecuniary benefits.

Recognizing that any attempt to require ERISA fiduciaries to consider nonpecuniary factors in making investment decisions would likely fail judicial scrutiny, the DOL carefully drafted the proposed regulation to retain the existing ERISA fiduciary standard, but specifically included ESG factors as pecuniary considerations. If adopted, the proposed regulation would be a radical departure from the existing regulations inasmuch as ERISA fiduciaries would effectively be required to factor in ESG considerations in their investment decisions. The DOL, in the preamble to the proposed regulation, noted studies that showed ESG focused considerations yield higher returns and used that rationale as justification for the changes. Although there is much debate on this topic, especially recently, it remains to be seen if such ESG considerations truly do yield higher long-term returns.

At this point, an ERISA fiduciary would be well advised to act cautiously when considering ESG factors in investment decisions and voting. Even if the proposed regulation is adopted, it is certainly possible, and maybe even likely, that a future administration with a different political view would seek to amend its provisions. It is also not entirely clear that the proposed regulation would survive judicial scrutiny or provide liability protection for plan fiduciaries, especially in the context of individual account plans such as 401(k) plans, where investment decisions relating to ESG factors could always be second-guessed by plaintiffs' attorneys. Perhaps ironically, the proposed regulation, by specifically listing ESG factors in what "may" be appropriate for an ERISA fiduciary to consider, could introduce a new avenue for potential liability for plan fiduciaries who are accused of not properly reviewing and promoting ESG factors in their decision making. At the same time, such plan fiduciaries could be accused of disguising nonpecuniary investment factors as pecuniary factors.

The proposed regulation is not specifically applicable to outside investment managers who do not otherwise manage "plan assets" (e.g., investment managers of collective investments funds which qualify as "venture capital operating companies" or managers of funds in which benefit plan investors do not own 25% or more of any class of equity interest of such fund). Nonetheless, the proposed regulation could have a potentially positive impact on raising ERISA-based capital for any investment fund or product that has a purpose of focusing on and/or promoting ESG factors and that is able to describe such factors in a manner, which are consistent with the proposed regulation. However, by effectively requiring ERISA fiduciaries to consider ESG factors, whether or not an investment manager is an ERISA fiduciary, such managers' investment policies on ESG could be a gaiting issue for raising ERISA capital. That is, if a manager indicates that it does not generally consider ESG factors in its investment decisions, a broad interpretation of the proposed regulation could cause an investing plan to conclude that an investment with such manager violates ERISA.

At this time, it is unclear what the impact (whether intended or unintended) will be on ERISA fiduciaries and those investment managers seeking to raise ERISA capital. Until the proposed regulation is finalized or re-proposed is some other form, we continue to caution investment managers from recommending and/or advertising that any of their investment products are appropriate for ERISA-based capital in particular, as that decision should be left to the ERISA plan's investment committee and/or manager deciding to make the investment.

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