A SUMMARY: DOL Proposed Rule on Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights

INTRODUCTION

On October 14, 2021, the Department of Labor (DOL) issued proposed rule, Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights[1], which replaces the current regulation, the Financial Factors in Selecting Plan Investments rule[2] ("Current Regulation" or "Investment Duties Regulation"). The Current Regulation could expose plans' investments and portfolios to avoidable climate-change-related risks which negatively impact performance, particularly over longer time horizons. DOL is proposing the new rule in selecting plan investments and exercising shareholder rights. Overall, the proposed new rule allows fiduciaries to consider environmental, social, or governance ("ESG") factors as material to the risk-return analysis as any other such factors; although this is not a requirement.

BACKGROUND

For many years, the DOL's non-regulatory guidance has recognized that, under the appropriate circumstances, ERISA fiduciaries can make investment decisions that reflect climate change and ESG considerations, including climate-related financial risk, and choose economically targeted investments ("ETIs") selected, in part, for benefits apart from the investment return. The Department's non-regulatory guidance has also recognized that the fiduciary act of managing employee benefit plan assets includes the management of voting rights as well as other shareholder rights connected to shares of stock, and that management of those rights, as well as shareholder engagement activities, is subject to ERISA's prudence and loyalty requirements.

On June 30 and September 4, 2020, the DOL published proposed rules to remove prior non-regulatory guidance and to amend the DOL's Investment Duties regulation under Title I of ERISA at 29 CFR 2550.404a-1 (Current Regulation or "Investment Duties Regulation").The stated objective was to address perceived confusion about the implications of nonregulatory guidance with respect to ESG considerations, Economically Targeted Investments (ETIs), shareholder rights, and proxy voting. The 2020 proposals expressed concern that some ERISA plan fiduciaries might be making improper investment decisions, and that plan shareholder rights were being exercised in a manner that subordinated the interests of plans and their participants and beneficiaries to unrelated objectives.

On November 13, 2020, the DOL published a final rule titled "Financial Factors in Selecting Plan Investments," 85 FR 72846, which adopted amendments to the Investment Duties regulation that generally require plan fiduciaries to select investments and investment courses of action based solely on consideration of "pecuniary factors." The Current Regulation also contains a

[1] https://www.federalregister.gov/documents/2021/10/14/2021-22263/prudence-and-loyalty-in-selecting-plan-investments-and-exercising-shareholder-rights

[2] https://experientialwealth.com/wp-content/uploads/2020/11/DOL-Financial-Factors-Final-Rule-Summary-2020-11-13.pdf

prohibition against adding or retaining any investment fund, product, or model portfolio as a qualified default investment alternative (QDIA) if the fund, product, or model portfolio reflects non-pecuniary objectives in its investment objectives or principal investment strategies. On December 16, 2020, the DOL published a final rule titled "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights," which also adopted amendments to the Investment Duties Regulation to establish regulatory standards for the obligations of plan fiduciaries under ERISA when voting proxies and exercising other shareholder rights in connection with plan investments in shares of stock.

PROPOSE RULE

On May 20, 2021, President Biden signed "Executive Order on Climate-Related Financial Risk," 86 FR 27967. The policies set forth in Section 4 directed the DOL to consider publishing, by September 2021, for notice and comment a proposed rule to suspend, revise, or rescind "Financial Factors in Selecting Plan Investments," and "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights," 85 FR 81658.

Exclusive Purpose and Prudent Person Rule are the pillars to fiduciaries responsible for administrating and managing plan and investing plan assets subject to ERISA.

- ERISA Section 404(a)(1)(A) – **Exclusive Purpose Rule** states that a fiduciary shall discharge that person's duties with respect to the plan solely in the interests of the participants and beneficiaries, for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan,
- ERISA Section 404(a)(1)(B) – **Prudent Person Rule** states that a fiduciary shall discharge that person's duties with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

The proposed safe harbor rule would amend the Investment Duties regulation with the entire regulation being republished and to be consistent with:

Investment Prudence Duties

- The Prudent Person Rule is deemed to be satisfied with respect to a particular investment or investment course of action if the 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, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties, and has acted accordingly.
- Appropriate consideration means:

  (i) a determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio, to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action compared to the

opportunity for gain (or other return) associated with reasonably available alternatives with similar risks, and

(ii) consideration of the composition of the portfolio with regard to diversification, the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan, and the projected return of the portfolio relative to the funding objectives of the plan as those factors relate to such portion of the portfolio. [this is more applicable to consideration for defined benefit pension plan]

- Further, consideration of the projected return of the portfolio relative to the funding objectives of the plan may often require an evaluation of the economic effects of climate change and other ESG factors on the particular investment or investment course of action. Thus, a fiduciary's duty of prudence may often require an evaluation of the effect of climate change and/or government policy changes to address climate change on investments' risks and returns.
- A fiduciary may consider any factor material to the risk-return analysis, including climate change and other ESG factors. Under ERISA, if a fiduciary prudently concludes that a climate change or other ESG factor is material to an investment or investment course of action under consideration, the fiduciary can and should consider it and act accordingly, as would be the case with respect to any material risk-return factor.
- To eliminate any doubt, the proposed regulation provides examples of factors that a fiduciary may consider in the evaluation of an investment or investment course of action if material, including:
  (i) **climate** change-related factors, such as a corporation's exposure to the real and potential economic effects of climate change, including its exposure to the physical and transitional risks of climate change and the positive or negative effect of Government regulation and policies to mitigate climate change;
  (ii) **governance** factors, such as those involving board composition, executive compensation, and transparency and accountability in corporate decision making, as well as a corporation's avoidance of criminal liability and compliance with labor, employment, environmental, tax, and other applicable laws and regulations; and
  (iii) **workforce** practices, including the corporation's progress on workforce diversity, inclusion, and other drivers of employee hiring, promotion, and retention; its investment in training to develop its workforce's skill; equal employment opportunity; and labor relations.

Investment Duty of Loyalty

- A fiduciary's evaluation of an investment or investment course of action includes ESG considerations, including climate-related financial risk, are, in appropriate cases, risk-return factors that fiduciaries should take into account when selecting and monitoring plan investments and investment courses of action.
- 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 **goals unrelated** to the plan and its participants and beneficiaries.

- The fiduciary is not prohibited from selecting the investment, or investment course of action, based on collateral benefits other than investment returns (i.e. pecuniary factors), so long as the requirements of the proposal are met. These include, in the case of such a collateral benefit for a designated investment alternative for an individual account plan, the prominent display of the collateral-benefit characteristic of the fund in disclosure materials. Further, the fiduciary cannot accept reduced returns or greater risks to secure the collateral-benefit.
- Eliminates the current regulation's special rule that prohibits certain investment alternatives from being used as a QDIA.
- Confirms that consideration of an economically material ESG factor, including climate-related financial risk, is consistent with ERISA's duty of loyalty.
- 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. The weight given to any factor by a fiduciary should appropriately reflect a prudent assessment of its impact on risk-return. Whether any particular consideration is such a factor depends on the particular facts and circumstances.
- If, after the assessment of risk-return impact, a fiduciary prudently concludes that competing investment choices, or investment courses of action, equally serve the financial interests of the plan, a fiduciary can select the investment, or investment course of action, based on collateral benefits other than investment returns.
- All ESG is not equal, and when it is not material to the risk/return analysis, ESG still may be a legitimate collateral benefit for consideration under a tie-breaker analysis. The DOL is concerned that the documentation provisions under Current Regulation could have a chilling effect on the use of the tie-breaker provision more generally, including when ESG is not under consideration. Therefore, the proposal does not place parameters on the collateral benefits that may be considered by a fiduciary to break the tie and rescinds the Current Regulation's requirement for a fiduciary to specially document its analysis in those cases where the fiduciary has concluded that pecuniary factors alone were insufficient to be the deciding factor.
- As an added measure of transparency and protection, the proposal requires in the case of a designated investment alternative for an individual account plan, including a QDIA, that the plan fiduciary must ensure that the collateral benefit characteristic of the fund, product, or model portfolio is prominently displayed in disclosure materials provided to participants and beneficiaries.

SHAREHOLDER RIGHTS/PROXY VOTING PROVISIONS

The proposed rule makes three changes to the current regulation's provision on exercises of shareholder rights, including proxy voting.

- Eliminate "the fiduciary duty to manage shareholder rights appurtenant to shares of stock does not require the voting of every proxy or the exercise of every shareholder right." In general, fiduciaries should take their rights as shareholders seriously, and conscientiously exercise those rights to protect the interests of plan participants. Thus, the elimination does not mean that fiduciaries must always vote proxies or engage in shareholder activism.
- Remove the two "safe harbor". One of these safe harbors permits a policy to limit voting resources to particular types of proposals that the fiduciary has prudently determined are

substantially related to the issuer's business activities or are expected to have a material effect on the value of the investment. The other safe harbor permits a policy of refraining from voting on proposals or particular types of proposals when the plan's holding in a single issuer relative to the plan's total investment assets is below a quantitative threshold.

- Eliminate the requirement that when deciding whether to exercise shareholder rights and when exercising shareholder rights, plan fiduciaries must maintain records on proxy voting activities and other exercises of shareholder rights.

This summary, prepared by Philip Chao, is for general informational purpose only and should not be deemed as delivering any legal or regulatory guidance or advice regarding the subject matter. Please refer to the final rule in its entirety for a more complete understanding and application. Please consult with legal and regulatory counsel before taking any action. https://www.federalregister.gov/documents/2021/10/14/2021-22263/prudence-and-loyalty-in-selecting-plan-investments-and-exercising-shareholder-rights