Voya Alert!

October, 2021

DOL Issues Proposed Regulations on Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights

On October 14, 2021, the Department of Labor (DOL) published proposed amendments to its rules regarding fiduciary "investment duties" under Title I of the Employee Retirement Income Security Act of 1974 (ERISA). These amendments are intended to address uncertainties in the application of ERISA's fiduciary duties of prudence and loyalty to the fiduciary's consideration of climate change and other environmental, social, and governance (collectively, ESG) factors when making investment decisions and when exercising shareholder rights (including voting on shareholder resolutions and board nominations) on behalf of ERISA plan participants and beneficiaries.

The full text of the proposed rule is at https://www.govinfo.gov/content/pkg/FR-2021-10-14/pdf/2021-22263.pdf.
The DOL Fact Sheet is found at https://www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/our-activities/resource-center/fact-sheets/notice-of-proposed-rulemaking-on-prudence-and-loyalty-in-selecting-plan-investments-and-exercising-shareholder-rights.pdf.

Plans Impacted:
The proposed amendments would apply to all employee benefit plans that are subject to Title I of ERISA. An employee benefit pension plan is subject to Title I of ERISA unless it meets one of the following exceptions:

- A 401(a), 401(k), 403(b) or 457(b) plan of a governmental employer (including a public school);
- A top hat 457(b) plan of a nonprofit organization;
- A 401(a), 401(k), or 403(b) plan of a church or church-related entity unless the plan administrator has irrevocably elected to have ERISA apply to that plan;
- A 403(b) plan of a nongovernmental/non-church 501(c)(3) organization that meets the non-ERISA regulatory safe harbor rules; and
- IRAs that do not have employer contributions or active employer involvement.

Public Comment Period: The public may comment on the proposed regulations for the 60-days running from October 14, 2021 through December 13, 2021.

Background
The proposed regulations amend the 2020 final regulations on "Financial Factors in Selecting Plan Investments" and "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights" (collectively, the 2020 Rules) which generally had required that plan fiduciaries evaluate investments and investment-based actions solely on "pecuniary" factors. The 2020 Rules became effective January 2021; however, in March 2021, the DOL announced that they would not enforce the 2020 Rules.

Pursuant to an executive order of President Biden, the DOL revisited the 2020 Rules, in furtherance of policies to mitigate climate-related financial risk and actions to help safeguard the financial security of America's families, businesses and workers from climate-related financial risk that may threaten the life savings and pensions of U.S. workers and families.

Prior to the 2020 Rules, the Department had consistently recognized in its various interpretive guidance that ERISA does not prohibit fiduciaries from making investment decisions that reflect ESG considerations depending on the facts and circumstances. As appropriate economic considerations that present material business risk or opportunities to companies, such material ESG issues should be considered by a prudent fiduciary, along with other relevant economic factors, to evaluate the risk and return profiles of alternative investments.

Proposed Rules
The proposed amendments address the Department's concern that the 2020 Rules have created uncertainty and are having the undesirable effect of discouraging ERISA fiduciaries' consideration of climate change and other ESG factors in investment decisions, even in cases when it is in the financial interest of plans to take such considerations into account. The DOL was concerned that the two safe harbors in the 2020 Rules could be construed as permission for plan fiduciaries to broadly abstain from proxy voting without properly considering their fiduciary duties as shareholders and to plan participants and beneficiaries.

Consideration of ESG Factors as an Investment Duty
The proposed regulations establish that material climate change and other ESG factors are no different than other "traditional" material risk-return factors that are part of a plan fiduciary's investment duties. Thus, a fiduciary's duty of prudence may require an evaluation of the economic effects of climate change and other ESG factors on the particular investment or investment course of action. Examples of such factors in the proposed amendments include:

- 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 regulations and policies to mitigate climate change;
- 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
- 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.

Designated Investment Alternative Provisions Modified
The proposal removes the special rules for designated investment alternatives (DIAs) imposed by the 2020 Rules that required plan fiduciaries to select investments and investment courses of action based solely on pecuniary factors rather than also considering non-pecuniary objectives in those investment objectives or principal investment strategies. The proposed regulations instead apply the same standards to DIAs as apply to other investment—namely, that a plan fiduciary must focus on material risk-return factors, including ESG factors as required by the facts and circumstances, and not subordinate the interests of participants and beneficiaries (such as by sacrificing investment returns or taking on additional investment risk) to objectives unrelated to the provision of benefits under the plan.

The proposed regulations also allow a plan fiduciary to select a fund to serve as a Qualified Default Investment Alternative (QDIA) if it, or any of its component funds in a fund-of-fund structure, has investment objectives, goals, or principal investment strategies that include, consider, or indicate the use of non-pecuniary factors in its investment objectives, even if the fund is objectively economically prudent from a risk/return perspective or even best in class, a rescission of the 2020 Rule. The proposed regulations note that the term "designated investment alternative" does not include brokerage windows, self-directed brokerage accounts, or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan.

Improvements and Clarification of Application of the Tie-Breaker Test
The proposal replaces the 2020 Rule provisions with a broader standard that requires a plan fiduciary to conclude prudently that competing investments, or competing investment courses of action, equally serve the financial interests of the plan over the appropriate time horizon. In such cases, the plan fiduciary is not prohibited from selecting the investment or investment course of action based on economic or non-economic benefits other than investment returns.

The proposed changes also remove the 2020 Rules' special documentation requirements for ESG investments, noting that these create unnecessary burdens for application of the tie-breaker provision which dampened the consideration of ESG factors, even when those factors are financially material to the investment decision.

The proposal does not place parameters on what may be considered a collateral benefit. When ESG factors are not considered material to the risk/return analysis, they may still be a legitimate collateral benefit for consideration in a tie-breaker analysis.

To the extent individual account plans use a tie-breaker in the selection of a designated investment alternative, the plans must prominently disclose the collateral considerations that were used as tie-breakers to the plans' participants.

Shareholder Rights/Proxy Voting Provisions

The proposed regulations seek to align with the DOL's longstanding view that proxies should be voted as part of the process of managing the plan's investment in company stock unless a responsible plan fiduciary determines voting proxies may not be in the plan's best interests, such as if there are significant costs or efforts associated with voting.

The proposed amendments remove the two "safe harbor" examples in the 2020 Rules regarding proxy voting policies that would have permitted a fiduciary 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; and
- Refrain 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.

The DOL notes that those safe harbors do not adequately safeguard the interests of plans and their participants and beneficiaries.

The proposed regulations remove the requirement that plan fiduciaries maintain records on proxy voting activities and other exercises of shareholder rights. According to the DOL, imposing such a requirement may create the misperception that proxy voting and other exercises of shareholder rights differ from other fiduciary activities. The proposed rule instead directs fiduciaries to the generally applicable ERISA fiduciary duties of prudence and loyalty.

This publication is meant only as a high level summary of some of the key points contained in the proposed regulations. Plan sponsors should review the final regulations with the plan's attorney to determine impact of these changes on the sponsor's retirement plan.