SALTZMAN & JOHNSON
LAW CORPORATION

(510) 906-4710
www.sjlawcorp.com

MEMORANDUM

TO: ERISA Trust Fund Clients
CC: Investment Consultant
FROM: Shaamini Babu and Allan Shuldiner
DATE: October 19, 2023
RE: ESG and ETI Considerations; and Proxy Voting

On December 1, 2022, the U.S. Department of Labor ("DOL") issued Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 87 Fed. Reg. 73,822, final regulations ("2022 DOL Reg.") regarding the use of environmental, social and governmental ("ESG") considerations and economically targeted investments ("ETI") by ERISA plans as well as proxy voting. These final regulations became applicable on January 30, 2023. There are ongoing efforts to overturn these regulations.

ERISA plans may consider ETI and ESG factors as explained below. We will continue to work with the Investment Consultant to evaluate any reporting requirements.

Definition of ESG and ETI

ESG considerations – A wide variety of factors can fall into these categories and there is not a single consensus definition. Environmental factors can include rating a company on factors such as greenhouse gas emissions, waste management, natural resource conservation, energy efficiency and sustainability. Social factors can include human rights, labor standards in the supply chain, exposure to illegal child labor, an adherence to workplace health and safety and charitable contributions. Governance factors can include management structure, employee relations, executive and employee compensation, transparency and stockholder rights.

ETIs – This is the selection of securities for the economic benefits they create, apart from an investment return. For example, investments that create jobs, improve the availability of affordable housing or improve the infrastructure in a particular geographic locale might be given preference over other investments.

What ESG and ETI investments have in common is that they are selected in part for collateral benefits in addition to the impact these considerations can have on investment return.

Fiduciary Duties

The fiduciary duty of loyalty requires the fiduciary to discharge his or her duties *solely* in the interest of participants and beneficiaries and for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable plan expenses. ERISA §404(a)(1); 29 U.S.C. §1104(a)(1). In short, this duty requires fiduciaries to avoid a conflict of interest.

The fiduciary duty of prudence requires the fiduciary to discharge his or her duties "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 in the conduct of an enterprise of a like character and with like aims." ERISA §404(a)(1)(B); 29 U.S.C. §1104(a)(1)(B). Use of a prudent process is key. To evaluate whether a plan fiduciary has breached their fiduciary duty of prudence, courts focus "not only on the merits of the transaction, but also on the thoroughness of the investigation into the merits of the transaction." *Howard v. Shay*, 100 F.3d 1484 (9th Cir. 1996).

It has been the practice for over twenty years for each Presidential administration to modify the guidance on the appropriate usage of ESG investing. Democratic administrations generally support the expansion of ESG investing while Republican administrations generally try to limit its use. Nevertheless, there is agreement that the fiduciary duties of loyalty and prudence provide the relevant boundaries.

The preamble provides that the 2022 DOL Reg. "retains the core principle that the duties of prudence and loyalty require ERISA plan fiduciaries to focus on relevant risk-return factors 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."

<u>Development of the Law in ESG Investing: 2018 – 2020 DOL Regulation (Trump Administration)</u>

Even under the 2018 guidance, there is acknowledgement that ESG considerations could present a material business risk or opportunity to companies, which investment professionals would treat as material economic considerations. DOL Field Assistance Bulletin 2018-01 (Apr. 23, 2018). Examples of ESG considerations as material economic concerns are that a company's improper disposal of hazardous waste can implicate business risks, litigation exposure and regulatory obligations while a dysfunctional corporate structure can present a pecuniary risk.

The 2020 DOL Regulation required plan fiduciaries to select investments based solely on "pecuniary factors". 29 C.F.R. §2550.404a-1(c) (2020). As such, it only allowed ESG or ETI factors as a tiebreaker where the competing investments were indistinguishable based on pecuniary factors alone. 29 C.F.R. §2550.404a-1(c)(2) (2020). For example, this meant that selecting an investment in part on the basis of utilization of union labor was impermissible except in the presumably rare instance that this investment was "indistinguishable" from another investment and thus, the ETI was used as a tiebreaker. 72 Fed. Reg. 72862 (Nov. 13, 2020).

For defined contribution plans, the 2020 Regulation allowed the placement of a prudently-selected, well-managed and properly diversified ESG-themed alternative as part of a menu of options, as it would not require the plan to forego other, non-ESG options. However, the prior guidance expressed doubt on whether it would ever be prudent to have an ESG option as the plan's qualified default investment alternative (QDIA), which is the default option for participants who have not actively chosen other investment options. 29 C.F.R. §2550.404a-1(c).

New Law: 2022 DOL Regulation

The DOL found that "pecuniary factors" was confusing and had a chilling effect to financially beneficial choices. The DOL revised the standard to allow the use of ESG factors when they are reasonably determined as "relevant to a risk and return analysis," using an appropriate time horizon consistent with the plan's investment policy. 29 CFR §2550.404a-1(b)(4). The risk and return factors may include the economic effects of climate change and other ESG factors on the investment or particular course of action. Consideration of any particular factor depends on the facts and circumstances and its weight should reflect a reasonable assessment of its impact on risk-return. *Id*.". 29 CFR §2550.404a-1(b)(4). The 2022 DOL Regulation allows the use of collateral factors such as ESG and ETI concerns when the fiduciary prudently concludes that competing investments "equally serve" the plan over of the appropriate time horizon and removed the documentation requirement. 29 CFR §2550.404a-1(c)(2).

For defined contribution plans, the 2022 Regulation reaffirmed that it does not violate the fiduciary duty of loyalty to take participant preferences into account and allow participants to select an ESG or ETI investment as part of their menu of options. 29 CFR §2550.404a-1(c)(3). Further, it eliminated the prior heightened regulatory scrutiny for QDIAs, as "the central premise behind the final rule's amendments to the current regulation is being perceived by plan fiduciaries and others as an impediment to protecting the financial benefits of plan participants and beneficiaries by prohibiting or encumbering plan fiduciaries from managing or taking advantage of climate change and other ESG risk factors in selecting investments." 2022 DOL, at 73843. Instead, a plan fiduciary may select a QDIA pursuant to the same fiduciary duties of prudence and loyalty that it exerts when selecting investments that are not QDIAs. 29 CFR §2550.404a-1(c)(3); 2022 DOL, at 73843. While plans may allow ESG-focused investments as part of their menu of options, any such investment must still be prudent and the plan fiduciary must not sacrifice investment returns or take on greater risk.

Efforts to Overturn and Repeal the 2022 DOL Regulations

Congress

These 2022 DOL Regulations have been controversial politically. Federal lawmakers passed a resolution disapproving it with votes in the House of 216-204 and in the Senate of 50-46. This would have prevented it from being enacted in substantially the same form as the disapproved rule. President Joe Biden vetoed the resolution on March 20, 2023, thereby making it an enforceable regulation.

Litigation

Utah v. Walsh - On February 22, 2023, a coalition of 25 states filed a lawsuit in federal district court, arguing that the regulation violates federal law by allowing employee benefit plans to focus on social issues rather than long-term financial stability. The district court rejected plaintiffs' claims and held that the regulation was within the scope of the DOL's regulatory authority. *Utah v. Walsh*, 2023 U.S. Dist. Lexis 168696 (N.D. Tex. 2023) [1].

[1] The states of California, Nevada and Hawaii are not plaintiffs in this suit.

Braun v. Walsh – On February 21, 2023, a conservative nonprofit, the Wisconsin Institute for Law and Liberty, filed a separate lawsuit against the final regulations. *Braun v. Walsh*, E.D. Wisc., 2:23-cv-00234. Plaintiffs allege that the Department of Labor lacks the authority to make environmental policy or advance the policy objectives of ESG, and allowing ESG investments contradict ERISA's duty to maximize the investment returns for participants and beneficiaries. They also claim that eliminating the documentation requirement for their investment choices in an ESG investment eliminates a layer of protection for plan participants.

<u>Proxy Voting</u>

The fiduciary duty to manage plan assets that are shares of stock includes the shareholder rights to vote those shares, or proxy voting. 2022 DOL Regulation, 87 Fed. Reg. 73,827. The DOL viewed the regulations under the prior administration as one that wanted to curb the practice of plan fiduciaries casting votes in favor of social or political positions that did not advance the financial interests of plan participants. The prior rule required plan fiduciaries to not participate in proxy votes unless the fiduciary prudently determined that that the matter had an economic impact on the plan and required documentation on proxy voting activities. The DOL concluded that these encouraged abstention from voting as the normal course of action. 2022 DOL Regulation, 73,828.

The DOL did not want to create a perception that proxy voting and other exercises of shareholder rights are disfavored or carry greater fiduciary obligations than other fiduciary activities. *Id*. Accordingly, the DOL removed safe harbors to avoid proxy voting and regulatory language that specified that shareholder rights do not require the voting of every proxy, as well as the documentation requirements. *Id*. The new rule emphasizes that fiduciaries must follow the duties of prudence and loyalty. When deciding whether to exercise shareholder rights, plan fiduciaries must act in interest of plan participants and beneficiaries, consider any costs involved with voting, and not subordinate the interests of plan participants and beneficiaries to another objective. 29 CFR §2550.404a-1(d)(2)(ii)(A)-(D). Fiduciaries are not required to submit a proxy vote.

The new rule effective December 1, 2023, requires that investment managers with investments in a pooled vehicle to vote proxies in proportion to each plan's economic interest. 29 CFR §2550.404a-1(d)(4)(ii). As this may be difficult for an investment manager to administer, it may instead require a plan to accept an investment policy statement prior to the investment so that they may vote proxies as a single unit rather than in proportion to each plan's economic interest. *Id*. If such an investment policy statement is presented, the plan must assess whether it is consistent with their fiduciary duties before deciding to retain the investment manager.