DOL Proposes to Formally Regulate ESG Investing

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On June 30, 2020, the United States Department of Labor (DOL) published a Proposed Rule in the Federal Register seeking to formalize guidance concerning environmental, social, and governance (ESG) considerations in selecting investments for plans subject to the Employee Retirement Income Security Act of 1974 (ERISA).

Background

ESG considerations are not new to institutional investing. ESG investments are similar to "socially responsible investments" in that the underlying holdings of funds have undergone some level of ethical and moral review, but ESG funds go a step further to incorporate the ESG component as part of the long-term financial strategy of the fund. ESG investing has become an increasingly popular topic of conversation, in part due to increased awareness by participants and plan fiduciaries that mutual fund investments may include holdings in companies or industries to which they are morally or ethically opposed. As more attention has been drawn to the underlying holdings of mutual funds, participants and fiduciaries are increasingly considering whether investments which take into account greater ethical and moral considerations may be made available under their plans.

Under Section 404(a) of ERISA (the prudent person standard), fiduciaries with discretionary authority over a plan's investments (or investment alternatives in the case of a participant directed defined contribution plan) must act solely in the interest of plan participants and beneficiaries, and for the exclusive purpose of providing benefits and defraying reasonable expenses of administering the plan. The DOL has long interpreted this prudent person standard to place limitations on plan fiduciaries' consideration of non-pecuniary (collateral) benefits when evaluating a potential investment. Although older guidance allowed limited consideration of collateral benefits, the most recent DOL guidance prior to the issuance of the Proposed Rule, DOL Field Assistance

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Bulletin 2018-01, provided two restrictive guiding principles in weighing ESG factors when considering investments:

- Fiduciaries cannot accept lower investment returns or higher risks for participants in order to promote collateral social policy goals; and
- Fiduciaries should use collateral factors such as ESG considerations only as a "tie-breaker" when two investments are otherwise economically equivalent with respect to return and risk.

Taking these factors into account, plan fiduciaries have been advised to tread cautiously when evaluating an investment with an ESG component for addition to a plan's investment lineup, and to focus on financial return as central to the decision-making process.

Proposed Rule

The Proposed Rule, "Financial Factors in Selecting Plan Investments" would amend the regulations under Section 404(a) of ERISA to provide regulatory guidelines for applying the prudent person standard to ESG investment selection, which the DOL considers "a growing threat to ERISA's fiduciary standards." As the DOL states in the preamble to the Proposed Rule, it "is designed in part to make clear that ERISA plan fiduciaries may not invest in ESG vehicles when they understand an underlying investment strategy of the vehicle is to subordinate return or increase risk for the purpose of non-pecuniary objectives." To achieve this objective, the Proposed Rule provides the following guidance:

- The duty of loyalty and prudence under Section 404(a) of ERISA is satisfied in connection with a fiduciary's investment decision if the investments or investment courses of action are selected based solely on pecuniary factors and not on the basis of any non-pecuniary factor.
- ESG or other similar considerations are pecuniary factors only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories. Such factors should reflect a prudent assessment of their impact on risk and return.
- The duty of loyalty under Section 404(a) of ERISA requires that fiduciaries do not subordinate the interests of participants or beneficiaries to the fiduciary's or others' interests.
- Where investment alternatives are determined to be economically indistinguishable, and one of the investments is selected on the basis of a non-pecuniary factor, the fiduciary must document specifically why the investments were determined to be indistinguishable and why the selected investment was chosen based on the purposes of the plan, diversification of investments, and the interests of plan participants and beneficiaries. Importantly, the DOL notes that "economically indistinguishable" investments rarely exist, if ever, indicating a potential for increased scrutiny.
- In the context of defined contribution plans, prudently selected ESG funds will not violate ERISA if: only objective criteria are used to select and monitor investment alternatives

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(benchmarks, expense ratios, fund size, historic returns, etc.), the process of applying such criteria is documented, and ESG is not a component of the plan's qualified default investment alternative (QDIA).

Impact of Proposal

The Proposed Rule seeks to solidify the DOL's current position that ERISA does not allow plan fiduciaries to sacrifice return or assume any additional risk in order to incorporate non-pecuniary goals. In so doing, the Proposed Rule makes it clear that financial return is paramount by imposing a burden on fiduciaries to carefully document their investment decision-making process whenever a potential investment has a non-pecuniary or collateral objective. This documentation requirement puts fiduciaries on notice that ESG investments will be subject to considerable scrutiny for possible breach of fiduciary duty. This burden and compliance challenge will undoubtedly have some degree of chilling effect on ERISA plan ESG investing, at least for the foreseeable future.

Looking Toward a Final Rule

Given that it is a presidential election year, the current administration is likely to attempt to finalize a regulation prior to the election — since an effective final rule would require more effort to undo in the event of a new administration with a differing view on ESG investing under the prudent person standard. As such, the DOL has established a short 30-day public comment window for the proposed rule (expiring July 30, 2020) — and will probably work swiftly to issue a final rule within the coming months, likely before year end.

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