Publications

DOL Proposes Rule to Crack Down on ESG

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On June 23, 2020, the Department of Labor ("DOL") issued a proposed regulation (the "Proposed Rule") defining plan fiduciaries' duties under the Employee Retirement Income Security Act of 1974 ("ERISA") when considering economically targeted investments or those that incorporate environmental, social, and governance ("ESG") factors. The Proposed Rule embodies some of the prior guidance and adds new recordkeeping requirements setting forth how plan fiduciaries can meet their fiduciary obligations when making ESG investments. The Proposed Rule, in conjunction with recent enforcement activity, demonstrates a renewed interest and skepticism by DOL about ERISA plans' ESG investing practices. Because the Proposed Rule could have a major impact on ESG investing, interested stakeholders should strongly consider submitting comments before the close of the 30-day comment window.

ESG Investing

ESG investing – a term first coined in 2005 – is an outgrowth of the socially responsible investing movement, which has long sought to encourage people and institutions to take into account moral and ethical considerations when making investment decisions. Unlike some socially responsible investment strategies based on non-pecuniary considerations, ESG investing is often grounded on the premise that ESG factors are relevant to an investment's financial performance.

The argument that ESG factors have economic relevance has, in part, spurred a significant growth in ESG-focused investment strategies internationally over the past decade. Many institutional investors, including public pension plans, have embraced the use of ESG factors in investment selection. Although some private sector retirement plans have been slower to adopt ESG investing due to concerns that ESG investing creates regulatory or litigation risk, a growing number of plans have begun to incorporate ESG factors into some of their investment decision-making.

ERISA & Prior Guidance

ERISA requires fiduciaries act "solely" in the interest of the plan participants and beneficiaries and for the "exclusive purpose" of providing benefits and paying reasonable administrative expenses. Over the past 40 years, DOL has periodically issued guidance addressing the extent to which these duties under ERISA allow for socially responsible and/or ESG-based investment decisions.

Notably, DOL guidance has regularly shifted back and forth at the margins with changes in Presidential administrations. Historically, Democratic administrations have been more permissive in their social and ESG investing approach while Republican administrations have taken a more restrictive approach. Most importantly, DOL, regardless of the party in office, has been consistent in its position that a fiduciary cannot inappropriately sacrifice returns or take on additional risk when making investment decisions for ERISA plans and that the economic returns of an investment must be the plan fiduciary's primary consideration.

Prior DOL guidance has allowed ERISA fiduciaries to consider the collateral benefits (*i.e.*, non-economic benefits) of a potential investment if (a) the investment has an expected rate of return commensurate with rates of return of available alternative investments with similar risk characteristics and (b) the investment is otherwise an appropriate investment for the plan. This standard – often referred to as the "all things being equal test" – essentially permits a fiduciary to use non-economic factors as a tie-breaker for two equivalent investments. The concept has been incorporated into federal laws intended to *encourage* divestment from Sudan and Iran (*i.e*., the Sudan Divestment Act of 2007 and the Iran Sanction Act of 2010).

DOL's Current Concerns with ESG

In the preamble to the Proposed Rule, DOL indicates that the agency has a growing concern that market trends emphasizing the non-economic benefits of ESG investing may lead ERISA plan fiduciaries to make investment decisions for reasons other maximizing returns for plan participants. DOL also noted that some investment products are marketed to ERISA governed retirement plans on the basis of benefits unrelated to financial performance. DOL appears particularly concerned that ESG investing may result in higher fees and that there is a "lack of precision and rigor in the ESG investment marketplace," meaning that there is "no consensus about what constitutes a genuine ESG investment; and ESG rating systems are often vague and inconsistent, despite featuring prominently in marketing efforts."

DOL does acknowledge that ESG considerations may have an impact on an investment's financial performance. For example, DOL specifically cites "a company's improper disposal of hazardous waste" and "dysfunctional corporate governance" as examples of ESG considerations that would be appropriate economic considerations. However, DOL states that "ESG investing raises heightened concerns under ERISA," and the Secretary of Labor opined in the Wall Street Journal that "ESG factors often are touted for reasons that are nonpecuniary—to address social welfare more broadly, rather than maximize returns."

Importantly, DOL has recently begun to incorporate a focus on ESG investing into its enforcement activities. In May, DOL's New York Regional Office sent letters to several ERISA plan sponsors and investment consultants requesting information about their ESG investments and decision-making. Other DOL offices have opened investigations or sent queries related to whether and how fiduciaries, including asset managers, are making investment decisions based on ESG considerations.

Similarly, the Securities and Exchange Commission ("SEC") has included ESG in its examination and oversight priorities. In this regard, SEC's Office of Compliance, Inspections, and Examinations recently published examination priorities that focus on a review of the accuracy and adequacy of disclosures by registered investment advisors with respect to "responsible investing." In essence, SEC is interested in how advisers market ESG strategies and whether advisers' disclosures regarding ESG strategies are accurate. SEC's Division of Investment Management has also asked for public comment as to whether the Names Rule under the 1940 Act should apply to ESG funds. Given the lack of standardized taxonomy and terminology in this space, SEC is seeking to understand whether terms like ESG are likely to mislead investors.

The Proposed Rule

The Proposed Rule amends regulations under section 404(a) of ERISA to set forth DOL's position on ESG investing, using DOL's prior regulatory and sub-regulatory guidance as the starting point but arguably making some important additions. The Proposed Rule makes the following key changes to the language of the long-standing regulation governing a fiduciary's duty of prudence and loyalty by stating that a fiduciary satisfies its duties of prudence and loyalty in the following circumstances:

- The Proposed Rule confirms that an ERISA fiduciary's duties of prudence and loyalty are satisfied where the fiduciary has "selected investments and/or investment courses of action based solely on their pecuniary factors and not on the basis of any non-pecuniary factor." The Proposed Rule also prohibits fiduciaries from subordinating the interests of participants and beneficiaries to the interest of the fiduciary or any other interest.
- The Proposed Rule amends the existing regulation to provide that fiduciaries must compare investments (or investment courses of action) to other available investments (or investment courses of action) based solely on economic factors. DOL clarified in the preamble its view that that the purpose of this change is to remind fiduciaries that they should not let non-pecuniary considerations distract them from obtaining the best economic results for the plan.
- The Proposed Rule explicitly sets forth DOL's position that ESG considerations may only be taken into consideration if they "present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories."
- The Proposed Rule states that, where investment alternatives are economically indistinguishable, and where the investment selected is based on non-pecuniary ESG factors, fiduciaries should document why the investments are determined to be indistinguishable and why the investment is chosen. In doing so, DOL retained the "all things being equal test" while noting the proposed regulation's requirement that fiduciaries document their decision-making process. DOL explained its view in the preamble that the documentation requirement is necessary to safeguard against fiduciaries making decisions based on non-pecuniary factors without proper analysis or rigor.
- The Proposed Rule adds specific requirements for fiduciaries considering adding ESG oriented investments within defined contribution plans. In doing so, DOL sets forth in the proposed regulation its position articulated in sub-regulatory guidance to DOL enforcement offices under Field Assistance Bulletin 2018-01. The Proposed Rule states that a fiduciary's addition of prudently selected ESG oriented investments to a defined contribution plan would not violate ERISA where:
  - The fiduciary only uses objective risk-return criteria to select and monitor all investment alternatives in the plan, including ESG-oriented investment alternatives;
  - The fiduciary documents its selection and monitoring of the investment; and
  - The ESG oriented fund is not added as, or a component of, a QDIA. The Proposed Rule prohibits the use of ESG-themed funds as QDIAs.

Conclusion & Outlook

The Proposed Rule represents an important evolution of DOL's views on ESG investing. Although many of the concepts are consistent with longstanding DOL interpretations of ERISA, the Proposed Rule's changes to the regulations describing fiduciaries' duties of prudence and loyalty could create significant challenges for ERISA plan fiduciaries considering ESG investing. Interested stakeholders should consider submitting comments during the 30-day comment window.

DOL has a strong incentive to finalize the rule this year. In the event that President Trump does not win a second term, it is entirely possible – if not likely – that a Democratic administration would seek to unwind the rule. That is considerably easier to do if the rule is not final and effective. It is also worth noting that the ultimate fate of the rule could be in the hands of the next Congress, which has the ability to overturn any rulemaking through the Congressional Review Act.

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