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You Can't Always Get What You Want: The End of ESG Investing in ERISA Accounts

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The United States Department of Labor ("DOL") is forging ahead with a controversial new proposed rule that would dramatically change the landscape of ESG investing in retirement accounts. The rule, which would make several changes to the Employee Retirement Income Security Act of 1974 ("ERISA"), seeks to make law in an area where DOL's prior guidance has tended to change with each administration. Critics of the proposal, however, worry about the future of ESG investing following the imposition of DOL's new rule, which severely limits the ability of ERISA fiduciaries to invest in ESG investments.

The Proposed Rule

The rule, which DOL has named "Financial Factors in Selecting Plan Investments," was proposed on June 23, 2020. According to DOL's Fact Sheet, the proposal includes five key changes to ERISA:

- An affirmative statement "that ERISA requires plan fiduciaries to select investments and investment courses of action based on financial considerations relevant to the risk-adjusted economic value of a particular investment or investment course of action[;]"
- An express statement that complying with ERISA's duty of loyalty "prohibits fiduciaries from subordinating the interests of plan participants and beneficiaries in retirement income and financial benefits under the plan to non-pecuniary goals[;]"
- A requirement that fiduciaries "consider other available investments to meet their prudence and loyalty duties[;]"
- An acknowledgement that ESG factors can be pecuniary "but only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories" (including new documentation and analysis requirements for investment "tie-breaking"); and
- A provision on "selecting designated investment alternatives for 401(k)-type plans" which

reiterates that the duties of prudence and loyalty apply to a fiduciary's choice of investment alternative to be offered in a 401(k)-type plan.

DOL asserts in its Fact Sheet that the proposed rule's "aim is to assist ERISA fiduciaries by establishing clear regulatory guideposts for plan fiduciaries in light of recent trends involving ESG investing that the Department is concerned may lead ERISA plan fiduciaries to choose investments or investment courses of action to promote environmental, social, and public policy goals unrelated to the interests of plan participants and beneficiaries in financial benefits from the plan and expose plan participants and beneficiaries to inappropriate investment risks."

DOL's regulations only apply to private-sector retirement schemes and thus do not reach retail investment accounts or non-corporate institutional pensions and 401(k) plans, yet would still apply to over $9 trillion in assets.

The Employee Benefits Security Administration submitted the rule change last week to the White House Office of Management and Budget for final approval. It is expected that the proposal, supported by the current administration, will become law in the very near term.

An Unusual Rulemaking Process

The proposed rule has been pushed through at an incredible—and highly unusual—pace. Usually, a change of this type takes about eighteen months, but the administration fast-tracked this one to less than six months. In order to move the rule through quickly, DOL's proposal was only subjected to a 30-day comment period—much shorter than the typical 60- to 180-day comment periods. Strikingly, of the over 1000 comments received, the vast majority—over 95%—expressed opposition to the proposal. DOL, however, was undeterred by this overwhelming opposition.

The rapid pace and widespread opposition to the proposal could come back to haunt DOL, though. Once implemented as a rule, the proposal's rapid pace and controversial process are likely to become subjects of close judicial scrutiny. Critics of the rule believe that it may not withstand legal challenge given the truncated comment period and overwhelming opposition. This begs the question, what is DOL thinking?

DOL's Justification

Under ERISA, fiduciaries are "required to act solely in the interest of the plan's participants and beneficiaries." DOL appears to interpret "interest" to mean solely a pecuniary interest, taking nothing else into account. Because ESG investing inherently involves an assessment of more than just financial outcomes, DOL does not consider ESG investing to be consistent with ERISA fiduciary duties. In fact, Secretary of Labor Eugene Scalia has stated plainly that the only "social goal" ERISA plan managers should be focused on is "providing for the retirement security of American workers."

DOL's news release about the new rule explains that the rule's aim is "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-financial objectives." DOL asserts that its new rule will improve the performance of conventional active funds, and that the corporate plans under its purview will see better outcomes by switching actively-managed ESG investments out for traditional indexes.

DOL also touts the new rule for providing clarity. In the past, DOL issued several Interpretive Bulletins providing guidance on ESG investing (or the prior names by which it was known), and each one seemed to undo the last. The proposal, as administrative law, would override all prior agency guidance, eliminating the confusion as to DOL's position. In addition, prior to this new proposal, DOL allowed "non-pecuniary factors" to be considered as tie-breakers in cases where potential investments had equal likely returns and risks. Now, DOL has indicated that it does not believe such situations actually often arise and has added, through the new rule, an analysis and documentation requirement in the narrow set of cases where they do. Under the new rule, a company seeking to use an ESG investment with "non-pecuniary benefits" must demonstrate that the investment is a *better* financial choice than *all* other available investments.

Although many are critical of the proposed rule, the administration has defended the proposal on the grounds that ESG funds do not perform as well as other investments. Whether or not this is accurate, however, is an open question, given the lack of uniform standards governing ESG funds, and many financial services companies and institutional investors opposing the rule find this premise faulty.

Critical Reception

Opposition to the proposal has been widespread, uniting investment managers, politicians, labor unions, and pension funds alike. For example, opponents of the rule include Fidelity Investments, BlackRock, Vanguard, State Street Global Advisors, the AFL-CIO, pension funds, and 401(k) provider groups. In their July 30, 2020 opposition letter, Senators Elizabeth Warren (D-MA), Patty Murray (D-WA), and Sherrod Brown (D-OH) called the proposal "rushed and out-of-touch" and cautioned that it "would undermine fiduciaries' ability to consider all available information and make sound investments[.]"

Supporters of the rule, however, have argued that investment management is not the way to solve issues like climate change. Supporters also applaud DOL for providing clarity after two decades of back and forth guidance on ESG investing. The United States Chamber of Commerce and the American Legislative Exchange Council are among the supporters of the rule, with the latter cautioning that fiduciaries should avoid "risky, politically driven investment choices."

Critics disagree, arguing that the DOL proposal does not actually provide clarity and instead makes it unclear whether and when ESG criteria may be considered ***at all***. Further, proponents of ESG investing argue that ESG-related criteria are relevant to the performance of companies and investments, and those that manage well material risks arising out of ESG concerns will perform the best. Moreover, while DOL opines that ESG investments are volatile and do not perform as well as traditional investments, this has not proven to be true. As documented in an abundance of studies conducted by financial watchdogs, business schools, and financial services firms, among others, ESG investments have in recent years kept pace with, and often outperformed, other investments. For example, a BlackRock study recently showed that in Q1 of 2020, 94% of sustainable indexes performed better than traditional ones.

The Effect of the New Rule

With the rule likely to take effect imminently, the future of ESG investing is uncertain. Critics of the new rule are concerned that it will limit investment options for retirement plans, effectively taking ESG investments off the table. Many critics have pointed out that DOL's new rule is not only contrary to marketplace trends and data, but reflects an outdated understanding of investing, ignoring the

unmistakable shift towards ESG investing over the last several years. What will become of ESG after the implementation of the new DOL rule remains to be seen, but, with DOL's $9 trillion reach, what is certain now is that the effects of the new rule will soon be acutely felt by institutional investors and financial services firms alike.

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