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The Department of Labor's ESG Proposed Rule: A Retirement Committee Perspective

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A recently proposed Department of Labor regulation entitled "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights" (the "Proposal") addresses the duties of retirement plan fiduciaries when considering economically targeted investments – i.e., investments that take into account environmental, social, and governance ("ESG") factors. Issued in response to a May 20, 2021 Executive Order, the Proposal would significantly modify prior, Trump-era rules on the subject. This post examines the Proposal from the retirement committee perspective.

The Evolution of Retirement Plan ESG Investing

The Department of Labor ("Department") has a longstanding position that trustees, investment managers and other fiduciaries charged with the investment of the assets of ERISA-covered retirement plans must not sacrifice investment returns or assume greater investment risks as a means of promoting collateral social policy or goals. If, however, an economically targeted investment has an expected rate of return at least commensurate to rates of return of available alternative investments, and if an economically targeted investment is otherwise an appropriate investment for a plan, then plan fiduciaries could use these collateral considerations as the deciding factor for an investment decision. This rule, which dates back to a 1994 Department of Labor interpretive bulleting, is colloquially referred to as the "all things being equal" test or the "tie-breaker" standard.

For the next two decades, the Department continued to endorse the "all things being equal" in subsequent guidance, with minor variations. At no time did the Department ever vary from its regulatory position, however: fiduciaries run afoul of ERISA if they accept reduced expected returns or greater risks to secure social, environmental, or other policy goals. Then, in 2015, the Department added an important nuance to its views of ESG investing. For the first time, the Department recognized that there could be instances when ESG issues:

[P]resent material business risk or opportunities to companies that company officers and directors need to manage as part of the company's business plan, and that qualified investment professionals would treat the issues as material economic considerations under generally accepted investment theories. As appropriate economic considerations, such 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. [Field Assistance Bulletin 2018–01, citing to Interpretive Bulletin 2015–01].

Thus, the Department recognized that ESG factors might, in addition to acting as mere tie-breakers, also bear directly on an investment's underlying economic merits.

In 2020 though, the Department abruptly changed direction, issuing a final regulation that modified the rules governing the consideration of ESG factors in three important ways:

- The 2020 rule clarified that a fiduciary's duties of prudence and loyalty are satisfied where the fiduciary's investment decisions are based solely on their *pecuniary factors* and not on the basis of any non-pecuniary factor." A pecuniary factor for this purpose is "a factor that a fiduciary prudently determines is expected to have material effect on the risk and/or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives and the funding policy . . . ."

- According to the 2020 rule, ESG factors can be only used as a tie breaker between financially equivalent investments. Thus, investment alternatives must be economically indistinguishable. In addition, where the investment selected is based on nonpecuniary ESG factors, fiduciaries are required to document their determination that the selected investment is indistinguishable from a pecuniary standpoint.

- The 2020 rule bars the use of an ESG-oriented fund as a qualified default investment alternative (QDIA) if its investment objectives or goals or its principal investment strategies include, consider or indicate the use of one or more nonpecuniary factors.

While the 2020 rule nowhere uses the term "ESG investments" or "ESG factors," the rule was clearly intended to discourage the use of ESG factors by fiduciaries of ERISA-covered plans either as tie breakers or in connection with an investment's underlying economic merits.

The Proposal

The Proposal reverses much of the substance of the 2020 final regulation. From the perspective of retirement committee members who are charged with curating 401(k) investment menus, the Proposal makes the following changes:

- <u>Materiality of ESG Factors</u>

The Proposal clarifies that a fiduciary may consider *any* factor material to the risk-return analysis, including climate change and other ESG factors. Thus, climate change and other ESG factors are no different than other traditional material risk-return factors. The Proposal nevertheless singles out certain ESG factors that a fiduciary may consider in the evaluation of an investment or investment course of action if material, which 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.

- Jettisoning of the "Pecuniary Factors" Test

The Proposal removes any reference to pecuniary factors in the provision of the regulation governing the application of the ERISA duty of loyalty. It also confirms that consideration of an economically material ESG factor, including climate-related financial risk, is consistent with ERISA's duty of loyalty. Depending on the investment or investment course of action under consideration, relevant factors may include the items enumerated above.

- Reinstating the Prior Law "Tie-Breaker" Test

The 2020 final rule focused on whether the competing investments are indistinguishable based solely on consideration of risk and return. Thus, investments might not be indistinguishable despite that they might be equally appropriate additions to the plan's portfolio. Under the Proposal, the tie-breaker standard is broadened such that it applies when choosing between competing choices or investment courses of action that a fiduciary prudently concludes "equally serve the financial interests of the plan." Thus, for example, two investments may differ on a wide range of attributes, yet when considered in their totality can serve the financial interests of the plan equally well. The Proposal also disposes with the additional documentation requirements that the 2020 final rule impose on fiduciaries with applying the tie-breaker provision.

- Investment Options and QDIAs Applying ESG Factors

The Proposal allows fiduciaries to make available investment alternatives, including QDIAs, which take collateral ESG factors into consideration, provided that the fiduciary discloses the collateral ESG benefits to plan participants.

In the Preamble to the Proposal, the Department explains that the purpose of the disclosure requirement is to ensure that plan participants "are given sufficient information to be aware of the collateral factor or factors that tipped the scale in favor of adding the investment option to the plan menu, as opposed to its economically equivalent peers that were not." The Proposal offers flexibility on how to make the disclosure. Fiduciaries can, for example, use the existing rules requiring plan administrators of 401(k) and other defined contribution plans that permit participants to direct how their accounts are invested to provide investment and expense information under the Department's 2010 regulation on the subject.

The Effect on Retirement Committees

The incentives (or pressure) to include 401(k) investment alternatives that take ESG factors into account can come from two sources: at the request of rank-and-file plan participants or as a matter of a retirement committee's preferences. The Proposal radically changes the calculus either way. The

Proposal's most fundamental change is that a fiduciary is no longer constrained by the pecuniary factor limitation and its corresponding documentation requirement; rather, a fiduciary is free to consider ESG factors when crafting a plan's menu of investment options and when selecting a QDIA.

Additionally, a retirement committee seeking to apply the tie-breaker test is no longer subject to an impossibly narrow standard. Rather, two investments may now differ on a wide range of attributes, yet still be deployed to break a tie, provided that they equally serve the financial interests of the plan. This change takes a good deal of pressure off fiduciaries as they deliberate over competing investments, one of which includes ESG factors. Committees also have the ability under the Proposal to designate a QDIA that takes ESG factors into consideration.

Despite the material break from the 2020 rule, the Proposal makes clear that plan fiduciaries must act prudently and diversify plan investments, and they must act solely in the interest of the plan's participants and beneficiaries. These twin duties of prudence and loyalty are neither negotiable, nor have they changed.

If the Proposal were to be adopted, retirement committees and other fiduciaries would be able to take ESG factors into account. However, nothing in the Proposal gives committee members or other fiduciaries license to pursue ESG objectives unmoored from or indifferent to an investment's underlying economic merits.

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