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DOL proposal would curtail social investing

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In this article

The latest social investing proposal from the Department of Labor (DOL) would require ERISA fiduciaries to subordinate environmental, social or corporate governance (ESG) factors to financial ones when making investment decisions for retirement plans. Under the proposal, fiduciaries could invest in an ESG fund only if they base the decision solely on objective financial criteria and document the rationale for reaching that conclusion. If finalized, the proposal could result in fewer ERISA plans investing in ESG funds. Comments are due by July 30.

Social investing ups and downs

The proposal comes after more than two decades of inconsistent social investing guidance from DOL. The agency's first piece of comprehensive guidance on ESG investing, Interpretive Bulletin 94-1, introduced an "all-things-being-equal" or "tie-breaker" standard. Under this standard, nonpecuniary benefits could be the deciding factor between investments with commensurate rates of return and similar risk characteristics.

Since then, the agency has issued additional subregulatory guidance that retained the tie-breaker standard but with varying openness to social investing. The last piece of guidance, Field Assistance Bulletin (FAB) 2018-01, took a narrow view of the rules, advising fiduciaries to focus first on financial factors that have a material effect on an investment's return and risk. The FAB recognized ESG factors could be economically relevant but warned fiduciaries against "too readily" treating ESG factors as having financial benefits.

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DOL clarifies position

The preamble to the new proposal asserts that DOL has always held the position that "the paramount focus of plan fiduciaries must be the plan's financial returns and risks to participants and beneficiaries." Although only a small portion of retirement plan assets is currently invested in ESG funds, the agency recognizes that fiduciaries, sponsors and participants recently have placed greater emphasis on ESG factors. DOL perceives this trend as alarming and worries fiduciaries may be selecting ESG funds that sacrifice investment returns for nonpecuniary interests.

According to the agency, "[W]ithout rulemaking, ESG investing will present a growing threat to ERISA fiduciary standards and, ultimately, to investment returns for plan participants and beneficiaries." The agency is also concerned that some funds may be marketed to fiduciaries as appropriate for ERISA plans, even though the marketing materials acknowledge that the fund may perform differently due to its pursuit of ESG goals.

As a result, the proposal seeks to provide "clear regulatory guideposts" to keep plan fiduciaries focused on financial factors. Like FAB 2018-01, the preamble to the proposal recognizes that in some instances, ESG issues that increase an investment's relative risk or present a business opportunity might legitimately be economic considerations for making investment decisions. However, this is limited to situations in which qualified investment professionals would treat ESG factors — such as a company's improper disposal of hazardous waste or dysfunctional corporate governance — as material considerations under generally accepted investment theories.

The proposal is unclear whether fiduciaries could consider leadership on ESG issues as relevant to the company's financial soundness as an investment. However, this seems contrary to the purpose of the proposal.

New regulatory requirements proposed

ERISA requires fiduciaries to act prudently under the prevailing circumstances and for the exclusive purpose of benefitting participants and defraying plan expenses. The existing "investment duties" regulation (29 CFR § 2550-404a-1) explains how fiduciaries satisfy their duty of prudence when making investment decisions for a plan. The proposal would amend the regulation to add new requirements that investment fiduciaries would have to follow to meet their duty of loyalty.

The proposal stops short of saying ESG investments are always incompatible with the duty of loyalty. However, the rule would set strict guidelines for ERISA fiduciaries' investment decisions, providing a structure for separating a legitimate use of risk/return factors — which sometimes might include ESG considerations — from inappropriate investments that sacrifice return or take on additional risk. The proposal distinguishes guidance for individual-account plans from other plans, although the practical impact of the two sets of rules is likely to be the same.

Investment duties

To strengthen the rules around the duty of loyalty, the proposal would:

- Add three new requirements for investment duties, under which the fiduciary has to:
  - Evaluate investments based solely on pecuniary factors that have a material effect on risk and return
  - Prioritize the interests of plan participants and beneficiaries over unrelated objectives and ensure the plan does not sacrifice investment return or take on additional investment risk to promote nonfinancial goals
  - Not otherwise act to subordinate the interests of the participants and beneficiaries to another's interests
- Require each investment evaluation to include a comparison with available alternative investments

The proposed rule includes two new paragraphs relating to the evaluation of nonpecuniary factors. These paragraphs emphasize that fiduciaries may not sacrifice return or take on additional risk for nonpecuniary goals. In particular, fiduciaries may treat ESG considerations as pecuniary factors only if the ESG considerations present economic risks or opportunities that qualified investment professionals would treat as material. The proposal would require the following:

- Fiduciaries treating ESG considerations as pecuniary factors must examine the level of diversification, degree of liquidity and potential risk/return relative to other available investment alternatives that would play a similar role in the plan's portfolio.
- Fiduciaries relying on a nonpecuniary factor to choose one investment over an "economically indistinguishable" alternative must document how they determined the two alternatives were indistinguishable and why the selected investment was chosen based on the plan's purposes and investment diversification, as well as the interests of participants and beneficiaries.

Applying new requirements under individual-account plans

The preamble notes that tiebreakers have little relevance to these plans, since investment options are selected to offer a range of choices to plan participants. Accordingly, the proposal's separate guidelines for individual-account plans effectively restate the investment requirements but drop the provisions relating to economic indistinguishability.

The proposal would let a fiduciary include in an individual-account plan's investment lineup a "prudently selected, well managed, and properly diversified fund" that includes ESG goals in its investment mandate or fund name if three conditions are met:

- The fiduciary uses only objective risk/return criteria (such as benchmarks, expense ratios, fund size, etc.) in selecting and monitoring all investments.
- The fiduciary documents the selection and monitoring process.
- The ESG fund is not added as a component of the plan's QDIA.

Likely impact on ESG investing

If the proposal is finalized, it may have a chilling effect on ESG investing by retirement plans. The rule sets a high bar for nonindividual-account plans: Fiduciaries considering an ESG investment would effectively have to prove it was economically indistinguishable from a non-ESG investment. DOL thinks this is rarely the case, suggesting that ESG funds often have higher fees than non-ESG funds. Plans that already have ESG investments in their portfolios would have to meet the same strict standards to justify keeping those investments or else divest.

Individual-account plans may include ESG funds only if the plan fiduciary can justify their inclusion using solely pecuniary factors. DOL expects that the new rule would cause ESG-themed mutual funds to have fewer customers since ERISA defined contribution plans that currently offer these mutual funds would have to drop any that don't merit selection based on financial considerations alone.

DOL requests comments

Throughout the proposal, DOL scattered several comment requests, including for information on:

- The possible addition of explicit requirements for individual-account plan fiduciaries to focus solely on pecuniary factors and justify the choice between economically indistinguishable investments
- The prevalence of ESG investing
- The frequency with which fiduciaries will find two investments to be economically indistinguishable
- The costs and benefits of the proposed rule
- Suggested alternatives to the proposal, particularly ones that reduce the burden on small entities

Related resources

Non-Mercer resources

- Proposed regulations (Federal Register, June 30, 2020)
- Fact sheet (DOL, June 23, 2020)
- News release (DOL, June 23, 2020)
- FAB 2018-01 (DOL, April 23, 2018)
- Interpretive Bulletin (IB) 2016-01 (Federal Register, Dec. 29, 2015)
- IB 2015-01 (Federal Register, Oct. 26, 2015)
- IB 94-1 (Federal Register, June 23, 1994)

Mercer resources

- The ABC of ESG (Jan. 29, 2019)
- Responsible investment
- Mercer's ESG ratings

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