June 29, 2020

U.S. Department of Labor Issues Proposed Restrictions on ESG Investing

Key Takeaways

- On June 23, 2020, the U.S. Department of Labor ("DOL") proposed rules to clarify that fiduciaries under the Employee Retirement Income Security Act of 1974, as amended ("ERISA") must evaluate and make investments on behalf of ERISA plans solely on the basis of so-called "pecuniary factors," and may not take on additional risk or sacrifice returns to promote unrelated environmental, social and governance objectives.[1]
- If adopted, the proposed rules could make ESG-motivated investing more onerous for ERISA fiduciaries, and could indirectly strengthen the influence of the non-U.S. ESG investor market.

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Background

ERISA is a broad statutory framework that governs most employee benefit plans for U.S.-based employees ("Plans"). These Plans include traditional "defined benefit" pension plans (where participants are entitled to a guaranteed benefit upon retirement, based on a Plan formula) and "defined contribution" pension plans, such as "401(k) plans" (where the retirement benefit is based on the investment management of contributions made to the Plan by the employee and/or their employer). Collectively, such ERISA Plans hold more than $10 trillion in assets, making them an attractive source of capital for investment funds, public and private companies and other entities seeking investment in the market.

ERISA imposes fiduciary duties and other obligations on persons responsible for managing Plan assets ("ERISA Fiduciaries"), which includes the selection of investment alternatives for Plans in which participants manage their own accounts (i.e., "individual account plans"). In particular, ERISA Fiduciaries are required to act for the "exclusive purpose of providing benefits to participants and their beneficiaries" (the "Exclusive Benefit Rule"), which is the focus of the DOL's attention in the proposed rules.

ERISA Fiduciaries have long sought guidance from the DOL on the extent to which investment decisions made to promote ESG objectives would be consistent with the Exclusive Benefit Rule. The existing guidance provides that, while ERISA Fiduciaries must primarily seek to obtain favorable risk-adjusted returns for

[1] Press release available here.

Plans when choosing among investment alternatives, the consideration of ESG factors would be permissible as a "tiebreaker" between investment alternatives with the same risk and return profile. In 2018, the DOL interpreted this "tiebreaker" role narrowly, indicating that ESG factors may "break the tie" only insofar as they present material business risk or opportunities that qualified investment professionals would treat as economic considerations under generally accepted investment theories (i.e., "pecuniary factors").

The proposed rules, if adopted as proposed, would codify this most recent guidance, provide more certainty on how the guidance applies and make it more difficult for subsequent administrations to issue further "clarifications" on the role that ESG factors may play under the Exclusive Benefit Rule. The proposed rules will become effective 60 days after the final version of the rule is published in the Federal Register.

Proposed Rules

The proposed rules would expressly require ERISA Fiduciaries, when considering investments (or investment courses of action), to base their decisions *solely* on so-called "pecuniary factors," without subordinating the interests of Plan participants or beneficiaries in their retirement income or financial benefits to unrelated objectives. In so doing, ERISA Fiduciaries would also be expressly required to consider how the investments (or investment courses of action) compare to available alternatives. "Pecuniary factors" for these purposes would include factors that have a material effect on the risk and/or return of an investment, based on appropriate investment horizons consistent with a Plan's investment objectives and funding policy. These requirements would apply both to investments by defined benefit Plans as well as to the selection of investment alternatives for inclusion as part of an individual account plan. ERISA Fiduciaries would be precluded from considering ESG factors or objectives, except insofar as such factors would be treated as material economic considerations under generally accepted investment theories.

The proposed rules would also impose documentation requirements on ERISA Fiduciaries, when they do make investment decisions based on ESG considerations. If investment alternatives are found to be economically indistinguishable even after carefully evaluating them in accordance with the proposed rules, an ERISA Fiduciary may base an investment decision on ESG factors. In such cases, however, the ERISA Fiduciary must specifically document how it reached the conclusion that the available investment alternatives were indistinguishable as well as how the ESG-motivated investment was otherwise consistent with a Plan's purposes and the Plan participants and beneficiaries' interests.[2]

The proposed rules do not expressly prohibit ERISA Fiduciaries from selecting funds that have ESG-serving mandates for inclusion in an individual account plan. However, such investment alternatives must still be selected based on their "pecuniary factors," and they may not be used as a Plan's "qualified default

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[2] In its description of the Proposed Rule, the DOL also cautioned ERISA Fiduciaries to be skeptical of ESG rating systems. In the DOL's view, these systems are often vague and inconsistent, and have limited value in determining whether a proposed investment actually furthers ESG-related goals.

investment alternative" (i.e., the "default" investment alternative to which contributions are directed absent any direction from a Plan participant).

Consequences to the ESG and Investment Management Industries

The proposed rules place a higher burden on any ERISA Fiduciary that makes ESG-related investments to justify or document the basis for the conclusion that such an investment is consistent with their investment duties. This places additional administrative burdens on an ERISA Fiduciary that it would not face with non-ESG-related investments. The proposed rules would not only makes the choice of ESG-related investments more onerous for any ERISA Fiduciary; it also suggests that such a choice could lead to a breach of its fiduciary duties.

Further, the proposed rules arise against the backdrop of a thriving international ESG market, with both U.S. and European ESG funds reporting record inflows in 2019. The impact of the proposed rules remains unclear, but if U.S. investors cannot as easily invest in ESG funds through their retirement funds, it is possible that the share and influence of non-U.S. investors in the ESG market could increase.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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