DOL Has Discouraging Words for ESG Funds

By Kerry Pechter *Thu, Jun 25, 2020*

The DOL has never suggested that fiduciaries should pick a fund that subordinates financial performance to activism. But this proposal lacks the nuance or flexibility that the DOL has expressed in the past.

Under a new Department of Labor proposed rule, ERISA plan fiduciaries would not be able to include ESG funds in plans when the investment strategy of the vehicle is to "subordinate return or increase risk for the purpose of non-financial objectives."

"Private employer-sponsored retirement plans are not vehicles for furthering social goals or policy objectives that are not in the financial interest of the plan," said Secretary of Labor Eugene Scalia, in a press release Tuesday evening. "[Plans] should be managed with unwavering focus on a single, very important social goal: providing for the retirement security of American workers."

The proposal would make five core additions to the regulation:

- New regulatory text to codify the Department's longstanding position 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 regulatory provision stating that compliance with the exclusive-purpose (i.e., loyalty) duty in ERISA section 404(a)(1)(A) 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 new provision that requires fiduciaries to consider other available investments to meet their prudence and loyalty duties under ERISA.
- The proposal acknowledges that ESG factors can be pecuniary factors, but only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories. The proposal adds new regulatory text on required investment analysis and documentation requirements in the rare circumstances when fiduciaries are choosing among truly economically "indistinguishable" investments.
- A new provision on selecting designated investment alternatives for 401(k)-type plans. The proposal reiterates the Department's view that the prudence and loyalty standards set forth in ERISA apply to a fiduciary's selection of an investment alternative to be offered to plan participants and beneficiaries in an individual account plan (commonly referred to as a 401(k)-type plan). The proposal describes the requirements for selecting investment alternatives for such plans that purport to pursue one or more

> environmental, social, and corporate governance-oriented objectives in their investment mandates or that include such parameters in the fund name.

This proposed rule says little that is new. "ERISA fiduciaries may not sacrifice investment returns or assume greater investment risks as a means of promoting collateral social policy goals," a DOL Field Assistance **Bulletin** said in 2018, and in previous bulletins.

But this proposal lacks the nuance or flexibility that the DOL has expressed in the past. Phyllis Borzi, the director of the Employee Benefit Security Administration under President Obama, described previous policy to *RIJ* in an email this week.

"Throughout the history of ERISA, on a bipartisan basis, the DOL has consistently refused to ban either ESG/ETI investing or proxy voting," Borzi told RIJ this week. "Instead, the Department has consistently said that while financial considerations must be paramount and fiduciaries cannot sacrifice return to advance other objectives, that when faced with multiple investment possibilities with equal financial characteristics and impacts, a fiduciary can take ESG/ETI factors into consideration (the so-called "all things being equal" rule).

"But since the end of the George W. Bush Administration, the U.S. Chamber of Commerce has aggressively and successfully lobbied the Department to issue guidance that in effect creates a strong deterrent effort for a fiduciary to consider these factors," she said.

"In the Obama Administration, the Department issued guidance to reiterate the balanced interpretation of ERISA that existed since the late 70's and reverse the strong inference that the legal barriers were nearly insurmountable to engage in ESG investing. One of the earliest things the Trump Administration did was to try to go back to the unfavorable interpretation issued in the waning days of the Bush Administration. This is simply a continuation of that effort."

Is there a danger that activist fiduciaries might try to divert plan assets toward *their own* social or political goals? This concern may have been pertinent in the defined benefit pension era, when fiduciaries controlled vast pools of money, but it seems less so in the 401(k) era, when participants can choose their own investments.

A study of thousands of companies, published in the ***Journal of Sustainable Finance and Investment***, found no evidence of poor performance by ESG companies. "The results show that the business case for ESG investing is empirically very well founded. Roughly 90% of studies find a nonnegative ESG–CFP (corporate financial performance) relation," the study said.

A 2016 survey by Natixis Global Asset Management of 951 U.S. employees participating in defined contribution plans demonstrated interest from individuals in ESG investments: 64% said they were concerned about the environmental, social and ethical records of the companies they invest in and 74% said they would like to see more socially responsible investments in their retirement plan offerings."