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The DOL Proposes New Regulations on the Use of Environmental, Social, and Governance (ESG) Factors When Selecting Plan Investments

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The Department of Labor (DOL) issued proposed regulations outlining plan fiduciary duties provided by the Employee Retirement Income Security Act of 1974 (ERISA) that relate to the use of environmental, social, and governance (ESG) factors when selecting plan investments. The proposed rule seeks to clarify prior DOL guidance and to add some new requirements with respect to the selection of ESG investments.

The upward trend of socially responsible spending and investing in recent years has resulted in an array of ESG-focused investment vehicles. The Preamble of the proposed regulation cites a Morningstar report that provides: "Flows into sustainable funds totaled $21.4 billion in 2019, a nearly fourfold increase over the previous calendar-year record, which was set in 2018.'[1] There is no consensus, however, regarding what constitutes a genuine ESG investment. In addition, some ESG investments may come with higher fees as a result of additional monitoring and investigation required to confirm their ESG status and lower returns. The DOL views such funds as problematic for ERISA plans that have a fiduciary duty under ERISA to maximize funds available to pay retirement benefits.

Section 404 of ERISA provides that a plan fiduciary must act prudently and diversify plan investments. ERISA also requires fiduciaries to act for the exclusive purpose of providing benefits to their participants and beneficiaries, to incur only reasonable expenses to administer the plan, and to act solely in the interest of plan participants and beneficiaries.

Historically, DOL guidance on ESG investment has changed its position based upon the leanings of the current Presidential administration. Democratic administrations generally tend to permit an ESG investing approach whereas Republican administrations generally believe that economic returns alone should determine a plan's investment approach. Consistent with this history, the Preamble provides that the underlying goal is to ensure that plan fiduciaries select investments based solely on financial considerations relevant to providing a "secure retirement for American workers." The Preamble argues that such goal is the "paramount, and eminently-worthy, 'social' goal of ERISA plans."

The Preamble provides that the proposed regulations are intended to build upon the ERISA fiduciary regulations that address the duty of prudence and set forth the DOL's current position on ESG investing. The proposed regulations:

- Provide that the fiduciary duties of prudence and loyalty as provided by ERISA are satisfied when the fiduciary relies upon pecuniary factors alone to select investments.
- Prohibit fiduciaries from allowing non-pecuniary interests such as environmental or social factorsas seen in ESG funds to take precedence over economic pecuniary interests when selecting an investment.
- Require fiduciaries to compare investments based upon central specified economic factors, *e.g.,* level of diversification, degree of liquidity, and potential risk and return.
- Allow ESG considerations only if they equate to material economic considerations under generally accepted investment theories.
- Provide that, when investments are economically indistinguishable, then fiduciaries may rely upon the DOL's historic "All Things Being Equal Test" and select an ESG investment. If an ESG investment is selected, the fiduciary is then required to document why the investment was selected and to detail the decision-making process.
- Provide that for defined contribution individual account plans, such as participant directed 401(k) and 403(b) plans, fiduciaries adding ESG investments would not violate ERISA so long as:
    - The fiduciary uses objective risk-return criteria to select all investment alternatives in the plan, including ESG investments;
    - The fiduciary documents its selection and monitoring of the investment; and
    - The ESG fund is not added as a qualified default investment alternative.

Historically, the purpose of ESG investing is to drive change in corporations which may result in a pecuniary gain for investors. The proposed regulations shift the impetus to prefer investment returns over such other non-pecuniary factors. Interested parties may submit comments to the DOL during the 30-day comment window.

[1] *See https://www.morningstar.com/articles/972860/the-esg-fund-universe-is-rapidly-expanding.*

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