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## DOL Unveils New ESG Proposal, Raising Significant Questions for ERISA Fiduciaries and the Industry

In response to perceived abuses, and acknowledging the rapid growth in environmental, social & governance (ESG) investing, the U.S. Department of Labor (DOL) issued a highly-anticipated notice of proposed rulemaking (https://www.dol.gov/sites/dolgov/files/ebsa/temporary-postings/financial-factors-in-selecting-plan-investments-proposed-rule.pdf) that would clarify the circumstances under which ESG investing, including the selection of ESG funds in plan lineups, may be conducted in a manner that accords with the fiduciary duties under Sections 403 and 404 of the U.S. Employee Retirement Income Security Act of 1974, as amended (ERISA). This proposal comes just two years after the DOL issued Field Assistance Bulletin (FAB) 2018-01. It is also part of a continuum of ERISA-ESG guidance over the decades, across both Democrat and Republican administrations, that has sought to address how ERISA's stringent fiduciary duties may be satisfied when one or more E (*e.g.*, climate change), S (*e.g.*, employee relations) and or/G (*e.g.*, corporate governance) factors are pursued either because they are material to investment performance or because they further some public policy or similar goal.



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If the proposal is adopted as-is, plan sponsors, other fiduciaries and the industry, will face a tall order in incorporating ESG factors, especially in furtherance of policy or other non-financial goals (*e.g.*, impact investing), with respect to both the (1) management of plan assets and (2) selection and monitoring of plan investment options available under individual account plans, as the case may be. Here are the initial key takeaways:

- **Integration:** ESG strategies, such as integration, that incorporates one or more E, S and/or G factors because of materiality to investment performance, would still be considered consistent with ERISA's fiduciary duties, provided: (a) there is documentation as to the basis for the materiality determination; (b) other "qualified investment professionals" (*i.e.*, an objective standard) would similarly conclude that the ESG factor is material to investment performance based on "generally accepted investment theories"; (c) the weight given to the ESG factor in the materiality analysis is appropriate (a point the DOL stressed in FAB 2018-01); and (d) the ESG investment is measured against "other available alternative investments" with respect to diversification, liquidity and potential risk-return of the plan portfolio. Point (d) is perhaps the biggest deal because it is arguably *de facto* the tie-breaker test, which the DOL historically used only when the ESG factor was not material to investment performance, and will raise compliance risk for ERISA fiduciaries (investment managers may be able to mitigate this risk through representations from the appointing fiduciary). The DOL noted in the preamble that this requirement was intended to clarify "that an investment or investment course of action must be compared to available alternatives [and] is an important reminder that fiduciaries must not let non-pecuniary considerations draw them away from an alternative option that would provide better financial results."

- **Other types of ESG investment strategies:** The DOL technically allows an ERISA fiduciary to select an ESG investment, in whole or part, for non-financial/pecuniary reasons, which is in keeping with their long-standing guidance. However, the DOL tightens the screws by requiring that the investments be pursued only if they are "economically indistinguishable" from non-ESG investments, and the fiduciary documents such basis "based on the purposes of the plan, diversification of investments, and interests of plan participants and beneficiaries in receiving benefits from the plan." There are two immediate considerations: (a) how does "economically indistinguishable" standard differ from the tie-breaker test that the DOL historically used in these contexts? and (b) can these conditions ever be met if the investment is pursued partly for non-pecuniary reasons but, as the DOL acknowledges (referencing Dudenhoeffer), the interests of participants and beneficiaries are in pecuniary benefits? In terms of the former, the DOL's intent is that there is no difference; in terms of the latter, the DOL acknowledges that this standard

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would only be met in exceedingly rare circumstances, a position that harkens back to the DOL's 2008 ESG guidance. Because the DOL believes a fiduciary finding that an ESG investment is economically indistinguishable from a non-ESG investment to be a rare occurrence, it does not believe the aforementioned documentation requirements will be a significant cost to the industry.

- **Individual Account Plans:** The plan may offer an ESG investment alternative, including an ESG-themed fund, to participants, subject to these two conditions: (a) "the fiduciary uses (and documents using) only objective risk-return criteria, such as benchmarks, expense ratios, fund size, long-term investment returns, volatility measures, investment manager investment philosophy and experience, and mix of asset types" in selecting and monitoring the fund; and (b) no ESG fund is added as, or as a component of, a QDIA. Consequently, "fiduciaries considering investment alternatives for individual account plans should carefully review the prospectus or other investment disclosures for statements regarding ESG investment policies and investment approaches." The first condition would eliminate the possibility of adding an ESG fund to a plan lineup for any reason other than those investment-return related criteria, such as to promote a public policy (*e.g.*, climate change, etc.). Commenters should seek clarification from the DOL as to whether this was their intent. The second condition is plain on its face and is equally significant: any ESG-related QDIA, regardless of whether it's a themed fund, and irrespective that just one component of the QDIA takes ESG into account, is out, even if the ESG fund is selected for the plan solely on the basis of investment performance materiality. It's unclear if this exclusion is limited to ESG funds whose objectives include non-pecuniary ESG goals or whether it applies to all types of ESG funds.

- The DOL cautioned that "fiduciaries should also be skeptical of "ESG rating systems" - or any other rating system that seeks to measure, in whole or in part, the potential of an investment to achieve non-pecuniary goals - as a tool to select designated investment alternatives, or investments more generally."

- The proposed rule, if adopted, would take effect 60 days after publication in the Federal Register, though the DOL is open to comment on whether transition relief should be available.

- ESG funds and products that have short track records, low assets under management, and/or are somewhat more expensive than similar non-ESG funds, will be particularly vulnerable under this proposal.

- As noted above, there is a 30-day comment period for this proposal.

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