Federated Hermes

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New DOL proposed rule endorses ESG-related investments in retirement plans:

What advisors need to know about prudent ESG investing

Since taking effect in January, the Department of Labor's ("DOL") 2020 regulation "Financial Factors in Selecting Plan Investments" (more commonly, if inaccurately, thought of as the DOL ESG Rule) stirred up equal measures of controversy and confusion about the role of environmental, social and governance ("ESG") factors in retirement plans governed by ERISA. Some fiduciaries appeared unsure how to determine when such factors were "pecuniary," or whether they could be used as default investments. With uncertainty came caution, and—rightly or wrongly—avoidance of perceived risk.

DOL immediately began addressing these concerns in March by suspending enforcement of the 2020 rule—it has now taken the next step of proposing a new rule ("the Proposal") to take its place.

So what does the new Proposal actually do, and why did DOL take action so quickly to begin to replace the 2020 rule?

DOL: 2020 rule confusing, creates false perception of ESG investment risks

When DOL took the unusual step of suspending enforcement of the 2020 Financial Factors rule in March, it noted that the new fiduciary test for "pecuniary" or "non-pecuniary" factors was confusing, and that the rule overall created a false perception that ESG-related investments presented more fiduciary risk. As a result, DOL was concerned that the rule already was having a chilling effect on prudent and appropriate ESG-related investments in ERISA plans only weeks after it went into effect.

To combat these issues, DOL decided to employ a "one-two punch" of suspension and replacement. Suspending the 2020 rule after it had been in effect for less than two months sent the immediate message that DOL did not want fiduciaries to avoid ESG-related investments. DOL telegraphed the second punch right away—during the announcement of the enforcement suspension, DOL stated it was their intent to begin working on a new rule that would "…better recognize the important role that [ESG] integration can play in the evaluation and management of plan investments."

"…the current regulation, and investor confusion about it, including whether…ESG factors may be treated as 'pecuniary' factors…has already had a chilling effect on appropriate integration of…ESG factors in investment decisions, which has continued through the current non-enforcement period… After conducting a further review of the current regulation, the Department believes there is a reasonable basis for these concerns."

— Preamble at 86 FR 57,275

Just seven months later (a blink of an eye in regulatory time), DOL published the new Proposal to do exactly that. The comment period expires on Dec. 13, 2021. The initial reaction to the Proposal by many plans and financial service providers appears to be favorable, and their comments are likely to address specific technical issues to improve the rule rather than voice fundamental objections to its goals. A final rule likely will be issued by mid-2022.

Fiduciary discretion restored: ESG to be treated like any other investment

DOL suspended enforcement of the 2020 "Financial Factors" rule in March because it found the rule was confusing fiduciaries and chilling appropriate ESG-related plan investments. The new Proposal would replace it, clarifying that prudent fiduciaries may consider ESG factors on the same terms as any other factors. The Proposal is open for comment until Dec. 13, 2021 Major provisions include:

- **Fiduciaries may consider any material factor:** Eliminates the 2020 rule's "pecuniary" vs. "non-pecuniary" test—fiduciaries may consider any "material" factor, including ESG factors. No special documentation or fiduciary process for ESG.
- **ESG "may often" be a material factor:** Though not mandating fiduciary consideration of ESG-related factors, DOL emphasizes that such factors not only can be material, but that prudence "may often require" their consideration.
- **ESG-related investments as QDIAs:** The Proposal removes the 2020 rule's vague and confusing restrictions on "non-pecuniary" factors in QDIAs—ESG-related investments are eligible to be default investments.
- **"Collateral" benefits as tiebreaker:** When several investments will "equally serve" the economic interests of the plan, fiduciaries may break the tie using "collateral benefits" (ESG or otherwise). If used, the "characteristics" of the collateral benefit must be prominently disclosed to participants.
- **Prudence and loyalty:** Fiduciaries may not subordinate participants' interests in their retirement income; or increase investment risks or reduce returns to achieve other goals.

So what does the new proposal actually do?

There appear to be two guiding principles motivating the Proposal and shaping its specific provisions.

First, DOL is asserting that ESG-related investments are not different or special, and should not be singled out for additional fiduciary scrutiny. Instead, they should be treated the same as any other investments reasonably available to the plan. Plan fiduciaries and their investment advisors will decide for themselves what factors are material based on the facts and circumstances of each plan and investment option.

Second, DOL is emphasizing that taking ESG-related factors into account should not be rare, or relevant only in special circumstances, but should be a common part of prudent fiduciary analysis. DOL emphasizes that a prudent investment process "may often require" consideration of ESG factors.

Consistent with these principles, the Proposal eliminates many of the process and documentation requirements the 2020 rule created, including the "pecuniary" vs. "non-pecuniary" factor test and requirements for specific documentation when non-pecuniary factors are considered. The Proposal also clears the way for ESG-related factors to be integrated into Qualified Default Investment Alternatives ("QDIAs"). Here is a summary of the major provisions and issues presented by the Proposal:

First and foremost, investments must be prudent

The Proposal reiterates bedrock fiduciary principles with a clearly defined statement of the duty of loyalty. Fiduciaries may not "subordinate the interests of [participants] in their retirement income or financial benefits under the plan to other objectives." Fiduciaries "…may not sacrifice investment return or take on additional investment risk to promote benefits or goals unrelated…" to participants' interests in retirement income and plan benefits.

Further, investments must be prudently selected. The fiduciary "must give appropriate consideration to those facts and circumstances…the fiduciary knows or should know are relevant…" to the investment decision, and "act accordingly."

The Proposal explains that "appropriate consideration" includes determining that the investment is "reasonably designed, as part of the plan's portfolio" to further the plan's purposes compared to "reasonably available" alternatives, taking into account diversification, liquidity and current returns relative to the cash flow needs of the plan.

ESG factors "may often" be material in prudently evaluating ERISA investments

In one of the most significant changes in the Proposal, the regulatory text directly states that the prudent fiduciary analysis of an investment "may often require an evaluation of the economic effects of climate change and other environmental, social or governance factors." It is important to note that this stops short of a mandate—the language does not actually require fiduciaries to consider ESG factors, but its inclusion in the regulatory text is very significant. In effect, DOL is putting a light thumb on the scale, indicating that DOL believes fiduciaries often will find ESG factors to be relevant to their analysis.

"The intent of the paragraph is to establish that material climate change and other ESG factors are no different than other 'traditional' material risk-return factors, and to remove any prejudice to the contrary."

— Preamble at 86 FR 57,277

This decision is likely to be one of the more controversial elements of the Proposal, as those who felt the 2020 Rule was inappropriately biased against ESG factors will confront those who feel the new Proposal is inappropriately biased in favor of ESG factors.

In the Preamble to the rule (the plain language explanation that DOL writes to accompany the rule's actual legal text), DOL offers insight into its policy view. "This decision," DOL wrote, "is intended to counteract negative perception of the use of climate change and other ESG factors in investment decisions caused by the 2020 Rules, and to clarify that a fiduciary's duty of prudence may often require an evaluation of the effect of climate change and/or government policy changes to address climate change on investments' risks and returns."

The direct reference to ESG factors will almost certainly be a key issue in the public comments. Those endorsing DOL's approach are likely to agree with DOL that the references are necessary to "remove any prejudice" against ESG resulting from the 2020 Rule, and to make it clear that ESG factors are relevant and are increasingly being utilized by professional asset managers. Those disagreeing with the specific references are likely to argue that DOL is again singling out ESG for special treatment, potentially limiting the free exercise of a fiduciary's discretion to consider any factor he or she finds relevant and material.

Fiduciaries may consider "any" material factor, including ESG:

The Proposal again directly references ESG factors in the regulatory text as part of its rejection of the "pecuniary" factor test in the 2020 rule. A "prudent fiduciary may consider any factor…that is material to the risk-return analysis, which might include, for example…" climate change-related factors, governance factors and workforce practices.

DOL explains in the Preamble that, "The intent of this new paragraph is to establish that material climate change and other ESG factors are no different than other 'traditional' material risk-return factors, and to remove any prejudice to the contrary. Thus, under ERISA, if a fiduciary prudently concludes that a climate change or other ESG factor is material to an investment or investment course of action under consideration, the fiduciary can and should consider it and act accordingly, as would be the case with respect to any material risk-return factor."

In many ways, this change restores to fiduciaries their traditional role in making investment decisions—rather than DOL singling out a particular type of investment for additional scrutiny, fiduciaries and their investment advisors historically have determined for themselves what investment factors to consider.

> **"…the Department believes that consideration of the projected return of the portfolio relative to the funding objectives of the plan not only allows but in many instances may require an evaluation of the economic effects of climate change on the particular investment or investment course of action."**
>
> — Preamble at 86 FR 57,276

However, the Proposal does change the language slightly from the traditional standard by adding the word "material." Prior to the 2020 rule, the ERISA standard since 1979 has been that the fiduciary would consider all "relevant" factors—the word "material" simply has not been a significant part of the historical legal analysis of ERISA fiduciary investment duties. It is not clear if the addition of "material" was intended by the Department to change the traditional fiduciary process by referencing the large body of securities law related to the term "material," but it is likely that the Department will receive comments seeking clarification of its intent. Further, as the only examples of "material" factors in the Proposal are ESG-related, there will likely be comments regarding whether these examples are appropriate even if the material standard is retained.

No additional restrictions on QDIAs:

The 2020 rule prohibited investments from being selected as QDIAs if their investment objectives, goals, or principal investment strategies included, considered or indicated the use of non-pecuniary factors. This vague and confusing language made it difficult to select QDIAs that utilized ESG factors. The Proposal removes this language entirely. As a result, there are no additional requirements related to QDIA selection; ESG-related investments are eligible to be QDIA's on the same basis as any other investment option provided that the investment is chosen as part of a prudent fiduciary process. .

This is significant due to the growing integration of ESG factors into investment analytics, and the significant amount of assets that flow into QDIAs. The purpose of automatic enrollment and QDIAs would be frustrated if fiduciaries cannot tell with certainty which investments are QDIA eligible and which are not.

Breaking ties—what to do when multiple investments "equally serve" the financial interests of the plan

It is not uncommon for a prudent fiduciary process to yield several investments that are "tied" as prudent choices for the plan. ERISA does not provide a means to differentiate between multiple prudent options, so fiduciaries have discretion in which they choose. Since the first comprehensive guidance was issued in 1994, DOL allowed fiduciaries to break such ties using what the Proposal now calls "collateral benefits."

"Collateral benefits" are benefits the investment offers other than those directly related to participants' retirement income needs. DOL gives several examples of such collateral benefits in the Preamble to the Proposal—these could include ESG factors that were not material, or taking into account participant interest in investment options that might lead to increased participation.

> **"Climate change is particularly pertinent to the projected returns of pension plan portfolios that, because of the nature of their obligations to their participants and beneficiaries, typically have long-term investment horizons."**
>
> — Preamble at 86 FR 57,276

The Proposal makes two significant clarifications compared to the current rule. First, whether investments are tied would be based on whether they "equally serve the financial interests of the plan over the appropriate time horizon," not whether the two investments are indistinguishable from one another. DOL makes the point that two investments might differ in a variety of ways, yet fulfill the same function in the portfolio equally well.

Second, the Proposal eliminates the special analysis and documentation of why a non-pecuniary factor was used to break a tie that is required by the 2020 rule. DOL concluded that this was unnecessary given that a fiduciary process had already screened the investments, and singling out this situation for additional documentation would have a chilling effect on using collateral benefits in appropriate situations.

Instead, the Proposal requires fiduciaries that use a collateral benefit to break a tie to "ensure that the collateral-benefit characteristic" is "prominently displayed in disclosure materials provided to participants…" DOL goes on to suggest that the annual participant "404a-5" disclosure may be a means to comply.

This will likely be an area in which comments raise a number of practical issues. The requirement would only apply if a collateral benefit was used to break a tie. How does a fiduciary prove that it did not use a collateral benefit to select an investment if a participant alleges a breach of duty due to the failure to disclose? Further, whether a disclosure is required, and the content of that disclosure would vary from plan to plan even with regard to the same investment, as different collateral benefits could be used by different plans.

Proxy voting and shareholder rights

Finally, the Proposal also changes the fiduciary standards used to vote proxies and exercise shareholder rights. Another 2020 rule on proxy voting was combined with the Proposal (enforcement of the 2020 proxy voting rule was also suspended in March). The Proposal reiterates that voting proxies is a fiduciary act, and fiduciaries should consider costs and benefits to reviewing and voting proxies, but it removes provisions in the prior rule that made it harder for fiduciaries to determine when it was appropriate to engage in shareholder votes and other activities.

Can plans currently invest in ESG-related options while the proposal is pending?

Yes, absolutely. Many investment managers incorporate various ESG factors into their investment analytics. They do so because they believe generally accepted investment theories show that ESG factors can help reduce risks and increase investment outcomes. This use of ESG factors is consistent both with the 2020 rule and the Proposal. While fiduciaries wait for the Proposal to be finalized, they can still select investments using ESG-related factors by using their normal, prudent, thorough and well-documented fiduciary process. Reviewing ESG as you would review any investment available to the plan will meet your fiduciary obligations during the interim.

Conclusion:

The new "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights" Proposal endorses the prudent fiduciary consideration of ESG-related investment factors, settling concerns about the prudence of ESG investments in ERISA plans. While there likely will be many comments, early responses from plans and financial service providers appear to be positive, and comments likely will focus on technical improvements rather than raising concerns about the Proposal's fundamental goals. It's too early to begin changing Investment Policy Statements or plan documents, but the Proposal provides a framework in which fiduciaries and investment advisors make financial decisions based on their expertise. This approach seems preferable to regulators singling out specific investment types for special scrutiny.

As an established voice in ESG investing, Federated Hermes is available to offer our insight on ESG issues affecting retirement plan sponsors. Please contact your Federated Hermes representative for consultation.

About the Author

The Hon. Bradford P. Campbell, partner at Faegre Drinker Biddle & Reath LLP, is a nationally-recognized figure in employer-sponsored retirement plans. He counsels his clients in ERISA Title I issues, including fiduciary conduct and prohibited transactions. Mr. Campbell served as Assistant Secretary of Labor for Employee Benefits and head of the Employee Benefits Security Administration from 2006-2009. As ERISA's former "top cop" and primary Federal regulator, he provides his clients with insight and knowledge across a broad range of ERISA issues, and also serves as an expert witness in ERISA litigation. Mr. Campbell has been listed as one of the 100 Most Influential Persons in Defined Contribution by 401kWire and has been listed as one of the top 15 ERISA attorneys in the country by a poll of the National Association of Plan Advisors. He has testified before Congress on employee benefits issues 11 times.

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