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DOL Plan Could Make ESG Retirement Investing Hip — Again

By **Al Barbarino**

Law360 (October 15, 2021, 5:47 PM EDT) -- A new U.S. Department of Labor proposal would rip down Trump-era barriers that discouraged ESG investing by employee retirement funds, but it may only be the latest volley in a fiery debate over whether such investments are economically relevant — and whether they benefit or harm investors.

The Oct. 13 DOL proposal reasserts that retirement plan fiduciaries — the individuals or entities that manage an employee benefit plan and its assets — may consider environmental, social and governance factors when they select investments. The proposal states that "climate change and other ESG factors are often material and that in many instances" fiduciaries should consider them in the assessment of "investment risks and returns."

The Trump administration regulations had led to a "real reluctance" on the part of plan fiduciaries to take ESG factors into account when making investment decisions, Ali Khawar, a DOL acting assistant secretary, said upon the proposal's release.

For decades, fiduciaries' consideration of investments has rested on choosing those that most positively impact the "economics" of a plan, Michael Kreps, principal and co-chair of the retirement services practice at Groom Law Group, told Law360.

"Then, if everything's equal between two investments, then you can consider non-economic factors," Kreps said.

But the October 2020 Trump regulations drilled home a message that retirement plan caretakers should focus on investment performance, not related ESG impacts, when deciding on plan investments, attorneys said.

The Trump regulations did not ban ESG-related investments. But they required strict application of the fiduciary duties under the Employee Retirement Income Security Act, and their tone further discouraged plan sponsors from making ESG investments, attorneys said.

"The Trump [rule] grudgingly acknowledged that under certain circumstances ESG factors may be relevant to the investment and financial case for a particular investment," said Julie K. Stapel, a Morgan Lewis & Bockius LLP partner who advises plan sponsors and investment managers.

For instance, the rule cautioned fiduciaries "against too hastily concluding that ESG-themed funds may be selected" based on what it called "pecuniary" factors, or factors related to money.

On the other hand, "The overall tone of the [new proposal] is one that gives comfort to the idea that climate change and other ESG factors can be appropriately considered within the ERISA fiduciary framework," Stapel said.

"It's a full-throated 'Yes' that climate change and other ESG factors can be factors that are material to the risk-return analysis, and they should be considered on equal footing with the myriad other investment factors," she said.

Kreps said the Trump-era rules — a reversal from Obama-era positioning — had made fiduciaries nervous about even considering the addition of ESG-related investments, whether or not they made economic sense.

"Even if you thought that a climate change or governance or diversity consideration was economically relevant, it was the rhetoric from the Trump administration around the rule that made you think that the DOL didn't agree with you," Kreps said.

Under the new plan, ESG factors are seen as posing financial risks that plan sponsors — of 401(k) and other defined contribution plans and defined benefit pension plans — should consider.

The proposed rule "retains the core principle that the duties of prudence and loyalty require ERISA plan fiduciaries to focus on material risk-return factors," according to a DOL fact sheet.

Kreps said the new proposal's "much more permissive tone … provides more latitude for fiduciaries to make their own decisions and apply their own judgment to a situation, while the Trump administration rule was at least in part trying to put the finger on the scale."

The new plan could pave the way for a significant uptick in the number of ESG-related investments retirement plans choose to make, some attorneys said.

"The DOL's new proposed regulation should dramatically expand the ability for plan sponsors to offer funds that focus on or include ESG as investment options for participants," Josh Lichtenstein, a Ropes & Gray partner focused on ERISA, told Law360 in an email.

The plan would "make it extremely clear that plan sponsors evaluating investments can consider ESG factors as economic factors, and may even create a presumption that plan sponsors should be considering ESG factors as part of all investment decisions," he said.

A Game of Regulatory Pingpong?

However, any "sea change" in ESG investing by retirement plans is unlikely, Stapel of Morgan Lewis argued, adding that a continued "pingpong" match on the issue between administrations could lead to pause on the part of fiduciaries.

"When January 2025 rolls around and a president is inaugurated, is this going to change again?" she said. "I think that worry, based on the history of this rule, could be the thing that still causes some people to hesitate."

As currently written, the new proposal might open the door for a new administration to immediately revert to prior policies, just as Biden has, Stapel said. In particular, the proposal provides specific factors — related to climate change, governance and "workplace practices" — that a fiduciary may consider in the evaluation of an investment, which a new administration could be quick to pick apart.

A more "principles-based" approach could have avoided the "wrath of a new administration," Stapel said. For instance, if the plan had stated simply that a fiduciary may "consider any facts and circumstances that are material to the risk-return analysis … that high-level, principles-based approach is hard to argue with," she said.

The DOL proposal touches on a broader regulatory tug-of-war playing out about whether ESG investing considerations are "economic" in nature and if they are "material" to investors.

"A principal idea underlying the proposal is that climate change and other ESG factors can be financially material and when they are, considering them will inevitably lead to better long-term risk-adjusted returns, protecting the retirement savings of America's workers," the DOL's Khawar said.

Meanwhile, Republicans have contended that ESG risks are not material and have no place in driving financial decisions. Republican leaders on the Education and Labor Committee, Reps. Virginia Foxx, R-N.C., and Rick Allen, R-Ga., issued a statement on Oct. 13 arguing that the DOL proposal encourages "non-financial goals."

"Democrats are allowing their extreme agenda to come before workers and retirees," Foxx and Allen wrote. "It is incumbent on the Department of Labor to ensure retirement savers are protected and that plan fiduciaries are not allowed to sacrifice retirement certainty in the name of non-financial goals."

If there was any agreement, it was that the new proposal could spur more investing by retirement plans in ESG-related enterprises.

The proposal would "pressure retirement plan fiduciaries to prioritize ESG factors when investing retirement plan assets" and jeopardize Americans' retirement savings, according to Foxx and Allen.

Elsewhere in Government, the ESG Debate Rages On

A similar war of words over ESG-related matters has played out as the Democratic-led U.S. Securities and Exchange Commission moves forward with plans to create a new, comprehensive framework for public companies and funds to disclose ESG-related risks.

The commission has generally argued that these risks are material, have real impacts on financial performance and should be incorporated into the regulatory landscape so that investors have a full view of their investment options.

Among the more outspoken critics of the SEC measures was West Virginia Attorney General Patrick Morrisey, a Republican, who in a scathing March 25 letter argued that ESG-related risks are not material and that the SEC is proceeding on an "unprecedented and dangerous course."

"The commission should stick to its core mission of requiring statements on matters that are material to future financial performance — not statements on issues that drive a political agenda," Morrisey wrote at the time.

Meanwhile, GOP senators on the Senate Banking Committee have blasted regional Federal Reserve banks for conducting research on ESG-related factors, including those related to racial disparities in the economic system.

Led by the committee's ranking member, Sen. Pat Toomey of Pennsylvania, the group said on Oct. 13 that Fed banks have "embraced politically charged social causes" outside the Federal Reserve's "historical mission and statutory mandate."

As for the new DOL plan, the public has 60 days to sound off on the intricacies and merits of the proposal, as well as the impacts that current regulations have had on their investment decisions. The comment period began Thursday, when the proposal was published in the Federal Register.

--Editing by Alanna Weissman and Kelly Duncan.
