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Thoughts on the DOL's Proposed ESG Regulation

by William D. Jewett on October 20, 2021

The latest installment in the regulatory back-and-forth over the investment of ERISA-governed retirement plan assets based on environmental, social, and corporate governance ("ESG") factors arrived on October 14, 2021 in the form of a newly proposed regulation on "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights."[1] This post focuses on the part of the regulation relating to the selection of plan investments. After briefly summarizing what's new, this post comments on winners and losers in this latest round of guidance, discusses how the proposal changes the risks affecting ERISA plan fiduciaries, and speculates on what it might take to settle the perennial uncertainties generated by changing Department of Labor ("DOL") guidance in this area.

What's New

The proposed regulation makes few overt policy changes but takes a 180-degree turn in the way it expresses the DOL's longstanding principle that plan investment decisions must serve the financial interests of plan participants in their retirement income without sacrificing those interests to unrelated objectives. Gone is any mention of purely "pecuniary" considerations, on which the existing regulation is narrowly focused. To amplify the license for plan fiduciaries to consider "any factor . . . material to the risk-return analysis," the proposed regulation includes a list of examples focusing explicitly on climate change, corporate governance, and workforce practices. Such ESG considerations, far from being set in opposition to pecuniary factors, are now presented as prime examples of factors that "may often" be material to a risk-return analysis.

Along with these stark changes in tone and implication – presented throughout as clarifications on points where the existing regulation left confusion – the proposed regulation includes more politically neutral liberalizations of the rules. Foremost among these is a change that rescues the longstanding "tie-breaker" rule from irrelevance, allowing plan fiduciaries to use non-economic considerations to choose between alternative investments that under the existing regulation must be "indistinguishable," which will rarely or never be the case. Under the proposed regulation, two investments need only "equally serve the financial interests of the plan over the appropriate time horizon" for the tie-breaker rule to come into play. Finally, there is one outright reversal of policy, rescinding the existing regulation's ban on qualified default investment alternatives ("QDIAs") that consider or include sub-funds that consider ESG factors.

Winners and Losers

The winners in this latest round would have to include, first, plan participants who believe that ESG considerations are relevant to their retirement investments. Participants

increasingly appear to want ESG investment options in their retirement plans. And the proposed regulation does not force ESG on anyone. Participants in self-directed retirement plans who do not want ESG considerations anywhere near their investments have only to make an affirmative choice of clearly non-ESG investments to avoid being defaulted into a QDIA that includes an ESG component, if their plan should have one.

Investment providers are also clear winners under the proposed regulation, especially those that seek to offer QDIAs with ESG components. The proposal will be welcomed more broadly by the many investment providers that operate globally, including in jurisdictions where consideration of ESG factors is mandatory.

Finally, on balance it appears plan fiduciaries are more winners than losers under the proposed regulation. On the one hand, plan fiduciaries contemplating the addition of an ESG investment option seem to have somewhat lower risk under the proposed regulation than under the existing regulation and its implied enforcement priorities. (The Trump-era regulation was accompanied by somewhat intimidating DOL information requests sent to the sponsors of plans offering ESG investments.) However, there remains the risk that guidance in this area will change again in the future. Moreover, under the current proposal, certain risks created by the existing regulation would arguably be replaced by new risks for fiduciary decision-makers.

Changes in Risks for Fiduciaries

While the proposed regulation may seem to lower the risks facing fiduciaries charged with selecting investments by liberalizing the factors that may be considered, certain commenters have speculated that the proposed regulation creates a presumption that ESG factors must be considered and thus poses a new risk for fiduciaries who might prefer to (but now cannot) disregard ESG considerations. Is this a valid concern? Despite a request for comments on whether climate change should be a presumptively material economic consideration, the proposal clearly still leaves it up to fiduciaries to determine what factors are material to their risk-return analyses. It seems unlikely that an examiner or a court would second-guess a fiduciary’s decision on how much weight to give to the ESG factors listed in the proposed regulation.

The proposed regulation leaves untouched, however, and may even increase, certain risks facing fiduciaries who might wish to embrace ESG investing more fully. Nowhere does the proposed regulation give a plan fiduciary protection for choosing to put ESG-themed funds on a plan's investment platform based on the availability of other non-ESG

funds for participants to select. And plan fiduciaries who seek to use the restored tie-breaker rule may do so at their own peril, because the proposed regulation requires a fiduciary who uses the tie-breaker rule to ensure that the collateral characteristic used to break the tie is "prominently displayed" in disclosure materials. The proposed regulation does not say that the collateral characteristic must be identified as having broken a tie,

but that may be what was intended. (The final regulation should clarify this one way or the other.) If the regulation is finalized as proposed, fiduciaries may now face the risk of being second-guessed on their use of the tie-breaker rule or accused of failing to meet the "prominently displayed" requirement.

Game Over?

The leading source of risk for investment fiduciaries remains the same as before the release of the proposed regulation: namely, the risk of being caught on the wrong side of the ESG question under a future administration that issues new guidance with different priorities. The DOL itself refers to stakeholders using a "ping-pong" metaphor to describe the regulatory back-and-forth, in its fact sheet on the new proposal. Our advice, as in previous posts on this topic, is that fiduciaries should proceed with caution until the DOL's back-and-forth on ESG has settled into a durable set of rules. The partisan reactions to the proposed regulation that have appeared to date suggest that the back-and-forth is far from over.

What would it take for guidance in this area to reach a state of equilibrium such that the rules are not subject to change with each new administration? One possibility would be for regulators to adopt a studied neutrality by including ESG factors among many others when listing examples of factors that may be material to a risk-return analysis, rather than focusing solely on the legitimacy of ESG factors. Another would be for regulators to acknowledge openly the difference between a change in policy and a mere clarification in an area where previous guidance has left confusion. Genuine clarification of the law and its application will always be helpful, but reversals in policy that purport to be mere clarifications seem to invite more of the same from future regulators.

The DOL does seem to be aware that stability in the applicable regulations should be a top regulatory priority, given that plan fiduciaries must evaluate potential investments over a long-term time horizon. Stakeholders have reason to hope that the final regulation will strike a balance that will assure them that they can rely on the rules for the foreseeable future.

Please contact a member of Verrill's Employee Benefits & Executive Compensation Group if you have questions regarding ESG investments.

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[1] For a brief history of the varying guidance in this area, see our blog post of April 12, 2021.

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