

MEMO# 32552

June 24, 2020

DOL Issues Proposal on ESG Investments in Retirement Plans

[32552]

June 24, 2020 TO: ICI Members

ESG Task Force

Pension Committee

Pension Operations Advisory Committee SUBJECTS: ESG

Pension RE: DOL Issues Proposal on ESG Investments in Retirement Plans

The Department of Labor (DOL) has issued a proposed rule intended to clarify its stance on selecting environmental, social and governance (ESG) investments for retirement plans.[\[1\]](#) The proposed rule is intended to “codify” DOL’s position on ESG investing and clarify previous guidance on the subject that DOL says “may have created confusion.”

The proposal does not fundamentally change DOL’s position on the application of ERISA’s fiduciary requirements to the selection of plan investments. Rather, it appears that DOL seeks to remove any doubt about the impermissibility of ERISA plan fiduciaries investing in ESG vehicles when they understand an underlying investment strategy of the vehicle is to subordinate return or increase risk for the purpose of non-financial objectives.

Comments on the proposal are due 30 days after the proposal is published in the Federal Register.

Background and Purpose

Since the Clinton Administration, generally, each incoming administration has made slight modifications to DOL’s guidance on ESG investments in ERISA plans. The Obama Administration issued Interpretive Bulletin (IB) 2015-01, replacing the Bush Administration’s IB 2008-01, and reinstating the language of the Clinton Administration’s IB 94-01. In 2018, the DOL under the Trump Administration issued Field Assistance Bulletin (FAB) 2018-01, providing guidance to its staff in national and regional offices, intended to “clarify” earlier DOL guidance issued in IB 2015-01.[\[2\]](#)

DOL proposes to replace IB 2015-01 with the new regulatory language, noting in the preamble that it “intends, by this proposal, to reiterate and codify long-established principles of fiduciary standards for selecting and monitoring investments, and thus to provide clarity and certainty regarding the scope of fiduciary duties surrounding non-pecuniary issues.”[\[3\]](#) DOL also explains its belief that the proposal would eliminate confusion, caused in part by DOL’s varied statements in its earlier sub-regulatory guidance.

While not provided as a reason for the proposal, it is likely that codifying the sub-regulatory guidance in this manner will make it more difficult for future administrations to modify the guidance.

Throughout the preamble, DOL expresses caution about certain forms of ESG investments, particularly those that may sacrifice investment return, increase costs, or assume additional investment risk to promote non-pecuniary benefits or objectives.

The proposal may have been prompted in part by a Trump executive order (EO) from back in April 2019 directing DOL to review positions that might result in ESG policies discouraging oil and gas investments.^[4] DOL does not, however, specifically mention the EO in explaining why it issued the proposal.

Proposal

The proposal would amend DOL's existing regulation that describes a fiduciary's investment duties under ERISA. The proposed regulation begins by reiterating the basic requirements that, in selecting plan investments, a fiduciary is subject to ERISA's duties of prudence and loyalty. DOL elaborates on these principles by including a new provision providing that these duties are satisfied if the fiduciary--

Has not subordinated the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to unrelated objectives, or sacrificed investment return or taken on additional investment risk to promote goals unrelated to those financial interests of the plan's participants and beneficiaries or the purposes of the plan.^[5]

Consideration of Pecuniary vs. Non-Pecuniary Factors and "Tie Breakers"

The proposal creates a new subsection that addresses the consideration of ESG considerations. It reiterates that a fiduciary must only focus on pecuniary factors and is prohibited from sacrificing investment return or taking on additional investment risk to promote non-economic goals. ESG considerations may be considered economic "only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories."^[6]

Like prior guidance, the proposal provides that non-economic ESG factors may be considered as a "tie-breaker" when a fiduciary has determined that two investments are "economically indistinguishable." In this regard, the proposal highlights that ERISA plan fiduciaries should document specifically why the investments were determined to be indistinguishable and why the investment option was chosen.^[7] In the preamble, however, DOL expresses skepticism regarding such situations, stating that it "expects that true ties rarely, if ever, occur."^[8] DOL specifically requests comments on this issue, "including whether true ties exist and how fiduciaries may appropriately break ties." DOL also asks whether this tie-breaker provision should apply in the case of individual account defined contribution plans.^[9]

ESG Investments May Be Offered Through Individual Account Plans, but Cannot Be Default Investment

The proposal includes an explanation of how the requirement that the fiduciary's evaluation

of an investment must be focused only on pecuniary factors applies in the context of the selection of investment options for participant-directed individual account plans.

The proposal states that a prudently selected, well managed, and properly diversified fund with ESG investment mandates could be added to the available investment options on a 401(k) plan without violating ERISA, only if:

- i. the fiduciary uses only objective risk-return criteria, such as benchmarks, expense ratios, fund size, long-term investment returns, volatility measures, investment manager tenure, and mix of asset types in selecting and monitoring all investment alternatives for the plan, including any ESG investment alternatives;
- ii. the fiduciary documents compliance with (i) above; and
- iii. the environmental, social, corporate governance, or similarly oriented alternative is not added as, or as a component of, a qualified default investment alternative (QDIA) that participants are automatically defaulted into.

DOL cautions in the preamble that while the proposal would allow a 401(k) plan fiduciary to include an ESG-themed investment alternative as an investment option, “the Department has consistently expressed the view that fiduciaries who are willing to accept expected reduced returns or greater risks to secure non-pecuniary benefits are in violation of ERISA.”

Effective Date

DOL proposes to make the new rule effective sixty days after publication of the final rule. However, DOL does request comments on whether “any transition or applicability date provisions should be added to for any of the provisions of the proposal.”^[10]

Next Steps

As stated above, comments on the proposal are due 30 days after the proposal is published in the Federal Register. ICI will work with a member working group to develop a comment letter. If you would like to participate in this working group, please contact the undersigned at shannon.salinas@ici.org.

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endnotes

^[1] The proposal is available at <https://www.dol.gov/sites/dolgov/files/ebsa/temporary-postings/financial-factors-in-selecting-plan-investments-proposed-rule.pdf>. DOL’s news release is available at <https://www.dol.gov/newsroom/releases/ebsa/ebsa20200623-0>, and a fact sheet is available at <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/financial-factors-in-selecting-plan-investments>. Also note that in conjunction with DOL’s release of the proposal, Labor Secretary Eugene Scalia published an Op-Ed in *The Wall Street Journal*. See “Retirees’ Security Trumps Other Social Goals,” *The Wall Street Journal*, published on June 23, 2020.

[2] ICI Memorandum No. 31192, dated May 3, 2018, *available at* https://www.ici.org/my_ici/memorandum/memo31192.

[3] See page 11 of proposal, linked in footnote 1 above. DOL also states that it “believes that providing further clarity on these issues in the form of a notice and comment regulation will help safeguard the interests of participants and beneficiaries in the plan benefits.” See page 12 of proposal.

[4] On April 10, 2019, the White House issued an Executive Order on Promoting Energy Infrastructure and Economic Growth (the EO). The stated goal of the EO is to promote private investment in US energy infrastructure, with a focus on crude oil and natural gas. The EO included a number of directives to DOL and appears focused on limiting the impact of ESG influences on curtailing investment in the fossil fuel energy industry. See ICI Memorandum No. 31723, dated April 22, 2019, *available at* https://www.ici.org/my_ici/memorandum/memo31723.

[5] See proposed section 2550.404a-1(b)(1)(ii).

[6] See proposed section 2550.404a-1(c)(1).

[7] In the preamble, DOL explains that it “believes this documentation requirement provides a safeguard against the risk that fiduciaries will improperly find economic equivalence and make decisions based on non-pecuniary factors without a proper analysis and evaluation.” See page 17-18 of proposal, linked in footnote 1 above.

[8] *Id.* at page 16.

[9] *Id.* at page 21.

[10] *Id.* at page 24.