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BLOG

To ESG or Not to ESG: ESG Investments and ERISA Plans

JUNE 29, 2020

On June 23, 2020, the Department of Labor (DOL) updated its "investment duties" guidance for Employee Retirement Income Security Act of 1974, as amended (ERISA), fiduciaries to address environmental, social, and corporate governance (ESG) investments. The updated guidance takes the form of a proposed rule (the Proposed Rule) clarifying the restrictions and fiduciary duties with regard to ESG investments in retirement plans. The DOL announces the Proposed Rule amid increased emphasis in the marketplace on investments and investment courses of action that further ESG investing. Over the past two decades, the DOL has wrestled with concern that ESG investing may prompt ERISA plan fiduciaries to make investment decisions in violation of their fiduciary responsibilities under ERISA. The DOL clarified its long-standing position that plan fiduciaries may not sacrifice investment returns to promote collateral or social goals.

A growing number of both defined benefit and defined contribution plans are adopting ESG investments, which focus on additional goals beyond simply maximizing returns. While there is no single definition of ESG investing, it encompasses socially responsible investing; sustainable and responsible investing; environmental, social, and corporate governance investing; impact investing, and economically targeted investing. The Proposed Rule is the third DOL publication focused on ESG and non-pecuniary investing within five years, demonstrating the importance of this issue to the agency. The concern is that ESG investing commonly comes with higher fees due to additional investigation and monitoring necessary for assessing ESG qualities and may sacrifice returns and assume greater risk in an effort to meet non-financial goals.

However, Title I of ERISA imposes rules on fiduciaries investing assets of ERISA-governed plans. Specifically, Sections 403(c) and 404(a) of ERISA require that such plan fiduciaries act "solely" in the interest of the plan's participants and beneficiaries, for the "exclusive purpose" of providing benefits to such participants and beneficiaries and to defray reasonable expenses of administering the plan. Courts have interpreted this "exclusive purpose" rule to refer to financial rather than non-pecuniary benefits. In the Proposed Rule, the DOL applies the fiduciary rules to ESG investing and stresses that "ERISA plan fiduciaries may not invest in ESG vehicles when they understand an underlying investment strategy is to subordinate return or increase risk for the purpose of non-pecuniary objectives."

In general, the guidance under the Proposed Rule increases the fiduciary liability risk of using ESG investments for retirement plan purposes by imposing increased fiduciary obligations and documentation requirements on such investments. The key takeaways from the guidance are:

1. fiduciaries must evaluate plan investments by solely focusing on financial considerations, not non-pecuniary goals;
2. fiduciaries must consider and compare available alternative investments when selecting an investment to meet their duties of prudence and loyalty under ERISA (NOTE – this is a new requirement which would be added by this guidance if finalized);
3. ESG factors may only be considered to the extent of their pecuniary impact as an economic risk or opportunity or for non-pecuniary purposes when two alternative investments appear economically identical and such consideration is properly documented; and
4. ESG investments may not be used as, or be a component of, a qualified default investment alternative (QDIA).

The news release accompanying the Proposed Rule summarizes the purpose of the ESG rules. Secretary of Labor Eugene Scalia said, “Private employer-sponsored retirement plans are not vehicles for furthering social goals or policy objectives that are not in the financial interest of the plan. Rather, ERISA plans should be managed with unwavering focus on a single, very important social goal: providing for the retirement security of American workers.” The guidance acknowledges that ESG goals may in certain instances present an economic business risk or opportunity which would allow for consideration for plan investments. However, the examples provided in the Proposed Rule are of improper disposal of hazardous waste and dysfunctional corporate governance, suggesting the relevant circumstances for investing plan assets in ESG investments is limited. Even if appropriate, any ESG investments must be selected ahead of other investment alternatives based solely on certain economic factors, including liquidity, diversification, and risk.

The guidance allows for consideration of non-pecuniary factors relevant to ESG investing only to “break the tie” in the rare circumstance when two alternative investments appear economically indistinguishable. In this circumstance, fiduciaries are required to document the occurrence, the basis for concluding that distinguishing factors could not be found, and why the selected investment was chosen based on financial interests.

In the context of selecting investment alternatives under a defined contribution plan, a prudently selected ESG investment may be added to the investment options without requiring the plan to forgo adding other non-ESG-themed investment options only if a fiduciary uses only objective risk-return criteria in selecting and monitoring alternatives and documents compliance with such monitoring. However, as mentioned above, an ESG investment may not be added as, or as a component of, a QDIA.

The Proposed Rule has generated quite a bit of discussion within the ERISA community. We note that it is only in proposed format and the DOL is accepting comments on the draft for 30 days after the date it is published in the Federal Register (which has not occurred as of this date). If the Proposed Rule is enacted in its current form, fiduciaries may be reluctant to offer ESG products to ERISA-governed plans, although ESG products are not prohibited investments. Fiduciaries of such plans will, however, have to engage in greater due diligence when selecting ESG investments.

As a best practice, we recommend taking a closer look at ESG investments currently offered or under consideration to ensure the Proposed Rule standards can be met to justify such ESG investments. Fiduciaries and committees responsible for managing both defined benefit and defined contribution plan investments should:

- review current plan investment options to identify any ESG investments;
- confirm the financial reasoning behind including such ESG investments;
- compare the ESG investments to available alternatives to remove underperforming investments;
- document their decision-making process; and
- implement policies for the future consideration of ESG investments which comply with the guidance under the Proposed Rule.

4 Min Read

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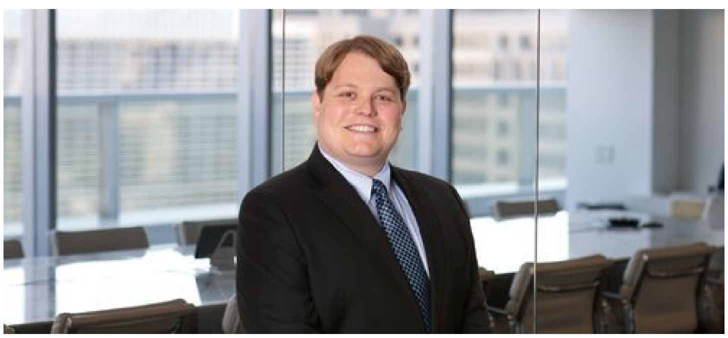

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