July 2, 2020

DOL Proposes New Rules Regulating ESG Investments

As ESG investing continues to accelerate, the Department of Labor ("DOL") has proposed for public comment rules that would further burden the ability of fiduciaries of private-sector retirement plans to select investments based on ESG factors and would bar 401(k) plans from using a fund with any ESG mandate as the default investment alternative for non-electing participants. The proposal asserts that "ESG investing raises heightened concerns under ERISA," and, in contrast to the broader investor community's recognition that ESG is about value and performance, and despite growing evidence that the investment returns of ESG funds can outperform those of non-ESG funds, the proposal reflects the DOL's continued concern that ESG investment might "subordinate return or increase risk for the purpose of non-pecuniary objectives." In terms of defining what would be an ESG-themed fund or mandate triggering heightened scrutiny and procedural requirements, the proposed rule casts the net widely to reach those featuring "one or more environmental, social, corporate governance, or similarly oriented assessments or judgments in their investment mandates, or that include these parameters in the fund name." Such assessments and judgments have, of course, become common and mainstream, with investors, companies and fiduciaries of all kinds bringing their business determinations to bear.

The proposed rules would prohibit a retirement plan fiduciary from making any investment, or choosing an investment fund, based on the consideration of an environmental, societal or governance factor unless that factor independently represents a material economic investment consideration under generally accepted investment theories or serves as a tiebreaker in what the DOL characterizes as the rare case of economically equivalent investments. In order to select an investment with an ESG component, the plan fiduciaries would be required to compare investments or strategies on "pecuniary" factors such as diversification, liquidity and rate of return. Specific documentation would be required for the tiebreaker justification and for the selection and monitoring of an investment alternative in a 401(k) plan that includes ESG in its mandate or fund name. Most significantly, the proposed rules would prohibit a 401(k) plan from providing a qualified default investment alternative ("QDIA") with an ESG component, no matter how small, even if that investment alternative satisfies the pecuniary factor requirements.

Numerous sophisticated investors have indicated that their ESG investments, social benefits notwithstanding, are fundamentally driven by expected financial

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returns, including considerations regarding long-term value, opportunity and risk, and have cited studies published over the past five years indicating that an ESG perspective can improve performance, including studies that show ESG-focused indexes have matched or exceeded returns of their standard counterparts, with comparable volatility, and investors who screened for ESG factors could have avoided 90% of S&P 500 bankruptcies from 2005 to 2015 and that S&P 500 companies in the top 25% by ESG ratings experienced lower future earnings-per-share volatility than those in the bottom 25%.

Amid the current pandemic, ESG funds have demonstrated outperformance relative to the market and continue to attract strong inflows, which appears to reflect growing investor recognition of the importance of ESG in risk management and mitigation, as well as the view that addressing ESG issues promotes long-term value creation. It is particularly anomalous, especially in these times, for the DOL to limit or unduly burden the ability of plan fiduciaries to exercise a judgment that items like good corporate governance, effectively navigating energy transitions or operating in a sustainable manner can enhance or protect returns.

If the proposed rules are adopted, ESG investment options will likely become more difficult to offer under a 401(k) plan, leading to less availability to plan participants of ESG investment alternatives as part of their retirement portfolios. The extensive scope of criteria that the DOL considers problematic will also likely result in increased costs and fees as plan fiduciaries seek to filter for these criteria. The rule may also have broader ramifications for the asset management industry which has actively integrated ESG into its product offerings. Increased scrutiny and litigation can also be expected relating to plan investments in funds that make investment decisions with reference to ESG metrics driven by stakeholder, rather than financial materiality.

At the same time, if implemented, the new rules may spur further demand for comparable, decision-useful ESG data to help satisfy the burden imposed by the DOL to justify the inclusion of ESG factors in private-sector retirement plans. The rules may also accelerate the work being done in business schools, academia, investment houses and sophisticated finance and valuation venues to measure ESG's impact and ensure that generally accepted investment theories do not have value-relevant ESG blindspots. With investors continuing to pour capital into ESG and increasing evidence of ESG outperformance, it remains to be seen whether the DOL proposal will be a deterrent to the entry of ESG into mainstream investing outside of the private retirement plan arena. And as companies are well aware, investors will continue to use ESG-related screens and factors to inform proxy voting

decisions on individual directors and proposals in both contested and uncontested situations, prioritize engagement requests and decide when and whether to escalate matters with a given portfolio company, whether publicly or privately.

The comment window on the DOL's latest proposal closes on July 30, 2020.

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