The DOL’s proposed rule is intended to provide plan fiduciaries with clear guidelines that would prevent any such fiduciary from causing a plan to make an ESG investment unless such investment is made solely in the best interests of the economic welfare of the employee benefit plan.

For years, the fiduciaries of employee benefit plans that are subject to ERISA have wrestled with how their fiduciary obligation to act in the best interests of the plan intersects with ESG concerns. The longstanding position of the DOL, as articulated in several Interpretive Bulletins over the years, is that an ERISA fiduciary may not cause a plan to sacrifice investment returns or assume greater investment risks as a means of promoting ESG policy goals. The DOL, however, has also recognized that, to the extent an investment is made based on economic considerations, the fiduciary can cause a plan to make such an investment without regard to any collateral benefits the investment may also promote. In addition, the DOL has commented on ERISA plans that maintain policy statements that incorporate ESG factors or integrate ESG-related tools, metrics and analyses to evaluate an investment’s risk or return or to guide plan fiduciaries in choosing among equivalent investments.

With its proposed rule, the DOL is attempting to address apparent confusion in the marketplace surrounding its prior guidance on ESG, especially given the increasing prevalence and popularity of ESG investment funds and strategies. On the release of the proposed rule, Secretary of Labor, Eugene Scalia stated that “[p]rivate employer-sponsored retirement plans are not vehicles for
furthering social goals or policy objectives that are not in the financial interest of the plan." Secretary Scalia further stated that “ERISA plans should be managed with unwavering focus on a single, very important social goal: providing for the retirement security of the American workers.”

The DOL’s proposed rule would add five core principles:

> Codifying the DOL’s longstanding position that ERISA requires plan fiduciaries to select investments and investment courses of action based on financial considerations relevant to the risk-adjusted economic value of a particular investment or investment course of action.

> Compliance with the exclusive-purpose (i.e., loyalty) duty in ERISA section 404(a)(1)(A), which prohibits fiduciaries from subordinating the interests of plan participants and beneficiaries in retirement income and financial benefits under the plan to non-pecuniary goals.

> Requiring fiduciaries to consider other available investments to meet their prudence and loyalty duties under ERISA.

> Acknowledging that ESG factors can be pecuniary factors, but only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories. In furtherance of this principle, the proposed rule will add new regulatory text on required investment analysis and documentation requirements in the rare circumstances when fiduciaries are choosing among truly economically “indistinguishable” investments.

> Clarifying the DOL’s view that the prudence and loyalty standards set forth in ERISA apply to a fiduciary’s selection of an investment alternative to be offered to plan participants and beneficiaries in an individual account plan (commonly referred to as a 401(k)-type plan), including describing the requirements for selecting investment alternatives for such plans that purport to pursue one or more environmental, social, and corporate governance-oriented objectives in their investment mandates or that include such parameters in the fund name.

The proposed rule comes at an interesting time for fund managers and plan fiduciaries alike. ESG investment funds and strategies are increasingly popular in the U.S., and by some estimates, investors have allocated more than US$12tn in U.S. assets to strategies that incorporate ESG criteria. The proposed rule may also run counter to some of the stated investment policy goals of many of the world’s largest, U.S.-based asset management firms (see BlackRock CEO Larry Fink’s letter to CEOs). U.S.-based asset managers are also under increasing market pressure to integrate ESG factors into their investment programs, with many investors including ESG inquiries in due diligence questionnaires and in-person evaluations, as well as negotiating a variety of ESG provisions in side letters. In addition, there is recent empirical
data to suggest that ESG investment funds have outperformed their conventional peers, in part by avoiding exposure to the oil and energy sectors.

The proposed rule also highlights the divergent approaches being taken in Europe and the U.S. In the coming years, certain E.U. legislative initiatives, such as the Disclosure Regulation and Taxonomy Regulation, will come into effect and require asset managers in the E.U., as well as certain non-E.U. fund managers marketing funds in the E.U., to evaluate and disclose climate and other ESG-related information. The E.U. framework is designed to incentivize investment in ESG strategies and to promote a wider climate agenda by providing uniform standards for reporting, marketing and benchmarking ESG investments.

In the near term, the proposed rule may result in a chilling effect for plan fiduciaries seeking to allocate plan assets to investment funds that integrate ESG criteria, even where a plan fiduciary’s selection of the investment in question is based solely on pecuniary factors. The rule is unlikely, however, to stop the industry’s overall trend toward incorporating ESG factors into investments strategies, and fund sponsors will therefore need to tailor their offering materials to market to investors with diverging priorities as it relates to ESG.

To this end, investment fund sponsors that seek to raise capital from ERISA plans should review their offering materials to ensure that any ESG-related disclosures clearly state that ESG factors integrated into the sponsor’s investment policy are and will be pecuniary in nature. Notably, the Office of Compliance Inspections and Examinations of the U.S. Securities and Exchange Commission (“SEC”) stated in its 2020 Examination Priorities that it intends to focus on the accuracy and adequacy of disclosures related to ESG investment products offered by SEC-registered investment advisers. Sponsors of investment funds are therefore encouraged to do a holistic review of their ESG disclosures and product offerings in light of the SEC’s and the DOL’s heightened focus on this area.

For many ERISA plans, the proposed rule will have little immediate practical effect. For plans that seek to allocate to ESG-oriented investments, however, the fiduciaries of such plans should maintain detailed records documenting their ESG investment selections, including records showing that any ESG investment selection was made having only considered pecuniary factors.