DOL embraces ESG, suspends enforcement of "Financial Factors" rule and begins work on a new rule

Fiduciaries may prudently select ESG investments while new rule is developed

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In summary

DOL says “yes” to ESG and “no” to confusing “pecuniary factors” test:

- **DOL will not enforce financial factors rule:** Citing ESG investment confusion caused by the “Financial Factors” rule, DOL will not enforce the rule while it develops a new rule.
- **New rule to reflect the “important role” and “value” of ESG in ERISA plans:** The new rule will reflect “…the important role that ESG integration can play in the evaluation and management of plan investments,” and will “…address the substantial evidence...of ESG considerations in improving investment value and long-term investment returns for retirement investors.”
- **Financial factors rule confusion chilled “appropriate” ESG investing due to false perception of fiduciary risk:** DOL suspended enforcement after just a few months due in part to concerns that the rule “…had a chilling effect on appropriate integration of ESG factors already,” because the rule “created a perception that fiduciaries are at risk if they include…ESG factors in the financial evaluation of plan investments.”
- **While DOL modifies rule, ESG permitted with prudent fiduciary process:** ESG factors and investments can be prudently selected in the meantime by following the plan’s prudent and thorough investment process used for all plan investments. Investments that successfully pass through a prudent process are prudent, whether they have ESG factors or not. That means investments must be selected because they are anticipated to benefit the plan, not for other reasons, such as what DOL has in the past termed “collateral goals” intended to benefit other causes or parties.

The Department of Labor (DOL) recently issued a strong statement in favor of ERISA plans selecting prudent investments that consider environmental, social and governance (ESG) factors. Intending to reassure plan fiduciaries and advisors confused by the new “pecuniary” and “non-pecuniary” tests in the “Financial Factors in Selecting Plan Investments” final rule, DOL announced that it suspended enforcement of the Financial Factors rule, and has begun working on a replacement rule.

Citing concerns that the new rule was causing uncertainty about ESG investments and was preventing some plans from properly utilizing ESG factors to reduce risk, increase portfolio diversity and improve investment value, DOL is purposefully sending a clear signal that ESG investing can be appropriate for ERISA plans, and that fiduciaries should not avoid prudent investments utilizing ESG factors.

This article discusses why DOL is reexamining the Financial Factors rule, and how fiduciaries may prudently select ESG investments while DOL is developing the new rule.

Financial factors rule creating misperceptions regarding the prudence of ESG investments:

Explaining its somewhat unusual decision to not enforce a current regulation, DOL wrote that it heard from a wide array of stakeholders that the new rule had “…already had a chilling effect on appropriate integration of ESG factors in investment decisions…” Though the rule did not actually prohibit ESG investments and clearly allowed the use of “pecuniary” ESG factors in evaluating investments, DOL concluded that the rule nonetheless “…created a perception that fiduciaries are at risk if they include any ESG factors in the financial evaluation of plan investments.”

To combat this false perception and to eliminate any confusion regarding how fiduciaries should consider ESG factors and ESG investments, DOL announced that it will begin work to “…craft rules that better recognize the important role that environmental, social and governance integration can play in the evaluation and management of plan investments…”

> **“We intend…to craft rules that better recognize the important role that environmental, social and governance integration can play in the evaluation and management of plan investments, while continuing to uphold fundamental fiduciary obligations.”**

The practical and legal implications of suspending enforcement:

As a legal matter, the Financial Factors rule technically still exists until it is formally amended or replaced following the completion of the new notice and comment rulemaking DOL announced—the DOL suspension of enforcement binds DOL but not others. For example, the rule provided a “grandfather” clause exempting any current plan’s ESG investment used as a Qualified Default Investment Alternative (QDIA) from having to comply until April 30, 2022 with the specific, new QDIA provisions in §404a-1(d)(2) of the Financial Factors rule. Despite DOL’s decision not to enforce the rule, this delayed effective date would still apply if a private litigant alleged a violation of those new QDIA provisions.

However, in practical effect, DOL's public announcement suspending enforcement and replacing the rule should reassure fiduciaries that confusion regarding what "pecuniary" means need not be a barrier to considering investments integrating ESG factors, or from considering ESG investments. Indeed, one of DOL's purposes in taking these steps is to encourage appropriate ESG investing by ERISA plans, correcting the misperception that ESG may offer unusual fiduciary risks.

In reality, the legal and the practical concerns are largely addressed by continuing to utilize a plan's prudent, thorough investment process for all investments. If the plan followed a well-designed, prudent investment process before the Financial Factors rule went into effect, it should not need to make any material changes in response to the new DOL announcement.

"…one of DOL's purposes in taking these steps is to encourage appropriate ESG-related investment by ERISA plans, correcting the misperception that ESG may offer unusual fiduciary risks."

So, what do fiduciaries do in the meantime? How do plans and advisors prudently consider ESG factors and investments?

While the regulation is effectively suspended for DOL enforcement purposes, the basic statutory duties of prudence and loyalty remain. As DOL noted in the announcement, "This enforcement statement does not preclude the Department from enforcing any statutory requirement under ERISA, including the statutory duties of prudence and loyalty in section 404 of ERISA." So how do fiduciaries comply with their statutory duties while DOL "fine tunes" the regulations?

The answer is surprisingly simple—plans and their advisors should continue to follow their current investment process (assuming it is prudent, thorough, and already complies with ERISA's requirements). Just as DOL wrote in 1994 when it first issued guidance on what we would now call ESG factors (they were called "economically targeted investments" then), investments utilizing ESG factors should be treated as any other potential plan investment. The use of ESG factors along with other investment analytical tools and considerations is increasingly common, and significant evidence shows that these can improve risk-adjusted returns and diversification for plans. DOL itself acknowledged that it has received, "substantial evidence…on the use of environmental, social and governance considerations in improving investment value and long-term investment returns for retirement investors."

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Of course, in order to comply with ERISA, fiduciaries must act solely in the interest of the participants and beneficiaries. That means investments must be selected because they are anticipated to benefit the plan, not for other reasons, such as what DOL has in the past termed "collateral goals" intended to benefit other causes or parties. That's why the key to prudently considering ESG investments is to review them along with other available plan investment options using the same fiduciary review process focused on the plan's needs. Fiduciaries do not need to view ESG investments as unusual or risky—they simply need to review and understand these investments as they would any other. The issue is not what investments a fiduciary considers, but how it considers them. It would not be prudent to select an investment that fiduciary review suggested would increase risks or reduce returns regardless of whether it utilized ESG factors—similarly, a fiduciary need not reject an investment that passes through its prudent fiduciary process simply because it utilizes ESG factors.

Conclusion:

While the new pecuniary factor test in the Financial Factors rule may have led to confusion and excessive caution regarding ESG investments by some ERISA fiduciaries, DOL is sending a clear message by suspending and working to replace the rule. Noting that ESG can offer value to ERISA plans, DOL is encouraging fiduciaries to appropriately consider ESG factors and investments. Fiduciaries may do so using the same prudent and thorough fiduciary process they use for all other investments. While the new regulation may ultimately "fine tune" how fiduciaries consider certain investment issues, a good fiduciary process can appropriately consider ESG investments in the interim.

As an established voice in ESG investing, Federated Hermes is available to offer our insight on ESG issues affecting retirement plan sponsors. Please contact your Federated Hermes representative for consultation.

About the Author

The Hon. Bradford P. Campbell, partner at Faegre Drinker Biddle & Reath LLP, is a nationally-recognized figure in employer-sponsored retirement plans. He counsels his clients in ERISA Title I issues, including fiduciary conduct and prohibited transactions. Mr. Campbell served as Assistant Secretary of Labor for Employee Benefits and head of the Employee Benefits Security Administration from 2006-2009. As ERISA's former "top cop" and primary Federal regulator, he provides his clients with insight and knowledge across a broad range of ERISA issues, and also serves as an expert witness in ERISA litigation. Mr. Campbell has been listed as one of the 100 Most Influential Persons in Defined Contribution by 401kWire and has been listed as one of the top 15 ERISA attorneys in the country by a poll of the National Association of Plan Advisors. He has testified before Congress on employee benefits issues 11 times.

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