Americans for Financial Reform Education Fund

Sustainable Investing Under the New ERISA ESG Rules

Despite recent rule changes, private retirement plan fiduciaries can still incorporate ESG factors into their investment actions. In fact, prudent plan management increasingly requires it.

As we look back on 2020, the public health crisis and economic fallout of COVID-19 has reinforced the need for sustainable economic development and investing. As a private retirement plan ("ERISA"[1]) fiduciary, you can protect your participants' retirement savings, maximize returns, and contribute to a more sustainable financial system by incorporating ESG factors into your investment actions.

Unfortunately, 2020 was a year of accelerating climate impacts, featuring devastating wildfires,[2] a record setting hurricane season,[3] and 16 separate billion-dollar climate disasters in the U.S totaling $46 billion in direct damages.[4] Climate impacts represent profound physical risk to assets in real estate, infrastructure, agriculture, and energy; and big polluters in fossil fuels and manufacturing must simultaneously contend with transition risk to their unsustainable business models.[5] COVID-19 also brought into focus the workforce, reputational, and liability risk associated with inadequate occupational safety and health measures. Meanwhile, the Black Lives Matter movement sparked renewed focus on firms' commitment to racial and economic justice, issues proven to impact financial performance.

Amid these crises, investors are increasingly recognizing the material benefits of ESG investing. Investors added $27.4 billion in ESG ETFs in 2020, doubling the size of the sector, and a group of 425 asset managers with $25 trillion aum plan to double their sustainable asset holdings (to 37 percent) over the next five years.[6] Recent research shows that nearly 60 percent of sustainable funds outperformed their non-ESG counterparts over the past decade,[7] and ESG funds also performed particularly well during the pandemic.[8] But DOL has recently put forward new rules meant to discourage ESG investing and bail out risky firms and sectors. One such rule[9], which went into effect on 1/12/2021, sets new guidelines for how ERISA fiduciaries should consider and document ESG factors in their investment actions. ***Here's what you need to know.***

Determining and Documenting ESG Materiality

ERISA fiduciaries have always been required to prudently consider all known 'pecuniary' (i.e., financially material) factors in their investment actions. Because many ESG factors are material,[10] ERISA fiduciaries should consider and document them when buying or selling assets, engaging with issuers, and filing or voting on shareholder proposals. Documenting financial materiality of investment actions has long been considered a best practice, though not an explicit ERISA requirement. The new rule and guidance states that:

[1] The Employee Retirement Income Security Act of 1974; Pub.L 92-406; 88 Stat. 829; 29 USC ch. 18 §1001 et seq.
[2] www.theguardian.com/us-news/2020/dec/30/california-wildfires-north-complex-record
[3] www.smithsonianmag.com/smart-news/2020-atlantic-hurricane-season-has-most-named-storms-record-180976272/
[4] www.ncdc.noaa.gov/billions/summary-stats
[5] www.marketwatch.com/story/3-energy-stocks-for-the-pandemic-rebound-that-has-already-started-11606753515
[6] www.wsj.com/articles/investors-pile-into-etfs-devoted-to-socially-responsible-esg-11608114604
[7] www.ft.com/content/733ee6ff-446e-4f8b-86b2-19ef42da3824
[8] www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/esg-funds-outperform-s-p-500-amid-covid-19-helped-by-tech-stock-boom-59850808
[9] 85 Fed. Reg. 72,846, 72,885 (Nov. 13, 2020), DOL, Employee Benefits Security Administration, "Financial Factors in Selecting Plan Investments," www.dol.gov/sites/dolgov/files/EBSA/temporary-postings/financial-factors-in-selecting-plan-investments-final-rule.pdf
[10] See, for example, www.msci.com/our-solutions/esg-investing/esg-ratings/materiality-map or materiality.sasb.org/

When determining materiality, fiduciaries should consider "ESG issues [that] present risk or opportunities…that qualified investment professionals would treat…as material economic considerations under generally accepted investment theories."[11]

When documenting materiality, fiduciaries should consider[12] and be able to demonstrate:

- that the investment course of action is reasonably designed to further the purposes of the plan compared to reasonably available alternatives with similar risk, considering:
  - the composition of the portfolio with regard to diversification;
  - the return of the portfolio relative to the anticipated cash flow requirements; and
  - the projected return of the portfolio relative to the funding objectives of the plan.

DOL states that the phrase "reasonably available alternative" suggests that fiduciaries are not required to "scour the market or to consider every possible alternative," and that the purpose and characteristics of a selected investment could be "sufficiently rare that a fiducary could prudently determine, and document, that there were no other reasonably available alternatives" better suited for the plan.[13]

ESG 'tie-breakers'

When choosing among investment alternatives that the plan fiduciary is unable to distinguish between on the basis of pecuniary factors alone, the fiduciary may use non-pecuniary factors as the deciding factor (the 'tie-breaker'), but must also document:

- Why pecuniary factors were not sufficient to determine a course of action;
- How the selected investment compares to alternatives with respect to:
  - the composition of the portfolio with regard to diversification;
  - the return of the portfolio relative to the anticipated cash flow requirements; and
  - the projected return of the portfolio relative to the funding objectives of the plan; and
- How the chosen non-pecuniary factors are consistent with the interest of plan participants in their retirement income or financial benefits under the plan.[14]

Fund selection for participant directed plans

ESG funds may be offered to participants as *designated* investment alternatives as part of a *prudently constructed lineup* of investment alternatives from which participants may choose. This applies even if the fund, product, or model portfolio is chosen above other plans by the fiduciary solely because it promotes, seeks, or supports one or more non-pecuniary goals. This provides an avenue for plan participants to designate investments based on sustainability-related preferences.[15]

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[11] 85 Fed. Reg. at 72,847, referring to DOL Field Assistance Bulletin 2018-01.
[12] 85 Fed. Reg. at 72,884; and CFR §2550.404a-1
[13] 85 Fed. Reg. at 72,853 and 72,854
[14] 85 Fed. Reg. at 72,884; and CFR §2550.404a-1
[15] 85 Fed. Reg. at 72,865, 72884; and CFR §2550.404a-1

In addition, funds with high ESG ratings may be selected[16] **as the qualified default investment alternative ("QDIA")**, or as a component of a QDIA, if both of the following are true:

- The fund was selected solely based on pecuniary factors for the appropriate investment horizons consistent with the plan's articulated funding and investment objectives; and
- The fund's stated objectives, goals, and principal investment strategies are *also* based entirely on the pecuniary factors, including material benefits derived from ESG considerations. **A fund must be excluded "if its investment objectives or goals or its principal investment strategies include, consider, or indicate the use of one or more non-pecuniary factors."**[17]

The incoming Biden Administration and the new Congress can and should protect Americans' retirement savings and maximize returns by providing clear guidance for ERISA fiduciaries directing them to incorporate ESG risks and opportunities into their investment actions.

[16] To determine if a particular fund meets these criteria, please consult with your legal counsel to ensure compliance with the final DOL rule.
[17] 85 Fed. Reg. at 72,884; and CFR §2550.404a-1