CARLTON FIELDS

DOL to Plan Sponsors: "It's Mostly All About the Benjamins!"

January 11, 2022

Almost one year from the date it updated its investment duties regulation (29 C.F.R. § 2550.404a-1), triggering our previous article "DOL to Plan Sponsors: 'It's All About the Benjamins!,'" the Department of Labor (DOL) issued proposed changes to temper that regulation's strong implication that environmental, social, and governance (ESG) factors should not be considered when selecting investment options for retirement plan participants and beneficiaries.

The new proposal was issued in response to President Biden's executive order asking the DOL and other federal agencies to review regulations issued between January 20, 2017, and January 20, 2021, with a focus on furthering protections to improve public health, protect the environment, and minimize climate change. The DOL also announced that, pending its review of the current regulation, it "will not enforce the current regulation … [and intends] to determine how to craft rules that better recognize the role that ESG integration can play in the evaluation and management of plan investments, while continuing to uphold fundamental fiduciary obligations."

The proposed changes clarify that, where a fiduciary prudently believes that ESG considerations are likely to affect investment returns or risks, it is prudent to consider those factors when making investment decisions. As is expressed in the proposed regulation's preamble, "under ERISA, if a fiduciary prudently concludes that a climate change or other ESG factor is material to an investment or investment course of action under consideration, the fiduciary can and should consider it and act accordingly, as would be the case with respect to any material risk-return factor." The proposed regulation would also permit the use of an investment that considered ESG factors as a qualified default investment alternative (used when participants fail to direct the investment of their account) so long as the same fiduciary standards were used in selecting that QDIA that applied to the selection of other investment alternatives.

How Broad Is a Fiduciary's Authority to Consider ESG Factors?

The regulation does not restrict or strictly define the factors that may be treated as “ESG factors,” but in light of the restrictions on considerations in general, a definition is probably unnecessary. The prime directive of the regulation at issue will remain the selection of investments that are in the best interests of a particular plan’s participants and beneficiaries. Subsection (b)(4) of the investment duties regulation allows consideration of any factor that is relevant to determining whether a particular investment option has the right balance between risk and return for the retirement plan and its participants and beneficiaries. Even if the earth, our children, and our children’s children would be better off with the promotion of ESG funds (a position we are neither supporting nor opposing), ESG considerations are only relevant as they relate to the projected risk and return of investments. In this way, the proposed changes are not earth shattering (or “earth saving”) — they reinforce that fiduciaries should use all information available to determine the best investments or investment options for plan participants and beneficiaries.

In our last article, we offered the following facetious summary of the current rule: “Dear Plan Fiduciary: You can be socially conscientious with your own money, but base the selection of your plan’s designated investment alternatives on economic grounds.” We might summarize the current rule as: “Dear Plan Fiduciary: You should base the selection of your plan’s designated investment alternatives on economic grounds, and if those economic grounds include ESG factors, so be it.” We concluded our last article with the following recommendation: “[F] iduciaries basing decisions on nonpecuniary considerations should be prepared to defend those decisions.” That recommendation will still apply if the proposed regulations are finalized because, although the proposed rule eliminates the requirement that fiduciaries document decisions based on ESG factors, fiduciary decisions can still be questioned, and fiduciaries will still need to prove that their primary considerations were financial considerations.

Parting Thoughts

Retirement plan investments are generally selected and monitored based on past performance (even though past performance may not be indicative of future returns). ESG factors currently tend to be forward-looking. Will investments in mutual funds made up of businesses with a diverse workforce outperform investment in businesses whose employees are more homogeneous? Will investments in mutual funds made up of businesses reliant on oil suffer as government programs continue to promote alternative fuels? Will investments in mutual funds made up of businesses reliant on clean water suffer as that scarce, valuable resource becomes more expensive or less available? Perhaps a positive side effect of this regulation will be to promote fiduciary defenses based on prudent future expectations in addition to past performance.

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