THE COMPASS
BY ENDEAVOR RETIREMENT

Get Ready for New ESG Investment Rules

ESG investments are on track to exceed $53 trillion by 2025, according to Bloomberg L.P. This will represent more than a third of the projected total assets under management by global asset managers. ESG investments incorporate environmental, social, and governance factors into their selection process. With this significant rise in ESG investing, the Department of Labor (DOL) and Securities and Exchange Commission (SEC) are drafting regulations and rules to protect investors.

Here's What You Really Need to Know:

1. The DOL's proposed rule addresses the fiduciary's obligation to select, monitor and review investments in a plan subject to the Employee Retirement Income Security Act (ERISA). The DOL's rule was proposed in October 2021, received over 22,000 comments, and is expected to be published as a final rule by December 2022.
2. The SEC has two proposed rules that will impact how plan fiduciaries apply due diligence to investments and investment managers. These rules focus on (1) enhancing disclosures about ESG investments and (2) naming ESG investments. The SEC comment period closes mid-August.
3. The framework for how the SEC and DOL address ESG investments share some similarities, but there are also many differences. These differences may be important for plan fiduciaries to understand when performing investment due diligence in retirement plans.

Let's Dive In...

Understanding the DOL's Perspective on ESG Investing

The Trump-era ESG regulation is no longer being enforced by the DOL, though it is still technically the current guidance. The proposed regulation from the Biden administration's DOL states that when making investment decisions for retirement plans, a fiduciary's duty of prudence may often require an evaluation of the economic effects of climate change and other ESG factors on that particular investment.

While this administration may be particularly focused on climate, it has always been the case that so long as a fiduciary focuses on the material risk and return characteristics to meet the duty of loyalty and prudence, then (so long as other fiduciary obligations are met) the investment-related obligations under ERISA Section 404 will be met.

Understanding the SEC's Perspective on ESG Investing

The SEC proposals are partly in response to discrepancies in ESG disclosures. The SEC first addressed this issue in an investor bulletin released in 2021. It explained the different types of ESG investments and their strategies. The SEC then issued a Request for Information, asking for input on ESG disclosures. After examining the feedback, commissioners discovered a glaring problem—greenwashing.

Greenwashing is information provided by a company that makes the fund seem more environmentally friendly than it truly is. "What happens is that what a fund is disclosing doesn't necessarily match up with what they're actually doing, and that mismatch is what we call greenwashing—essentially, they are over-exaggerating," explained Zeena Abdul-Rahman, Branch Chief of the Investment Company Rulemaking Office within SEC's Division of Investment Management.

In 2022, the SEC has now issued two proposals aimed at addressing these issues. The SEC's disclosure rule and names rule are both intended to eliminate misleading claims in ESG marketing and disclosures. Their goal is to ensure disclosures are consistent and reliable, so investors have the information they need to make informed decisions.

Know the Difference Between SEC and DOL Frameworks

While the SEC and DOL view ESG investing alike in many ways, there are also some major differences that fiduciaries should consider when conducting due diligence on investments. Here are a few:

- The DOL recognizes the concept of materiality, while the SEC does not. Materiality is an accounting concept that dictates any transactions or factors that significantly affect a product's financial performance. In the case of ESG investments, materiality is the assessment of which ESG factors are directly relevant to the long-term financial outcome of an investment either through reduction of risk or increasing return of the investment. Fiduciaries cannot consider ESG factors that are not material.
- The DOL is extremely focused on climate change in their proposal— using the term climate change twice as many times as governance and social. The SEC takes a broader view of environmental, social and governance issues.

Understanding the difference between the two frameworks is important as plan fiduciaries must perform due diligence on investments, including their investment managers. Keep in mind that investment managers may be making disclosures under the SEC framework, but the due diligence an investment advisor performs on an investment and their investment managers will be under a DOL framework, for purposes of ERISA plans.

Next Steps for Plan Sponsors

As you think about ESG investing and what it means for the retirement plan(s) with which you work, consider these next steps:

- Monitor the status of both the SEC and DOL's pending rules (and don't forget that rules usually change at least a little from the proposal to the final-rule stage).
- Understand the differences and similarities between the SEC and DOL frameworks.
- Seek help from your ERISA consultant to understand how these rules will affect the investments in the retirement plans you are working with; to get a head start, take inventory now and be sure you understand what's in your plan(s).