What You Need to Know About the Latest In ESG

In our June edition of The Compass, we updated you on the status of investing based on environmental, social, and governance (ESG) factors in retirement plans. With the Department of Labor's (DOL's) recent release of proposed regulations, it's time to revisit ESG.

In Short, Here's What You Need to Know:

- **Consideration of ESG factors is permissible (and seems to be encouraged):** The proposal makes clear that for the entire fund line-up — both the designated investment alternatives (DIAs) and the qualified default investment alternatives (the QDIA or default fund) — a fiduciary's duty **"may often require"** an evaluation of the economic effects of climate change and other ESG factors.
- **It's only a proposal:** The DOL's notice of proposed rulemaking (NPRM or called proposal throughout) is a proposal that is subject to a 60-day comment period ending December 13. Then, the DOL will evaluate the comments, and they can make changes to the proposal before publishing a final rule (hint: if you are going to Vegas, you would ***not*** bet that the proposal will become the exact final rule; people weigh-in and proposals change…nearly always).
- **The proposal combines ESG Investment duties and proxy voting:** The prior sub-regulatory guidance and 2020 regulations from the Trump administration handled ESG investing and proxy voting separately. This proposal combines the two and eliminates the documentation requirement and safe harbors that were in the 2020 proxy voting regulations.

Let's Dive In...

Now, Let's Dive into the Details, Starting with the Background:

Starting in 1994, ESG saw years of sub-regulatory guidance. In 2020, under the Trump administration, the DOL published a final rule on "Financial Factors in Selecting Plan Investments" as well as "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights" (referred to together as the 2020 Regulations). Both became final regulations aimed at uncertainty related to ESG investing and proxy voting. Many (including the DOL under the Biden administration) argue that the 2020 Regulations did not successfully address uncertainty but instead had a chilling effect on ESG investing.

Although the 2020 Regulations became effective, once in office, the Biden administration quickly made climate change a priority. The Biden administration issued an executive order in January 2021 directing federal agencies to review regulations from the Trump administration and ensure they were aligned with improving public health and protecting the environment. In March 2021, the DOL issued a non-enforcement policy for the 2020 Regulations. This means that if you don't comply with the 2020 Regulations, the DOL will not enforce any penalties against you; however, this doesn't prevent private litigants (for example, a class action lawsuit).

A second, more specific executive order was issued in May 2021 that ordered the DOL to publish a proposed rule to suspend, revise, or rescind the 2020 Regulations. After what the DOL described as the culmination of a long and intense process, the DOL published this proposal on October 14, 2021, to address the concern that the 2020 Regulations created uncertainty regarding ESG investing and discouraged fiduciaries from considering "climate change and other ESG factors in investment decisions, even in cases when it is in the financial interest of plans to take such considerations into account."

Repeat: this is only a proposed rule, and it still must go through a 60-day comment period. The comment period is followed by the opportunity for the DOL to make changes and publish the final rule in the Federal Register. You, yes, even you can comment on this proposal by sending your remarks to the DOL to be considered and published on the website.

ESG Investing

This proposal retains the core fiduciary principles for investing:

1. Fiduciaries must follow a prudent process.
2. Fiduciaries owe a duty of loyalty to participants and beneficiaries; this means putting the financial interests of participants and beneficiaries first.

In following a prudent process under the proposal, the important change from the 2020 Regulations is the distinction that for all investment options in the plan (both the DIAs and the QDIA) a fiduciary's duty of prudence ***may often require*** an evaluation of the economic effects of climate change and other ESG factors on the particular investment.

When considering ESG factors in investment selection, fiduciaries should focus on material risk and return factors. Keep in mind that materiality is the assessment of which ESG factors are directly relevant to the long-term financial outcome of an investment. Fiduciaries should focus on material ESG factors and not objectives that may be unrelated to the long-term financial interests of participants and beneficiaries in the plan. What's this mean? Here's an example:

- Fiduciaries **can select** an investment that considers a company's exposure to physical and transitional risks of climate change and the positive or negative financial impact the exposure will have on the company.
- Fiduciaries **cannot select** an investment because they support the environment and want to invest in a company that also supports the environment solely because their ethical and moral obligations are aligned.

However, the DOL does retain one instance when it is okay to look at these "collateral benefits." This means it is an instance when it is okay to look at factors that ***do not have*** material long-term financial benefits to participants and beneficiaries. When a fiduciary looks at all investment options and based on the material financial factors, the fiduciary narrows the investment options to a few investment options but it's a "tie," then the fiduciary can decide based on collateral benefits to the plan (such as the example described above). These collateral benefits could be ESG factors (or other non-ESG collateral benefits). Hint: I wouldn't use this "tie-breaker" as it seems like a good litigation target; just stick to material financial factors (which may include ESG factors) in your prudent process for selecting investments, including your QDIA…and may the best investment option win!

What about Proxy Rules?

We will dive deeper into proxy rules in a future edition, but here's the overview; in this proposal, the proxy voting rules are substantially updated and streamlined from the 2020 Regulations. The guidance directs fiduciaries to follow a prudent process and the duty of loyalty in alignment with the direction of the ESG investing guidance.

Action Items for Plan Sponsors

For plan sponsors and their service providers, consider these action items as you review the proposed rules:

1. Review the proposal but keep in mind it is only a proposal (and I think the heavy focus on climate will get some pushback despite the DOL saying that no one factor is more important than another factor. The proposal specifically says it is up to the fiduciary to weigh the factors based on the facts and circumstances)

2. Review your existing framework for selecting investments (which is likely an investment policy statement (IPS)) and determine if you are operating within that policy today (hint: you don't need a separate IPS for ESG, nor do you need to add a bunch of language to your IPS. Make sure your IPS aligns with what you are actually doing to review investments)

3. Review your investment line-up and seek the help of an investment professional if you are not already

4. Be on the lookout for the final rule during early 2022