How DOL Can Improve Proposed ESG Investment Rule

By **Brantley Webb** (August 5, 2022)

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The U.S. Department of Labor is finalizing its new rule governing the consideration of environmental, social and corporate governance, or ESG, funds and factors by retirement plan fiduciaries. The proposed ESG rule makes clear its intent to reject the Trump administration's prior rule on the same subject and carve a new path.[1]

However, the proposed rule contains some landmines that the DOL should avoid; it also misses some important opportunities to accomplish its stated goal of ensuring "that plans do not overcautiously and improvidently avoid considering material climate change and other ESG factors when selecting investments."[2]

The Trump Administration Rule

In the fall of 2020, the Trump administration DOL published a final rule that required retirement plan fiduciaries to select investment options based solely on pecuniary factors.[3] The Trump rule defined a "pecuniary factor" as one that "is expected to have a material effect on the risk and/or return of an investment."[4]

In contrast, fiduciaries could rely on factors that were not pecuniary only in tiebreaker situations — i.e., where fiduciaries were unable to distinguish between different investment options based on pecuniary factors alone.[5] The rule also forbid fiduciaries from selecting any investment fund as a default for participants if the fund included as part of its investment strategy one or more factors that were not pecuniary.[6]

The Trump rule was designed "to make clear that [Employee Retirement Income Security Act] plan fiduciaries may not subordinate return or increase risks to promote non-pecuniary objectives."[7] The nonpecuniary objectives in question? ESG goals.

The rule warned that ESG investing "raises heightened concerns under ERISA," and then-Secretary of Labor Eugene Scalia cautioned that "ERISA doesn't task retirement plan managers with solving the world's problems."[8]

The Trump rule would have made more sense if the DOL had determined, as a factual matter, that ESG considerations render an investment strategy riskier and/or poorer performing. However, the economic data didn't support such a finding, so the rule took a different path.

It concluded that ESG strategies are typically motivated by something other than financial benefits. The Trump rule thus added to the normal investment review process a requirement that plan fiduciaries also consider the motivations behind particular investment strategies. Any ESG motivations must be teased out, scrutinized and meticulously documented.[9]

This was effectively unadministrable and, in practice, led to fiduciaries simply culling ESG funds from their plans in the hopes of staving off litigation and government scrutiny.[10]

The Biden Administration Proposed Rule

The Biden administration DOL froze the Trump rule.[11] Soon thereafter, in October 2021, it announced a proposed rulemaking to replace the Trump rule with an entirely different approach.

The Biden administration's proposed rule jettisons the pecuniary factors framework and instead provides that fiduciary consideration of projected investment returns "may often require an evaluation of the economic effects of climate change and other environmental, social, or governance factors on the particular investment."[12]

It further provides that

> a prudent fiduciary may consider any factor in the evaluation of an investment [that,] depending on the facts and circumstances, is material to the risk-return analysis, which might include, for example: (i) Climate change-related factors, … (ii) Governance factors … and (iii) Workforce practices.[13]

Unlike the Trump rule, the new proposed rule considers ESG factors from an economic standpoint and endeavors to integrate its ESG guidance into the predominating risk-return framework fiduciaries already use to analyze investment options. The rule appears to assume that climate change and other ESG factors often materially affect investment risk return.

For example, the DOL explains that its "proposal makes clear that climate change and other ESG factors are often material and that in many instances fiduciaries ... should consider climate change and other ESG factors in the assessment of investment risks and returns."[14] The DOL then asks the more fundamental economic question: Are climate change risk and other ESG risks already priced into the market?

Mispricing — A Landmine to Avoid

Finance professionals usually assume that material risks are already incorporated into the price of individual securities. In other words, as soon as the market discovers a risk threatening a particular company, the company's stock price adjusts to reflect that risk.

Counterintuitively, following this type of downward adjustment, the expected return of the security actually increases. For instance, if a major oil spill becomes public knowledge, the stock price of the responsible oil company will decrease; after which, the stock carries higher risk, but also likely higher expected return.

The U.S. Supreme Court has incorporated this financial principle into its ERISA jurisprudence. In Fifth Third Bancorp v. Dudenhoeffer in 2014, the court examined the pleading standard for claims that a fiduciary should have removed an employer's single stock option from a retirement plan.[15]

The plaintiffs had alleged that, irrespective of the market price of Fifth Third's stock, the plan's fiduciaries should have known from public press and other information that the stock was overvalued. The Supreme Court rejected this argument explaining that

> where a stock is publicly traded, allegations that a fiduciary should have recognized from publicly available information alone that the market was over- or undervaluing the stock are implausible as a general rule, at least in the absence of special

> circumstances. Many investors take the view that "'they have little hope of outperforming the market in the long run based solely on their analysis of publicly available information,'" and accordingly they "'rely on the security's market price as an unbiased assessment of the security's value in light of all public information.'"[16]

Fiduciaries, the court concluded, could do the same.

The preamble of the proposed rule is in some tension with Dudenhoeffer's view of efficient financial markets. It suggests that some ESG risks, like climate risk, are not already priced into the market.

For example, the DOL asks for "comments on the extent to which climate-related financial risk is not already incorporated into market pricing," and implies at one point that climate risk is not priced into the market.[17]

Quoting a 2020 Federal Reserve Board report, it states: "Opacity of exposures and heterogeneous beliefs of market participants about exposures to climate risks can lead to mispricing of assets and the risk of downward price shocks."[17] In other words, investors may not be weighing climate risks accurately because there are no standardized climate risk disclosure requirements and there is still debate about the level of risk climate change actually poses.

In the final rule, the DOL should not make a determination that climate change and other ESG risks are mispriced in the market. Such a determination would expose the rule to legal challenge and render it as unadministrable as the Trump rule. It would effectively require fiduciaries to independently evaluate climate change and other ESG factors as macroeconomic risks not already reflected in the price of securities.

For example, a fiduciary would need to scour the public domain to evaluate whether the market was overvaluing an energy sector fund because investors were misjudging climate change risk. These are the pursuits of active investment fund managers, not retirement plan fiduciaries, who have more limited resources and information.

ERISA, moreover, requires fiduciaries to act as would reasonable individuals "in the conduct of an enterprise of a like character and with like aims."[18] It doesn't require fiduciaries to divine hidden risks that even the market hasn't discovered yet.

Key Opportunities Missed in the Proposed Rule

One piece of the puzzle the proposed rule misses is the role ESG funds and factors might play in ERISA's requirement that plan fiduciaries diversify plan investments so as to minimize the risk of large losses. Many ESG funds have hedging properties — i.e., they may help hedge an investment portfolio against certain potentially systematic risks, such as climate change, or other unsystematic risks, such as the risk of lawsuits concerning governance or discrimination.

These characteristics may make it appropriate for fiduciaries to consider ESG factors as they relate to diversification of the plan's investment portfolio as a whole — alongside their consideration of each investment option individually.

In addition, the Biden administration can do two other things to facilitate more robust consideration of ESG factors.

First, the Biden administration can work to better inform the market about ESG risks and benefits generally. Earlier this year, the U.S. Securities and Exchange Commission proposed a new rule with this aim.[19] Better data and information on ESG risks and benefits will give investment managers and fiduciaries more insight into ESG considerations and, ultimately, result in more accurate pricing of securities over the long term.

Second, the Biden administration can better equip retirement plans to fight truly frivolous litigation.

Fiduciaries operate in a hyperlitigious environment today. Hundreds of ERISA class actions have been filed against companies and other organizations in the last few years.

Of the top Fortune 100 companies in the U.S., dozens have been the target of an ERISA class action in the last five years. Of the top 50 national universities in the U.S.,[20] almost half have been hit with ERISA class actions in recent years.

Regardless of whether one believes these lawsuits have reduced plan fees, or had other positive effects, there can be no question that the litigation tidal wave has suppressed choice and innovation in plans. Compared to even a few years ago, plans have pared down investment menus — sometimes offering only a handful of options. Innovation is hyperscrutinized in litigation and therefore disfavored.

For example, plaintiffs have argued that funds must be at least five years old to be prudently placed into retirement plans. ESG funds would be easy targets for litigation because, plaintiffs would argue, they are new, there is uncertainty around their investment strategy, and they may compare less favorably to similar, non-ESG funds. In the current environment, it is likely that many fiduciaries will consider ESG funds with extreme caution — final rule or no.

The DOL could add additional provisions to the final rule to help insulate fiduciaries from frivolous challenges to ESG — and other — investment funds.

First, the DOL might make it clear that plan fiduciaries may reasonably consider risk return over longer time horizons, which are especially appropriate in the retirement context.

Second, the DOL could also make clear that the role of a fiduciary is not only to provide options that existing plan participants can use to invest existing plan assets, but also to attract new investments by existing participants — and new participants.

Thus, fiduciaries may properly — should they wish — consider investor interest and preferences as a factor in selecting and monitoring investment funds.

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[1] Proposed Rule, Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 86 Fed. Reg. 57272 (Oct. 14, 2021).

[2] Id. at 57296.

[3] Final Rule, Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72846 (Nov. 13, 2020).

[4] 29 C.F.R. § 2550.404a-1(c)(1); see also id. § 2550.404a-1(f)(3) ("The term pecuniary factor means a factor that a fiduciary prudently determines is expected to have a material effect on the risk and/or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives and the funding policy established pursuant to section 402(b)(1) of ERISA.").

[5] 29 C.F.R. § 2550.404a-1(c)(2).

[6] 29 C.F.R. § 2550.404a-1(d)(2)(ii).

[7] 85 Fed. Reg. 72848.

[8] Pension plan managers aren't supposed to solve the world's problems, Tampa Bay Times, Oct. 30, 2020.

[9] 29 C.F.R. § 2550.404a–1(c)(1) ("A fiduciary may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives, and may not sacrifice investment return or take on additional investment risk to promote non-pecuniary benefits or goals.").

[10] Bloomberg News, Labor rule on ESG already trimming fund options for retirement plans (Jan. 27, 2021). https://www.investmentnews.com/labor-rule-on-esg-investing-already-trimming-funds-in-retirement-plans-201970.

[11] However, interest abides in codifying the Trump Rule's provisions into law. Text - S.4484 - 117th Congress (2021-2022): Securing Employee Retirement Returns Act | Congress.gov | Library of Congress.

[12] 86 Fed. Reg. 57302 (proposed § 2550.404a-1(b)(2)(ii)(C)) ("The projected return of the portfolio relative to the funding objectives of the plan, which may often require an evaluation of the economic effects of climate change and other environmental, social, or governance factors on the particular investment or investment course of action.").

[13] Id. (proposed § 2550.404a-1(b)(4)).

[14] 86 Fed. Reg. 57276.

[15] Fifth Third Bancorp v. Dudenhoeffer, 573 US 409 (2014).

[16] Id. at 426. Quoting Halliburton Co. v. Erica P. John Fund, Inc., ante, at 273, 134 S. Ct. 2398, 189 L. Ed. 2d 339 (quoting Amgen Inc. v. Conn. Ret. Plans & Trust Funds, 568 U.S. 455, 462, 133 S. Ct. 1184, 1192, 185 L. Ed. 2d 308, 317 (2013)).

[17] 86 Fed. Reg. 57290.

[18] 86 Fed. Reg. 57289.

[19] 29 U.S.C. § 1104(a)(1)(B).

[20] 87 Fed. Reg. 36654 (June 17, 2022).

[21] For one ranking, see 2022 Best National Universities | US News Rankings. https://www.usnews.com/best-colleges/rankings/national-universities.