The Bell Tolls for ESG Investments in ERISA Plans

June 26, 2020

The loud ringing you hear is the Department of Labor tolling the death knell for environmental, social and corporate governance ("ESG") investing by benefit plans subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA").

The Department has proposed revised regulations outlining a fiduciary's duties under Section 404 of ERISA. These regulations affirm the Department's "longstanding and consistent" position that an ERISA investment fiduciary must be focused solely on the plan's financial returns and the interests of plan participants and beneficiaries in their plan benefits. In the preamble to the proposed revisions, the Department states that fiduciaries of ERISA plans are bound to maximize the funds available to pay retirement benefits and that the assets of such plans may not used in pursuit of other social or environmental objectives.

The proposed regulations assert that an ERISA fiduciary's evaluation of plan investments must be focused "solely on economic considerations that have a material effect on the risk and return of an investment." An ERISA fiduciary cannot subordinate the interests of participants and beneficiaries to unrelated objectives or sacrifice investment returns or take on additional investment risk "to promote goals unrelated to those financial interests of the plan's participants and beneficiaries or the purposes of the plan." These interests of plan participants and beneficiaries must be paramount.

Under the revised regulations, an ERISA fiduciary must give "appropriate consideration" to those facts and circumstances that the fiduciary knows or should know are relevant to the particular investment or investment course of action involved. Appropriate consideration includes a course of action "reasonably designed to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action."

Perhaps, most importantly, with regard to ESG motivated investments, the revised regulations state that "a fiduciary's evaluation of an investment must be focused only on pecuniary factors." Any ESG or other similar considerations will be considered pecuniary factors "only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories." Moreover, even in such circumstances, the weight afforded to such factors "should appropriately reflect a prudent assessment of their impact on risk and return."

Finally, the proposed regulations add requirements for including an investment alternative that promotes ESG factors as an investment option under an individual account plan like a 401(k) plan. The regulations state that the standards applicable under Section 403 and 404 of ERISA (including those elaborated in these regulations) "apply to a fiduciary's selection of an investment fund as a designated investment alternative in an individual account plan." An ESG-influenced investment option would not meet these statutory and regulatory requirements unless the plan fiduciary:

- uses only objective risk-return criteria in selecting and monitoring any ESG or similarly oriented investment alternatives;
- documents the determinations it makes relying on such risk-return criteria; and
- does not include such ESG or other similarly oriented investment as, or as a component of, a qualified default investment alternative.

While the proposed rulemaking, and its direction that fiduciaries must be focused in their actions on the risk-adjusted returns to the plan and the direct economic benefits to participants and beneficiaries, are consistent with the recent guidance pertaining to introducing private equity investments into the investment line-up of a 401(k) plan, the proposed regulatory changes do not appear to have any specific correlation to that separate guidance.

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Please do not hesitate to contact us with any questions.

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