Business Better (Episode 3): ESG Investments and the Impact of Recent DOL Proposed Regulations on Retirement Plans

Speakers: John Wright and Brian Pinheiro

John Wright:

Welcome to Business Better, a podcast designed to help businesses navigate the new normal, I'm your host, John Wright. For nearly 15 years I was Senior Vice President and General Counsel at Triumph Group, Inc., a global aerospace component supplier. I'm now a member of the Securities and M&A groups at Ballard Spahr, a national law firm with clients across industries and across the country.

John Wright:

On today's episode we'll be discussing a new set of proposed regulations issued by the United States Department of Labor providing guidance to retirement plan fiduciaries about investing plan assets in so-called ESG investment vehicles. We'll explore what these ESG investments are, what's different about considering them for retirement plans and what the Department of Labor's proposed regulations would do and what they wouldn't. We'll also talk about what the reaction to these proposed rules has been, how all of this affects retirement plan fiduciaries and what plan fiduciary should consider doing next.

John Wright:

To cover these topics I'm delighted to be joined by my colleague, Brian Pinheiro, a Partner in the Philadelphia office of Ballard Spahr. Brian is the Practice Leader of Ballard Spahr's Employee Benefits and Executive Compensation Group. He represents employers on matters relating to executive compensation, tax qualified retirement plans, and health and welfare benefit plans. Brian and his team have closely monitored the Department of Labor stance on social investing and they regularly advise plan fiduciaries on their ERISA fiduciary duties, including duties relating to the investment of plan assets. Brian, welcome to Business Better.

Brian Pinheiro:

Thank you, John, for having me.

John Wright:

Brian, probably many of those listening to this podcast are familiar with ESG and ESG investments. Certainly it's familiar to corporate lawyers like me who follow developments in corporate governance, but perhaps we should start by making sure our listeners know what we're talking about in the context of this proposed rule. What is an ESG investment?

Brian Pinheiro:

Well, John, ESG stands for environmental, social and governance factors. And in the way that the Department of Labor has used the term is referring to investments that have at least in part non-economic or non-financial objectives.

John Wright:

And are there different types of ESG investments?

Brian Pinheiro:

There are. The way the Department of Labor has used it in the proposed regulation they are using it in a very broad sense, and they are including things that people refer to as socially responsible investing or sustainable and responsible investing or impact investing and economically-targeted and investing. And that's actually one of the items that the commenters have picked up on and they have pointed out that the Department of Labor is using a definition of ESG that's really too broad.

And in particular, the one issue that comes up in several of the comments is the commenters are drawing a distinction between ESG integration and economically targeted investments.

John Wright:

Interesting. So we can talk about the comments and the reactions a little later, but it is good to know that this is a complex group of investments that we're talking about. Obviously we're talking to you here about the ESG investment vehicles in the particular context of retirement plans. Can you explain why that is different from other investment contexts?

Brian Pinheiro:

Sure. Retirement plans are governed by a federal law called the Employee Retirement Income Security Act of 1974 or ERISA, and ERISA charges those who are responsible for investing retirement plan assets as fiduciaries. Fiduciaries have to carry out their duties, in other words, they have to invest plan assets solely in the interest of plan participants and they have to invest plan assets in a prudent manner. So the question is from a fiduciary standpoint, is a plan fiduciary permitted to consider ESG investments when investing plan assets?

John Wright:

And what are the sorts of folks that we're talking about who play the role of fiduciaries with respect to these plants?

Brian Pinheiro:

Well, in a 401(k) or 403(b) plan which is the most common context in which this comes up, most employers will have formed a committee that is responsible for selecting the menu of investment options that are going to be available to participants under the plan and then participants can decide from that menu how to invest their plan assets. Those committees are typically made up of a representative from the finance function, a representative from the legal function, a representative from HR, certainly, and if there's a risk management function then you might see somebody from risk management. Those individuals together form the committee, the committee is the fiduciary that is responsible for selecting the menu of investment options that would be available under the 401(k) or 403(b) plan.

John Wright:

Having been on this type of committee in my time I've seen this apply a couple of different types of plans. Well, are we talking solely about 401(k) and 403(b) plans? Does it also apply to pension plans where you're looking at the investments that a retirement plan might be making for a union or the like?

Brian Pinheiro:

Yeah, it does. It technically applies to all retirement plans and even some welfare plans that have trust assets to support them. But primarily this is going to be an issue for the fiduciary's 401(k) and 403(b) plans. And the reason for that is because all of the investment risk in a 401(k) or 403(b) plan or any sort of defined contribution plan where each participant has an individual account, all of the investment risk is on the employee. So it is a really important fiduciary duty to select prudent investments for the menu of investment options for those employees. In a defined benefit plan and if there's a trust on the welfare side in those trusts as well, the risk of loss, the investment risk is on the employer. It is still technically applicable but we would expect and we have seen much more enforcement on the defined contribution side on investment fiduciary-type issues.

John Wright:

I see. So how are ESG investments treated currently with respect to retirement plans?

Brian Pinheiro:

Well, in 1994, the Department of Labor issued some informal guidance or sub-regulatory guidance that said you basically, if you're a fiduciary you cannot consider ESG factors except as a tiebreaker. And what I mean by that is if you have two investment options that you're considering and they are the same from an economic standpoint in terms of projected risk, projected return, you can use the ESG factors of one of them as a tiebreaker in how to select between the two of them.

Brian Pinheiro:

And that has been the rule or the DOL enforcement provision since the early '90s. All the way through 2018 they've restated it a few different ways. In 2018 they opened the door a little bit more and acknowledged for the first time that it is possible that an ESG factor could actually be an economic factor and they use this example in the proposed regulations. If you have a company that is violating the environmental laws, that's an ESG factor from the sense of it's environmental but it also could be economic because that company is very likely to have increased litigation costs, increased regulatory exposure. In that sort of circumstance the ESG factor could be considered an economic factor that could go into the fiduciary's analysis.

John Wright:

I see. So why is the Department of Labor issuing guidance on ESG investments now?

Brian Pinheiro:

Well, this is the first time the department has raised its view of ESG investments in the regulatory setting. All of the guidance the Department of Labor has issued since 1994 has been sub-regulatory or informal. It's now a proposed regulation, it went through the formal notice and comment period under the Administrative Procedures Act, and many commentators believe that it is being raised now so that the regulation can be both proposed and finalized before the election.

John Wright:

I see. Well, let's get into the specifics of the proposed rule. What does the Department of Labor say about fiduciaries and ESG investments?

Brian Pinheiro:

The proposed rule really covers three topics. And the first one is it really restates the traditional DOL view that a plan fiduciary cannot invest in an ESG fund when an underlying strategy of that fund is to subordinate return or increase risk in order to pursue non-economic ESG objectives, that's pretty consistent with what the DOL view has been for the past 26 years. The second item is, as I mentioned, this first came out in 2018 but it comes out again in the proposed regulation, the department acknowledges that there may be situations where ESG factors present material economic risks or opportunities. And in those situations, fiduciaries could consider the ESG factors with proper weighting against all of the other economic factors. And as I mentioned earlier the hazardous waste example is a good example where an environmental factor could also be considered an economic factor.

Brian Pinheiro:

And then the third point which is something that is brand new, the proposed regulation specifically addresses the use of ESG funds in 401(k) and 404(b) plans where participants have the ability to direct the investment of their accounts. And the DOL acknowledges that an ESG fund could be added to the investment lineup in one of those plans without sacrificing a non-ESG fund, you could just add an additional fund.

Brian Pinheiro:

The department says, "In those situations an ESG fund could be added if the fiduciary uses objective risk and return criteria and only those criteria to determine that it is in fact prudent to invest in the ESG fund. The fiduciary documents its analysis and its selection criteria and the fiduciary does not add the ESG fund as a default fund or a qualified default investment alternative."

John Wright:

Is this a different standard than that applied in other contexts?

Brian Pinheiro:

It is a different standard in the sense that it's never really been announced for 401k and 403(b) plans as to how a fiduciary should consider this, but the substance of the proposed regulation is really not that different from the department's long-held view and frankly it's distaste for ESG funds.

John Wright:

Got it. Well, let's take a second here to consider what the controversy is about the rule. Are there reasons for permitting retirement plans to offer ESG investments more freely than the rule would contemplate?

Brian Pinheiro:

Well, I think the overall concern, and this is reflected in many of the comments that were submitted to the department as part of the comment period, is that the Department of Labor is drawing bright lines where no bright lines actually exist. We have a very integrated and complicated global economy. Many stocks and many funds out there consider ESG funds and many investors consider ESG funds not as an either or proposition, but as part of an integrated decision as to whether a particular investment is a prudent investment.

John Wright:

And what's the other side of the coin. What's the other argument?

Brian Pinheiro:

Well, the argument I think is set forth in the statement of the secretary of labor when they released the proposed regulations. And the secretary says and I quote, "Private employer-sponsored retirement plans are not vehicles for furthering social goals or policy objectives that are not in the financial interests of the plan."

John Wright:

Why in a 401(k) plan shouldn't an individual participant have an option to make his or her own decision to invest in an ESG investment of the kind that you're talking about?

Brian Pinheiro:

Well, I think that's exactly the point of many of the comments that were critical of the Department of Labor's proposed regulation. We think going forward there will be more pressure from plan participants particularly younger planned participants to have a retirement plan investment option, one or more retirement plan investment options that are designed to be consistent with their social goals, especially coming out of the social upheaval of 2020. The fiduciaries of the plan have a fiduciary duty to provide a prudent menu of investment options. And the question really becomes, can in ESG fund option be part of a prudent menu of investment options?

Brian Pinheiro:

The way the Department of Labor has structured its proposed rule, the Department of Labor's view is not in most circumstances but perhaps in a few limited circumstances. And I think the way plan participants view that and a good portion of the investment community views that as ESG funds are economic in nature at some level and should be considered in every investment decision and should be available in the investment lineups in 401(k) and 403(b) plans.

John Wright:

And maybe you've covered this, but is this a new position for the Department of Labor?

Brian Pinheiro:

No, this isn't a new position, it's a position that they first announced informally in 1994 and haven't really gotten too far off the mark since then.

John Wright:

Let's talk about how this might affect enforcement or oversight. Are we expecting any changes in the way the Department of Labor will oversee the investment by plan fiduciaries in, or rather the structuring of alternative investment vehicles in plans and the decisions that a plan fiduciary is making, choosing the options available to plan participants?

Brian Pinheiro:

Well, interestingly we understand that the Department of Labor regional office in New York has sent out several enforcement letters to registered investment advisors asking them for information on the extent to which their retirement plan clients are investing in ESG funds. The commenters have picked up on that, not the commenters to the regulation but just generally commenters on the internet have picked up on that and pointed out that that seems like an intimidation tactic to further dissuade fiduciaries from selecting these ESG funds.

John Wright:

Is this tactic sort of a new tactic or is this a common vehicle applied in other situations?

Brian Pinheiro:

Well, it's a new tactic in the sense that the Department of Labor historically does not get too deep into the weeds on particular investments and the prudence of a particular class of investments, so this is new ground in a sense from the Department of Labor. More generally, the Department of Labor certainly has an agenda of regulatory items that it wants to enforce so if we see more of this activity from the regional office in New York or other regional offices then we'll know that ESG is rocketing up the agenda.

John Wright:

As we're recording this podcast, it's August 21st, what's been the public reaction to date to the proposed regulations.

Brian Pinheiro:

Well, the comment period was very short on the proposed regulations, it was only 30 days and the 30 days ended at the end of July. There have been 1500 or so comments submitted.

John Wright:

Wow.

Brian Pinheiro:

I've read through several of them, not all 1500, but the comments that I came across fall into a couple of different categories. First of all, many commenters pointed out that the 30-day comment period is far too short for a subject of this much importance and this much complication. And several commenters pointed out that this might be an effort to try to get the regulations proposed, commented on and finalized before a potential change in administration, which would make it harder if there is a change in administration to undo the regulations after the election. So that was one set of comments.

Brian Pinheiro:

Another set of comments, and we touched on this earlier was that the Department of Labor seems a little bit confused as to what ESG really means, and they pointed out this difference between ESG integration strategies and economically targeted investments which both fall under the umbrella in the DOL proposed regulation of what they're referring to as ESG. And the commenters have pointed out that ESG's integration strategies really consider ESG factors as important components of a range of economic information that a fiduciary or an investor would use to make a prudent risk-based determination of risk and return.

Brian Pinheiro:

For example, it would consider the impact of bad actors in the environmental area on the overall strength and prudence of investing in the company. Whereas in contrast, economically targeted investments or ETIs are investments that aim to provide both financial returns and collateral non-financial benefits to parties other than the investor. Think about benefits to the community or job creation or climate impact, those types of things. And the commenters make the point that we don't necessarily agree that the department should be regulating this at all, but if you are going to regulate it you should be focusing on economically targeted investments and not the broader ESG strategy that goes into all modern-day investment decisions.

John Wright:

That as an aside it sounds like some of these considerations are very similar to some of the debate that goes on in the corporate governance field about the purpose of the corporation and whether you can consider making corporate decisions factors that aren't purely the benefit to the stockholders, so it sounds like it's very similar in nature.

Brian Pinheiro:

I think it is and I think that's where many of the commenters are coming from.

John Wright:

Given this it's, you alluded earlier to the possibility that the current administration is trying to get this done before any potential change in administrations as a result of the election. What is the vulnerability of this proposed rule, if any, to that kind of a change?

Brian Pinheiro:

Well, it's interesting. If the effective date of the final regulation, whenever that might be, is after the date that a new administration takes over, then the new administration can simply suspend the effective date and never have it become effective. The Trump administration certainly has an interest in getting that effective date to take place prior to a new administration coming in if such a thing occurs. If the effective day goes into effect before a change in administration, the new administration would still have the ability to use what's called the Congressional Review Act to get Congress to overturn regulations that are issued in the last several months of the prior administration.

Brian Pinheiro:

And the benefit of the Congressional Review Act is that Congress can overturn a regulation in a filibuster proof way. When you go without the Congressional Review Act it will be very difficult because of the filibuster rules to be able to overturn prior regulations but those filibuster rules don't apply to regulations that are issued and finalized in the last eight months or so of the prior administration.

John Wright:

I take it that in theory that will turn in part on who controls the Senate and the House as a result of the coming election.

Brian Pinheiro:

Right. If this proposed regulation becomes final before January 20th, and as a result of the election the Democrats take over the presidency, the House and the Senate, then it would be relatively simple assuming everybody was on board to use the Congressional Review Act to overturn this regulation and either rethink it or just continue not to have a role.

John Wright:

Got it. Given all of this turmoil, what should a plan fiduciary do in response to the Department of Labor proposed regulations?

Brian Pinheiro:

Well, right now we think that fiduciary should wait and see as to what the final rule says and whether the final rule will continue to stand if there's a change in administration. We have not heard from clients that there is a clamor yet to add ESG funds, we think that is something that will take some time, remember we're still in the middle of a pandemic and people are out of work and there is priorities that are going to be exceeding the level of retirement plan investing. But at some point given that all of the social upheaval, we do think that there will be a push for retirement plan fiduciaries to consider ESG funds.

Brian Pinheiro:

At that point, assuming this rule becomes final and continues to stand, a fiduciary should consider and have a robust analysis and discussion about the prudence of adding an ESG fund, compare it to other funds that you already have or that you could otherwise add, and you need to make sure you have very good documentation of the analysis and the deliberation. This isn't something that you should shortchange in the minutes, you should go into quite a bit of detail to support the decision to add an ESG fund. And finally, again, if the proposed rule stands as currently written you cannot make the ESG fund the default fund or part of the default fund.

John Wright:

Well, Brian, this has been really interesting but we're coming to the time when we really want to wind up the podcast. As we come to a close are there any key takeaways or pointers that we should make sure that our listeners remember coming out of this podcast?

Brian Pinheiro:

Sure. If you are a retirement plan fiduciary you should understand that you do have an obligation to select a prudent menu of investment options if you're in a 401(k) or 403(b) plan. If there is a question or a proposal to add an ESG fund to your investment lineup, that is something that is currently not looked upon favorably by the U.S. Department of Labor. It is still possible to add it to your lineup but you need to take extra care in analyzing, reviewing the options, deliberating and documenting your decision. But unless you feel like you are under great pressure to add it I would certainly advise waiting until we see what happens with this proposed regulation, what happens with the election and let's see where the rules really shake out.

John Wright:

Well, Brian, thanks very much for those points and the thoughts on this new regulation. If somebody listening to the podcast wanted to get in touch with us in some way to explore this further or had questions, what would be the best way to do that?

Brian Pinheiro:

Well, we're always happy to entertain questions. You can reach me by phone or email. Phone is (215) 864-8511, and email is my last name which is Pinheiro, P as in Peter, I-N as in Nancy, H-E-I-R-O@ballardspahr.com.

John Wright:

Great, Brian, thanks very much.

Brian Pinheiro:

Thank you, John.

John Wright:

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