

## **Executive Summary**

While global and domestic interest in sustainable investing continues to set new records, private sector retirement plans subject to the Employee Retirement Income Security Act (“ERISA”) have not kept pace. Only a small percentage of ERISA-covered retirement plans are utilizing ESG investments, despite growing interest in sustainable investing from workers participating in retirement plans and employers sponsoring them. Why?

The answer appears to be, in large measure, because many ERISA retirement plan fiduciaries are unsure how ERISA’s fiduciary standards apply to such investments. Even though the U.S. Department of Labor (“DOL”), which regulates and enforces ERISA’s fiduciary requirements, has provided relatively consistent guidance and regulation applicable to ESG-related investments for nearly 30 years, its 2020 regulation, “Financial Factors in Selecting Plan Investments,” muddied the fiduciary waters.

- **Perception and Confusion:** Perceived as an anti-ESG regulation, the Financial Factors rule created a new fiduciary test for all investment factors, including ESG—fiduciaries generally may consider only factors deemed to be “pecuniary” (having a material effect on the investment during the time period the plan will hold the investment). “Non-pecuniary” factors could be considered only when pecuniary factors did not determine a clear outcome. This new test resulted in significant confusion, as ESG factors can be pecuniary or non-pecuniary.
- **Suspension and Replacement:** Citing confusion among fiduciaries—including the false perception that ESG factors present more fiduciary risk—and concern that the new Financial Factors rule was chilling appropriate ESG investing by ERISA plans, DOL took the unusual step of suspending enforcement of the rule in March, only two months after it went into effect. The White House issued an Executive Order in May directing DOL to write a new proposed regulation in September 2021, urging it to “...identify actions that can be taken under...relevant laws to protect the life savings and pensions of United States workers and families from the threats of climate-related financial risk.” While the new proposal is a priority for DOL and very likely will encourage ESG-investing by ERISA plans, the regulatory process takes time, and any new rule will not be finalized until well into 2022.
- **Fiduciaries Do Not Have to Wait for the New Rule:** ESG-related investments can be prudent for ERISA plans now. By employing a thorough, well-documented fiduciary process taking into account all relevant factors, and reviewing ESG-related investments using the same process and criteria as any other investment, fiduciaries may prudently select ESG-related investments (see Appendix).

This white paper examines the history of DOL fiduciary guidance and regulation related to ESG and its predecessors, and addresses how plans may prudently invest in ESG-related investments today.

## **Introduction:**

Global and domestic interest in sustainable investing, including the integration of environmental, social and governance (“ESG”) factors, reached record highs yet again in the first quarter of 2021. Globally, nearly \$2 trillion is invested in sustainable funds, and net inflows to these funds in the United States doubled in the first quarter of 2021 compared to the same period a year ago.<sup>1</sup>

It’s hardly surprising that demand continues to grow. Organizations increasingly desire to match their investment process with their organization’s values. In a recent survey, 57% of institutional investors utilizing ESG strategies in 2020 reported that they do so “to align investment strategies with organizational values.”<sup>2</sup> Further, strong short and long term performance of sustainable funds shows that sustainable investing is delivering real economic value. Sustainable funds outperformed their non-ESG peers in seven of the last ten years, and averaged 4.6% growth compared to 1.1% growth in the first quarter of 2021.<sup>3</sup>

U.S. institutional investors have been slower to embrace ESG than their European counterparts, but that trend is reversing—a recent survey found that 42% of U.S. institutional investors incorporated ESG factors into investment decisions, and 30% of those that had not were considering doing so.<sup>4</sup>

The notable exception, however, is private sector retirement plans. According to the *63rd Annual Survey of Profit-Sharing and 401(k) Plans* by the Plan Sponsor Council of America, less than 3% of surveyed retirement plans included ESG-related investment options for their participants.<sup>5</sup> This low take-up rate persists despite significant participant interest—another recent survey found that 9 out of 10 defined contribution retirement plan participants who were aware of their plan’s ESG options invested in those funds, and of those participants who did not have access to ESG options, 69% said they would or might increase their overall contribution rate if offered ESG options.<sup>6</sup>

*“...less than 3% of surveyed retirement plans included ESG-related investment options for their participants...despite significant participant interest—another recent survey found that 69% [of plan participants] said they would or might increase their overall contribution rate if offered ESG options.”*

Why are private sector retirement plans lagging so far behind other institutional investors despite the interest of their plan participants in having access to ESG options?

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<sup>1</sup> “Sustainable Fund Flows Reach New Heights in 2021’s First Quarter,” Morningstar, Alyssa Stankiewicz, April 30, 2021. These figures reflect only flows into mutual funds and Exchange-Traded Funds identified as sustainable funds by Morningstar—assets related to other investment vehicles and services not subject to the Investment Company Act of 1940 utilizing ESG-related investment factors and strategies are not included in these reports.

<sup>2</sup> “2021 ESG Investor Insights Report,” Natixis Investment Managers, David Goodsell, April 21, 2021.

<sup>3</sup> “Sustainable fund inflows hit record high in Q1 – Morningstar” (citing Refinitiv Lipper data), by Simon Jessop and Patturaja Murugaboopathy, Reuters, April 30, 2021.

<sup>4</sup> “Callan’s 8th Annual ESG Survey Shows Record Number Considering ESG in Future Investment Decisions,” Callan, October 6, 2020.

<sup>5</sup> “63rd Annual Survey of Profit-Sharing and 401(k) Plans,” Plan Sponsor Council of America, December, 2020 (surveying 602 plans reporting on their 2019 experience).

<sup>6</sup> “Could ESG Options Boost 401(k) Participation?” NAPA Net Staff, National Association of Plan Advisors Net Daily, May 13, 2021.

A significant factor is likely the lingering concern and confusion regarding whether ESG investments are compatible with the Employee Retirement Income Security Act (“ERISA”),<sup>7</sup> the Federal law governing private sector retirement plans. Though the U.S. Department of Labor (“DOL”), which regulates and enforces the fiduciary provisions of ERISA, issued guidance permitting ESG-like investments as far back as 1994, new regulations promulgated in 2020 under the Trump Administration created concern among some plan fiduciaries that ESG investments increased fiduciary liability risk. In 2021, the DOL under the Biden Administration moved quickly to allay these concerns, suspending enforcement of the 2020 rule and beginning work on a new regulation to replace it. However, despite the clear endorsement of prudent ESG investing by DOL, many ERISA fiduciaries still have questions about whether and how their plans may adopt sustainable investing.

In this paper, we will explain what the ERISA fiduciary duties are, what nearly 30 years of DOL guidance and regulation permitting sustainable investing actually said, and outline how fiduciaries may incorporate ESG into their ERISA plans today through a prudent, thorough, and well-documented investment selection process.

### **What is ERISA, and to Which Investors Does it Apply?**

ERISA is the Federal law governing pension, health and other employee welfare benefits provided by private-sector employers. It was passed with two primary goals—to protect the basic pension benefits of ordinary workers, and to promote the formation of employee benefit plans through a uniform set of Federal rules. ERISA succeeded on both of these fronts.

*“According to DOL data, there are about 722,000 ERISA-covered retirement plans, providing benefits to nearly 140 million people, and holding nearly \$10 trillion in assets...how ERISA applies to sustainable investing is significant to the wider adoption of ESG-integrated investing in the U.S.”*

To protect retirement benefits, ERISA provides favorable tax treatment for “qualified” plans and establishes minimum benefits, vesting rules and other participant rights and remedies. ERISA also created a new type of fiduciary duty, rooted in trust law, to ensure decisions were made solely for the benefit of the participants and beneficiaries of the retirement plan. Courts have described ERISA’s fiduciary duty as “the highest known to law.”<sup>8</sup>

Further, ERISA plans have proliferated since the law’s passage in 1974, and now play a very significant role in U.S. capital markets. According to DOL data, there are about 722,000 ERISA-covered retirement plans, providing benefits to nearly 140 million people, and holding nearly \$10 trillion in assets.<sup>9</sup> As these numbers illustrate, how ERISA applies to sustainable investing is significant to the wider adoption of ESG-integrated investing in the U.S.

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<sup>7</sup> 29 U.S.C. §1001 et. seq.—citations to ERISA provisions will refer to the Act, not the U.S. Code (i.e. ERISA §404(a) rather than 29 U.S.C. §1104(a)).

<sup>8</sup> *Donovan v. Bierwirth*, 680 F.2d 263, 272 n.8, (2d Cir. 1982).

<sup>9</sup> “Private Pension Plan Bulletin, Abstract of 2018 Form 5500 Annual Reports” Employee Benefits Security Administration, U.S. Department of Labor, January 2021.

- ***Types of Plans and Employers Covered by ERISA***

ERISA applies to benefit plans offered by private sector employers to their employees—this includes non-profit organizations, such as private charities or private schools and universities.<sup>10</sup> It does not apply to governmental entities, such as state agencies, or public schools and universities.<sup>11</sup> ERISA can apply to employers affiliated with religious organizations (termed “church plans” regardless of creed), but the law allows “church plans” to opt-out from many ERISA provisions, including its fiduciary standards.<sup>12</sup>

Despite the fact that ERISA does not apply to governmental plans, many state laws governing such plans use similar fiduciary standards, and the large body of ERISA law and guidance often influences the behavior of governmental plan boards, trustees and advisors.<sup>13</sup> The National Association of State Retirement Administrators, whose members are the directors of the nation's state, territorial, and largest statewide public retirement systems, noted that “Although public pension plans are not subject to ERISA, many public pension plans rely on ERISA interpretations as a key source of guidance regarding fiduciary standards.”<sup>14</sup> It is not uncommon, in fact, for some governmental and church plans to voluntarily follow ERISA's requirements as a “best practice” or guide for their own conduct.<sup>15</sup>

Common types of plans covered by ERISA include 401(k) plans, profit-sharing plans, traditional defined benefit pension plans, and some 403(b) plans sponsored by private entities, like private schools and universities (403(b) plans sponsored by governmental entities are not subject to ERISA). Sponsoring an ERISA-covered retirement plan is voluntary, and employers have considerable latitude in deciding what type of plan to offer, as well as its features and benefits beyond the minimum requirements.

### **The Role of the ERISA Fiduciary:**

ERISA protects plan participants by imposing strict legal duties on the plan's fiduciary—the person (or committee or other entity) who makes decisions for the plan. These fiduciary duties are defined by the ERISA statute, as well as in numerous regulations and guidance documents issued by the Employee Benefits Security Administration (“EBSA”), the agency within DOL charged with regulating and enforcing ERISA.

- ***What Makes You a Fiduciary?***

A person can be a fiduciary either by position or by action. The “named fiduciary” is the person or entity identified and charged with these responsibilities in the plan document. The “plan document” is a

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<sup>10</sup> Note that ERISA applies only to the employer's benefit plans—for example, ERISA likely would apply to the management of assets in a charitable foundation's retirement plan for its employees, but it would not apply to the management of the assets in the foundation's endowment.

<sup>11</sup> See., ERISA §3(32).

<sup>12</sup> See., ERISA §§3(33) and 4(b)(2).

<sup>13</sup> State and local government retirement plans are subject to the U.S. Tax Code and to relevant state laws. These laws differ from state to state, and can include state constitutional provisions, specific retirement plan statutes, statutes enacting ERISA-like standards, and statutes enacting the Uniform Trust Code, the Uniform Prudent Investor Act or the Uniform Fiduciaries Act.

<sup>14</sup> See., National Association of Retirement Plan Administrators website, Topics, ESG at [www.narsa.org/esg](http://www.narsa.org/esg), accessed on June 6, 2021.

<sup>15</sup> See., e.g., “Best Practices for Confident Plan Compliance,” TIAA, July 2020; “Although some plans may not be subject to ERISA's fiduciary requirements, it is widely recognized that satisfying those requirements—even for a non-ERISA plan—is a recommended best practice.”

written document required by ERISA that describes the terms and conditions for administering the plan, as well as participants' rights, benefits, and obligations within the plan. For example, the plan document might identify the CFO or an "investment committee" as the named fiduciary responsible for investment decisions. However, to ensure someone is always responsible for protecting participants, ERISA also imposes functional fiduciary status—any person, regardless of title, becomes a fiduciary to the extent that person exercises discretion over plan assets or plan administration.<sup>16</sup> In other words, the person or entity that actually makes investment decisions for the plan, such as deciding whether sustainable investments are available on the 401(k) plan's menu, is an ERISA fiduciary.

- ***Fiduciary Duties and Procedural Prudence***

Fiduciaries must act "solely in the interest" of the plan's participants, and for the "exclusive purposes" of providing benefits and defraying the reasonable expenses of administering the plan.<sup>17</sup> They must also act in accordance with the law and "the documents and instruments governing the plan," and diversify plan investments.<sup>18</sup>

The core of ERISA's fiduciary duty is procedural prudence, often referred to as the "Prudent Man" rule (in 1974, Congress did not use gender neutral terms, and Congress has not updated this portion of the statute). It states that fiduciaries must carry out their responsibilities "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise with like character and like aims."<sup>19</sup>

*"...fiduciaries are judged not on whether their decision proves to be correct in hindsight, but on the process they used to arrive at a decision. Fiduciaries are not guaranteeing investment performance when they make investment decisions—rather, their responsibility is to gather the necessary information, ask the necessary questions and consider the appropriate issues in making the decision."*

This legal standard means that fiduciaries are judged not on whether their decision proves to be correct in hindsight, but on the process they used to arrive at a decision. Fiduciaries are not guaranteeing investment performance when they make investment decisions—rather, their responsibility is to gather the necessary information, ask the necessary questions and consider the appropriate issues in making the decision.

DOL regulations further interpreting these investment selection duties explain that the fiduciary has met the prudence requirement if the fiduciary "has given 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 ... [and] has acted accordingly."<sup>20</sup> In other words, fiduciaries must consider all relevant factors in making an investment decision.

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<sup>16</sup> See., ERISA §3(21).

<sup>17</sup> ERISA §§404(a) and 403(c)

<sup>18</sup> ERISA §404(a)(1)(C) and (D).

<sup>19</sup> ERISA §404(a)(1)(B)

<sup>20</sup> 29 C.F.R. §2550.404a-1(b).



Fiduciaries first need to determine whether they possess the necessary investment expertise, and if not, to seek the assistance of an expert. It is common for ERISA plans to engage investment professionals to either recommend or to directly manage investments.<sup>21</sup> Many plans decide to adopt a voluntary document that describes the process by which that plan will make investment decisions, commonly called the investment policy statement (“IPS”).

Though ERISA does not require a plan to adopt an IPS, many plans work with their advisors or legal counsel to develop one because it becomes the roadmap for the plan’s procedural prudence—it describes how the plan will evaluate, select and monitor plan investments. For example, though it is not necessary that the IPS specifically address ESG issues, a plan could choose to describe the process by which it will consider climate or other kinds of ESG-related factors in making investment decisions.

- ***Fiduciary Issues and ESG: The “Why” and the “How”***

With respect to sustainable investing, the debate about incorporating climate considerations or other ESG factors into ERISA plans has focused on how to meet two key duties: to act solely in the interest of the plan, and to employ procedural prudence. The debate over acting solely in the interest relates to “why” the plan is including ESG—is it for the participants’ benefit or to serve other interests? Can other interests be considered at all? The debate about procedural prudence relates to “how” the plan selects specific investments—can ESG factors be relevant to the economic analysis, and how are they considered?

### **ERISA and Sustainable Investing: Nearly 30 Years of DOL Guidance and Regulation**

For many plan sponsors, plan fiduciaries and plan participants, their first exposure to the issue of prudently selecting ESG-related investments was the flurry of articles and controversy resulting from the Trump Administration’s 2020 regulation, “Financial Factors in Selecting Plan Investments.” As discussed in more detail below, this rule was perceived to be anti-ESG, and caused some fiduciaries to view ESG-related investments with some trepidation. In fact, the Biden Administration cited fiduciary confusion about the rule and the chilling effect it was having on appropriate ESG investing by ERISA plans as reasons for suspending enforcement of the Financial Factors rule, and for announcing DOL’s intention to replace the Financial Factors rule with a new regulation.

The reality, though, is that these issues are not new. DOL actually has a long history of guidance prior to the Financial Factors regulation. In reviewing that history of guidance, an interesting pattern emerges—while there is no doubt that each Presidential Administration had very different concerns about how ESG and similar investments could or should be used by ERISA-covered retirement plans, (Democratic administrations tended to encourage wider use, while Republican Administrations tended to warn against misuse), the actual policy adopted in the various iterations of the guidance was remarkably consistent.

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<sup>21</sup> A non-discretionary investment adviser recommending investments to the plan is often known as a 3(21) investment adviser, while an investment professional to whom discretionary investment authority is formally delegated by the plan is known as a 3(38) investment manager. Either approach is permissible under ERISA—some plan fiduciaries wish to retain final decision-making authority while others prefer to delegate.

- ***Three Consistent Themes Described in Inconsistent Tone and Terminology***

Since 1994, DOL has issued four guidance documents and one regulation regarding the prudent selection of ESG-like investments. Part of the confusion regarding this history is that each version had a very different tone, and used different terminology that evolved over time.

For example, the first two documents referred to “economically targeted investments,” a term that includes what later documents called ESG-related investments. Further, guidance documents issued under Presidents Clinton and Obama emphasized that such investments are appropriate for ERISA plans, and focused on how and why ERISA fiduciaries may select them. Documents issued under Presidents Bush and Trump allowed that such investments may be prudent, but emphasized the care fiduciaries should exercise when selecting them, and focused on the documentation required to justify fiduciaries’ actions if they did select such investments.

However, despite these tonal differences, the documents generally agree on three basic points, and arrive at essentially very similar underlying policy positions. Here are the three basic themes:

1. **ESG as a Collateral Benefit**: A particular investment that is prudent based on its non-ESG characteristics may also possess ESG features. These ESG features are a permissible “collateral benefit” that may be used to help decide among otherwise prudent investments, but they are not relevant to the initial fiduciary analysis of the prudence of the investment;
2. **ESG as a Relevant Factor**: Some ESG factors may be directly relevant to the fiduciary analysis of the investment. Rather than its ESG features being only a collateral benefit, a particular ESG investment could be prudent if selected based both on its ESG and non-ESG characteristics where these factors are material to the financial analysis of the investment; and
3. **Regardless, Investments Must Be Prudent**: Any investment has to meet the basic requirements of procedural prudence—when evaluated based on all relevant factors, the investment has to be prudent, regardless of any ESG factors. A particular ESG investment could be imprudent even though its ESG factors were appropriately considered because other factors made it imprudent for the plan (for example, unreasonably high fees or expenses). The investment cannot be selected if it likely would increase risks or reduce returns relative to other options available to the plan.

The final version of the controversial Financial Factors regulation is also consistent with these themes, but the very different rhetoric and tone surrounding the Trump Administration’s rule illustrates why confusion remains.

While the details of the final rule are discussed in more detail below, it is important to understand, that as a purely legal matter, all three of these outcomes are possible under the final Financial Factors rule. An ESG factor could be what the rule calls “pecuniary,” and therefore appropriately be considered as a directly relevant factor in the analysis of the investment. An ESG factor could be what the rule called a “non-pecuniary” factor, and therefore considered only as a collateral benefit, used as a tie-breaker but not otherwise considered in the analysis. And, finally, of course, an investment could fail to be prudent based on ESG and/or non-ESG reasons.

In fact, the final regulation took great pains to avoid mentioning “ESG” specifically—the term does not appear in the operative text of the regulation. Instead, the final Financial Factors rule states that any factor used to make an investment decision must be “pecuniary” (i.e. material to the financial analysis of the investment during the time frame the plan would likely hold the investment). It does not draw a distinction between an ESG factor and any other factor, such as past performance, tenure of the investment manager, fees, etc.

However, the rule was perceived to be anti-ESG because the Preamble (the narrative accompanying and explaining the operative text, providing context for interpreting the rule) focused on applying the “pecuniary” test virtually only to ESG factors. The Preamble uses the term “ESG” 346 times even though the regulatory operative text does not use the term even once. It is this heavy emphasis on ESG factors and the skeptical tone of the Preamble that led DOL to conclude the rule was chilling appropriate ESG investing, creating a false perception that ESG investments have a higher level of fiduciary risk.

As the Biden Administration prepares a new rule that likely will build on these three themes and encourage more ESG investing by plans, it is instructive to review how the evolving guidance addressed these three themes over time.

- ***What is “Sub Regulatory” Guidance?***

First, what is the difference between a sub regulatory guidance document and a regulation? Briefly, when a Federal regulatory agency provides guidance, it is stating its views on a matter under its jurisdiction, but it has not issued a legally binding regulation. The guidance typically has not gone through public notice and comment rulemaking, and is not entitled to the judicial deference afforded a regulation. Due to the legal complexity and procedural requirements of promulgating a binding regulation, many federal agencies, including DOL, issue sub regulatory guidance as a fast way to provide clarity on technical or ambiguous issues. However, because guidance is just a statement of agency views, it also can easily be rescinded or modified by the agency in the future.

The first three guidance documents discussed below are Interpretive Bulletins (“IB”). IB’s are a formal type of guidance document, published in a special section of the Code of Federal Regulations, but despite this formality they are not binding regulations. The first IB was rescinded and replaced by the second, and the second IB was rescinded and replaced by the third. The fourth guidance document, called a Field Assistance Bulletin (“FAB”), is a lesser form of guidance. It did not rescind the third IB, but it sought to interpret its application. A FAB is essentially a publicly-released internal memo from DOL, written by the director of EBSA’s regulatory division to the director of EBSA’s enforcement division, providing an explanation of how to apply the views in the IB for enforcement purposes.

**Interpretive Bulletin Establishes the “Collateral Benefit” Analysis:**

Since ERISA’s passage, a key issue has been what “solely in the interest” means in practice. Courts generally have interpreted the statute to establish a very high bar for fiduciary conduct. Well-known and often quoted decisions state that a fiduciary must act with “...complete and undivided loyalty to the



beneficiaries,”<sup>22</sup> and “...with an eye single to the interests of the participants and beneficiaries.”<sup>23</sup>

But does this mean that a plan fiduciary is prohibited from making investments that, though otherwise prudent, would offer “collateral benefits”—i.e., benefits to parties other than the plan participants? Or is it sufficient that the investment is prudent for the plan, allowing the fiduciary to consider collateral benefits in selecting from among equally prudent plan investments?

The issue presented itself almost immediately. In 1976, DOL was asked whether multiemployer pension plans (plans that provide benefits to union members in industries like construction) could invest in construction loans. These loan proceeds would fund construction projects hiring union workers, providing a collateral benefit to the union (as well as to plan participants).

Assuming the loans were otherwise prudent, were the plan fiduciaries nonetheless prohibited from making the loans? Or was the collateral benefit permissible if the loans were good investments? In this instance, DOL agreed to permit such loans as plan investments, subject to additional conditions intended to ensure the loans were of sufficient quality that a bank would be willing to engage in the same transaction.<sup>24</sup>

What followed were years of individual requests concerning the same core issue—if the plan is getting a prudent investment, can the investment offer other benefits beyond those accruing to the plan?

- ***Interpretive Bulletin 94-1 (“IB 94-1”) Articulates Collateral Benefit and Reiterates Prudence***

Finally, DOL decided in 1994 to issue the first comprehensive guidance document answering the collateral benefit question. Introducing a new term, “economically targeted investments” (“ETI”), DOL approved the collateral benefit approach as long as the investment was otherwise prudent.

*“...the fiduciary standards applicable to ETIs [a term that includes what is now called ESG] are no different than the standards applicable to plan investments generally.”*  
—IB 94-1

Specifically, DOL defined ETIs as “...investments selected for the economic benefits they create apart from their investment return to the employee benefit plan.”<sup>25</sup> These could include a wide range of “collateral benefits” from investment in the local community to environmental considerations. However, DOL also wrote that the “solely in the interest” fiduciary obligation prohibited, “...a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives.”<sup>26</sup> The IB also noted that, “...because every investment necessarily causes a plan to forgo other investment opportunities, an investment will not be prudent if it would be expected to provide a plan with a lower rate of return

<sup>22</sup> *Donovan v. Mazzola*, 716 F.2d 1226, 1238 (9th Cir. 1983) (quoting *Freund v. Marshall & Ilsley Bank*, 485 F. Supp. 629, 639 (W.D. Wis. 1979)).

<sup>23</sup> *Donovan v. Bierwirth*, 680 F.2d 263, 271 (2d Cir. 1982).

<sup>24</sup> See., Prohibited Transaction Exemption 76-1, Part B. While this exemption provided relief for the prohibited transaction of extending credit to a party in interest, the loan had to be prudent under ERISA Sec. 404(a) as well. DOL later cited this as an example of an investment that was prudent despite producing a collateral benefit in Interpretive Bulletin 94-01.

<sup>25</sup> 59 Fed. Reg. 32,607 (June 23, 1994).

<sup>26</sup> *Id.*

than available alternative investments with commensurate degrees of risk or is riskier than alternative available investments with commensurate rates of return.”<sup>27</sup> The guidance concluded by noting that, “the fiduciary standards applicable to ETIs are no different than the standards applicable to plan investments generally.”

The effect of this guidance was to permit what we would now call ESG considerations as collateral benefits that could be considered, while reminding fiduciaries that investments must otherwise be prudent, and that collateral goals can never be elevated above the participants’ economic interests.

- ***Interpretive Bulletin 2008-01 (“IB 08-1”) Retains Collateral Benefit and Prudence Concepts, But Clarifies Use and Documentation***<sup>28</sup>

In 2008, the Bush Administration became concerned that the guidance in IB 94-1 could be construed too broadly, allowing the desire for the collateral benefits of the ETI to subordinate the interests of the participants in their retirement income. To address this, DOL rescinded IB 94-1 and issued a new

Interpretive Bulletin stating that an ETI should only be permissible if it is economically equivalent to the non-ETI investment option, and plays the same role in the plan’s portfolio. Further, the guidance indicated the Department’s expectation that the fiduciary would document the basis for determining economic equivalence when it chose an investment based on collateral benefits.

*“[IB 08-1] represented a shift in tone and imposed a new documentation requirement [but] nonetheless retained and reinforced the basic holding of IB 94-1—that collateral benefits were appropriate to consider and did not render the investment imprudent.”*

This represented a shift in tone and imposed a new documentation requirement to demonstrate that the ETI investment selected actually was equivalent to the alternative investment it displaced. However, IB 08-1 nonetheless retained and reinforced the basic holding of IB

94-1—that collateral benefits were appropriate to consider and did not render the investment imprudent. The text specifically noted that ERISA does not provide a means for distinguishing between equally prudent investments, and thus collateral benefits were a permissible and reasonable means to do so.

### **Interpretive Bulletin Establishes the “Directly Relevant” Analysis:**

A major shift in DOL’s guidance came in 2015. In addition to adopting a tone more supportive of ESG, the Obama Administration acknowledged for the first time that ESG can be a relevant factor with which to assess the prudence of investments directly.

- ***Interpretive Bulletin 2015-01 (“IB 15-1”)***

DOL explained that it decided to rescind IB 08-1 for a familiar reason—its chilling effect on ESG. DOL wrote that the narrower view of the equivalence standard was “dissuading fiduciaries from...pursuing investment strategies that consider environmental, social, and governance factors, even where they are

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<sup>27</sup> Id.

<sup>28</sup> In the interest of full disclosure, the author promulgated IB 08-01 while serving as U.S. Assistant Secretary of Labor for Employee Benefits.

used solely to... identify economically superior investments.”<sup>29</sup>

In IB 15-1, DOL preserved the ETI collateral benefit analysis, and removed the additional document requirement. More importantly, it added the new relevant factor analysis. Finding that ESG factors could be material to the analysis of the investment, DOL wrote, “Environmental, social, and governance issues may have a direct relationship to the economic value of the plan’s investment. In these instances, such issues are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary’s primary analysis of the economic merits of competing investment choices.”<sup>30</sup>

*“The effect of [IB 15-1] was that ESG could now be a passenger in the otherwise prudent investment vehicle under a collateral benefit analysis, or be a driver as a material factor in the fiduciary analysis of the investment vehicle.”*

The effect of this guidance was that ESG could now be a passenger in the otherwise prudent investment vehicle under a collateral benefit analysis, or be a driver as a material factor in the fiduciary analysis of the investment vehicle.

- **Field Assistance Bulletin 2018-01 (“FAB 18-1”)**

The first round of DOL guidance during the Trump Administration in FAB 18-1 foreshadowed some of the issues later found in the Financial Factors rule, but did surprisingly little to change the Obama Administration’s guidance. FAB 18-1 did not rescind IB 15-1, but sought to clarify its application on two points.

First, the FAB reiterated that ESG factors can be relevant factors, but its tone suggested skepticism about how often that should occur. It stated that a fiduciary should use “generally accepted investment theories” and determine that the ESG factor likely will have a “material effect on the return and risk of an investment based on appropriate investment horizons consistent with the plan’s articulated funding and investment objectives” before concluding it is a relevant factor.

Second, the FAB suggested (but did not directly state) that “ESG-themed” investments were unlikely to be appropriate for use as Qualified Default Investment Alternatives (“QDIA”). These are investments into which participants are defaulted when they fail to give investment direction, and are widely used in connection with the automatic enrollment of participants. The guidance expressed concern that using collateral benefits to select the QDIA for a participant substitutes the fiduciary’s values and preferences in collateral benefits for the participants’ values, and may therefore “...raise questions about the fiduciary’s compliance with ERISA’s duty of loyalty.”

The effect of this guidance was primarily a shift in tone—it reiterated the underlying principles of IB 15-1 that collateral benefits are permitted and that ESG can be a relevant factor, but warned that ESG factors are not automatically relevant and required more scrutiny of the circumstances in which ESG issues would be considered relevant. The QDIA guidance served more as a statement of concern than actual guidance—the FAB did not actually state that using ESG in a QDIA was inappropriate.

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<sup>29</sup> 80 Fed. Reg. 65,136 (October 26, 2015).

<sup>30</sup> Id.

## **The First Regulation—the “Financial Factors” Rule**

The Trump Administration decided that guidance alone was not sufficient to address its concerns about what it saw as the inappropriate use of ESG, so it proceeded to propose an actual regulation addressing ESG in 2020.

- ***A Controversial Proposal Receiving Negative Public Comments***

Promulgated rapidly in 2020, the “Financial Factors in Selecting Plan Investments” rule started as an attempt to regulate ESG-related investments specifically, a break with prior guidance. The proposed regulation did not prohibit ESG factors, but it did single them out for additional fiduciary process and scrutiny not required of other types of investments. It also effectively prohibited ESG-related investments from being used in connection with QDIAs.

Thousands of comments from across the spectrum of interested parties objected to the proposal’s treatment of ESG factors. As a result, the final rule was materially changed. As discussed above, the final regulation was a mismatch of tone and legal effect. Legally, the final rule ended up being reasonably consistent with previous guidance.

Instead of singling out ESG factors for specific scrutiny, the regulatory text required that all factors (ESG or otherwise) used to select an investment must be “pecuniary” (i.e. a fiduciary must determine the factor would have a material effect on the investment during the time period the plan would hold it). “Non-pecuniary” factors could be present in an investment prudently selected based on its pecuniary factors, but could not be the basis for its selection. However, “non-pecuniary” factors could be used break ties between equivalent investments where pecuniary factors alone did not result in a final investment choice, with additional documentation. The final rule did still contain a provision making it difficult to use ESG-related investments as QDIAs.

Thus, the net effect was largely consistent with prior guidance. The “pecuniary” use of ESG was permissible (ESG could be a directly relevant factor), and the “non-pecuniary” use of ESG (as a collateral benefit) was permissible in certain circumstances.

The tone, however, remained very skeptical of ESG. In fact, the tone caused press articles and many observers to perceive the final rule as limiting ESG well beyond its actual legal effect.<sup>31</sup>

## **The Second Regulation—Biden Administration Suspends and Plans to Replace the Financial Factors Rule, Encourages ESG Investing**

The Biden Administration’s response to the Financial Factors rule has been robust, pushing ERISA and ESG investing issues to the forefront of public policy debate about ERISA and the potential financial impact of issues like climate change.

First, the Biden Administration issued a January 20, 2021 Executive Order<sup>32</sup> directing the DOL to review

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<sup>31</sup> See., e.g. “Trump Labor Department’s Rule Discouraging ESG Investing in Retirement Plans is Finalized Over Swell of Objections,” by Rachel Koning Beals, Marketwatch, October 30 2020.

<sup>32</sup> “Executive Order on Protecting Public Health and the Environment and Restoring Science to Tackle the Climate Crisis,” January 20, 2021.

the Financial Factors rule as part of a government-wide review of rules related to environmental policy. In response, DOL decided on March 10, 2021 to suspend enforcement of the Financial Factors rule.

Explaining why it suspended enforcement of the rule, DOL reported that a “wide variety of stakeholders, including asset managers, labor organizations and other plan sponsors, consumer groups, service providers and investment advisers” told the agency that even though the Trump rule had only been in effect for two months, it “...already had a chilling effect on appropriate integration of ESG factors in investment decisions...”<sup>33</sup> The acting head of EBSA stated that “These rules have created a perception that fiduciaries are at risk if they include any environmental, social and governance factors in the financial evaluation of plan investments,”<sup>34</sup> and went on state the DOL’s intention “...to conduct significantly more stakeholder outreach to determine how to craft rules that better recognize the important role that environmental, social and governance integration can play in the evaluation and management of plan investments...”<sup>35</sup>

*“[DOL] intend[s] to conduct significantly more stakeholder outreach to determine how to craft rules that better recognize the important role that environmental, social and governance integration can play in the evaluation and management of plan investments...”*  
—Ali Khawar, Acting Assistant Secretary, EBSA

Then, on May 20, 2021, the White issued a second Executive Order that directed DOL “...to consider publishing, by September 2021, for notice and comment a proposed rule to suspend, revise, or rescind...” the Financial Factors rule. Part of the motivation for this directive is concern that the Financial Factors rule left some ERISA plan fiduciaries with the false impression that integrating ESG factors into investment decisions is risky or imprudent. In fact, the Biden Administration is quite likely to embrace ESG-related investing in the new rule, as the new Executive Order went even further, asking DOL to “...identify actions that can be taken under...relevant laws to protect the life savings and pensions of United States workers and families from the threats of climate-related financial risk.”<sup>36</sup>

- **Climate-Related Financial Risk, Procedural Prudence and the Proposed Regulation**

While the Trump Administration’s Financial Factors rule sparked debate about whether and how ESG factors could be prudently considered, it is likely that the Biden Administration’s proposed regulation will spark debate regarding whether fiduciaries have an obligation to consider such factors, especially with respect to climate-related financial risk.

During the Financial Factors rule comment period, DOL received many submissions providing articles, papers and studies that argued a favorable correlation between consideration of ESG-factors and investment performance and risk. Since last year, additional reports and studies regarding climate

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<sup>33</sup> “US Department of Labor Releases Statement on Enforcement of its Final Rules on ESG Investments, Proxy Voting by Employee Benefit Plans,” Press Release 21-371-NAT, Employee Benefits Security Administration, March 10, 2021.

<sup>34</sup> Id.

<sup>35</sup> Id.

<sup>36</sup> “Executive Order on Climate-Related Financial Risk,” May 20, 2021.



change have been published, and likely will be provided to DOL in the course of considering the new rule proposal.

In addition to the DOL regulation, the SEC will shortly propose regulations likely to mandate and standardize reporting of climate information.<sup>37</sup> As such information becomes more readily available, and as regulatory standards provide some consistency and uniformity in that information, some commenters to the DOL proposal are likely to argue that generally accepted investment theories may require fiduciaries to consider such factors as a standard part of fiduciary investment review.

Other commenters are likely to disagree that climate risk is so broad-based that it is material other than in the case of certain industries or economic sectors, such as energy or heavy industries with regulatory and litigation risks related to pollution.

*“Fortunately, fiduciaries do not have to wait for DOL to complete its rulemaking to prudently consider ESG-related investments. Fiduciaries already have the tools they need to make these decisions...the same prudent, thorough and well-documented fiduciary process they have always used to make plan investment decisions...”*

While the Executive Orders suggest a significant interest by the Biden Administration in the financial risk posed by climate change, it is not clear how this concern would manifest itself in a specific policy position on the scope of fiduciary investment duty in the proposed regulation. Whether the proposal will expand on the principles in the prior guidance, clarifying that ESG factors are appropriate and can be directly material to fiduciary analysis, or whether the proposal will go farther, suggesting that fiduciaries should affirmatively consider such factors, remains to be seen.

It is likely that the new rule will be proposed in September 2021 as scheduled, given the high priority the Administration is placing on the rule. However, the regulatory process takes time, as it involves public notice and comment, revisions to the rule in response to comments, and other procedural steps. As a result, a final rule will likely not be completed until well into 2022.

If enforcement of the old rule is suspended, and the new rule is not yet written, where does that leave ERISA plan fiduciaries today? How can they address sustainable investing and make prudent decisions

about ESG right now?

### **Selecting Sustainable Investments in the Current Environment Using a Thorough, Prudent, and Well-Documented Fiduciary Process:**

There is increasing demand and interest in sustainable investing from both employers and employees. According to a 2020 survey by the Employee Benefits Research Institute, about 1 in 7 workers identified making “more environmentally or socially responsible investment options available” as the “most valuable improvement” their plan sponsor could make in their retirement plan.<sup>38</sup> Fiduciaries are

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<sup>37</sup> See., Spring 2021 Unified Agenda of Regulatory and Deregulatory Actions, Securities and Exchange Commission, “Climate Change Disclosure” Notice of Proposed Rulemaking, RIN# 3235-AM87, scheduled for October 2021. (“The Division is considering recommending that the Commission propose rule amendments to enhance registrant disclosures regarding issuers’ climate-related risks and opportunities.”)

<sup>38</sup> 2020 Retirement Confidence Survey Summary Report, Employee Benefits Research Institute, April 23, 2020, pg. 47.

being asked to consider sustainable investing and ESG options in their plans on a regular basis.

Fortunately, fiduciaries do not have to wait for DOL to complete its rulemaking to prudently consider ESG-related investments. Fiduciaries already have the tools they need to make these decisions—ERISA fiduciaries should rely on the same prudent, thorough and well-documented fiduciary process they have always used to make plan investment decisions, and simply incorporate ESG-related investments into that process. Reviewing ESG-related investments with the same process as other types of investments will provide fiduciaries the tools needed to evaluate whether any particular investment—including those with ESG-related factors—can be prudent for their plans.

As this paper discussed above, the history of DOL’s treatment of ESG has, in fact, been very consistent despite differences in tone and terminology. Regardless of whether a particular administration was skeptical of ESG or embracing it, the actual policies promoted were quite similar. They agreed that the primary fiduciary obligation is to make prudent investments for the plan participants. They agreed that participants’ interests cannot be subordinated to other goals. They agreed that fiduciaries must employ a prudent process to evaluate investments taking into account all relevant factors. They agreed that ESG can be a relevant factor where it is material to the analysis of the investment. They agreed that ESG factors can be used to decide among equivalent investments already determined to be prudent.

While the DOL is developing a new fiduciary rule, fiduciaries can apply these principles by employing their normal investment process. The process should include contemporaneous documentation of committee meetings, investment advisor reports and other steps taken to as part of the process. The attached Appendix provides more detail on the fiduciary do’s and don’ts of ESG investing.

However, fiduciaries should remember that the Financial Factors rule still exists, even though it is not being enforced by DOL. Thus, it can be the basis for a private lawsuit by a participant or class of participants. For example, it would not be advisable to exclude from consideration all investments that are not ESG-related. It would be difficult to demonstrate that refusing to consider the majority of the investments available to the plan is a prudent decision.

### **Conclusion:**

Workers and leaders of private sector businesses and charitable organizations want greater access to investments that reflect their values and their commitment to a sustainable economy. The Employee Retirement Income Security Act (“ERISA”) does not stand in the way of adopting such investments—it provides a framework for prudently selecting ESG investments that will meet the needs of the plan as well as our global community. While DOL under the Biden Administration drafts new regulations encouraging ESG investments, plan fiduciaries may consider sustainable investments today by employing a thorough, prudent, and well-documented fiduciary process.

## About the Author

The Hon. Bradford P. Campbell, partner at Faegre Drinker Biddle & Reath LLP, is a nationally-recognized figure in employer-sponsored retirement plans. He counsels his clients in ERISA Title I issues, including fiduciary conduct and prohibited transactions.

Mr. Campbell served as Assistant Secretary of Labor for Employee Benefits and head of the Employee Benefits Security Administration from 2006-2009. As ERISA's former "top cop" and primary Federal regulator, he provides his clients with insight and knowledge across a broad range of ERISA issues, and also serves as an expert witness in ERISA litigation.

Mr. Campbell has been listed as one of the 100 Most Influential Persons in Defined Contribution by *401kWire* and has been listed as one of the top 15 ERISA attorneys in the country by a poll of the National Association of Plan Advisors. He has testified before Congress on employee benefits issues 11 times.



*This paper was commissioned by Ceres, a non-profit organization that works with capital market leaders to develop market-based and policy solutions to global sustainability challenges. Its views are those of the author, and do not necessarily reflect the views of Faegre Drinker or its clients.*

*This paper does not provide legal or investment advice. Plan fiduciaries should seek appropriate legal or other counsel to evaluate their specific circumstances and to determine what investments are prudent for their plans. Fiduciaries should understand the material differences in regulation, transparency, and portability, among other factors, between different types of investment vehicles and investment strategies.*

## Appendix

### Overview of a Prudent Fiduciary Process Considering ESG Investments

While DOL drafts a new regulation to replace the 2020 Financial Factors in Selecting Plan Investments rule, it has suspended enforcement of the Rule. It is not necessary to wait for DOL to complete the new rulemaking (which may not be finished until well into 2022) for ERISA plan fiduciaries to prudently select and monitor sustainable or ESG-related investments.

Though DOL has suspended enforcement of the Financial Factors rule, it still exists as a Federal regulation. In addition, the underlying ERISA statutory obligations of prudence and loyalty continue to apply. However, the good news is that fiduciaries don't need to jump through new hoops to prudently select ESG-related investments. In fact, if fiduciaries have been employing a through, prudent and well-documented investment process, they can prudently consider ESG-related investments by treating them as they would any other investments.

Fiduciaries must carry out their responsibilities "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent [person] acting in a like capacity and familiar with such matters would use in the conduct of an enterprise with like character and like aims." Fiduciaries should determine whether they need the expert assistance of investment advisors, and engage those experts as necessary. It is advisable, but not required, to adopt an investment policy statement ("IPS") that will provide the blueprint for the plan's prudent investment process.

The investment review process should take into account all relevant factors regarding the available investment alternatives, ESG or otherwise. Common factors a fiduciary should consider include:

- The costs associated with the investment;
- How the investment fits within the plan's overall investment strategy and criteria;
- How the investment suits the needs of the plan's participants;
- The past performance of the investment;
- Any restrictions or additional fees the investment imposes when entering or leaving the investment; and
- Whether such an investment is permitted by the plan documents

The fiduciary may also determine that ESG factors are relevant to the analysis and include them, or it may consider those ESG factors as collateral factors used to choose between two equivalent investments.

However, simply because a prudent process may readily consider ESG-related investments does not mean that all ESG-related investments are appropriate for ERISA plans. Here are several considerations that should cause fiduciaries to reassess whether their utilization of particular ESG investment is prudent:

- **Negative Screening**—It is not advisable to apply a broad “negative screen” related to ESG or other factors. The fiduciary has a responsibility to consider all the investments reasonably available to the plan—if the initial review simply excludes entire industry sectors, for example, the fiduciary cannot evaluate the economic impact of the investment opportunities that are being excluded to compare them to the investments the fiduciary may choose. There is a fundamental difference between incorporating ESG investments into the prudent process to be reviewed on the same basis as all other investments, and refusing to consider non-ESG investments.
- **Reviewing Descriptive Language in the Investment Document**—Fiduciaries must review and understand the investments they select. That includes reviewing the prospectus or similar investment disclosure document. If those documents express investment goals and objectives that are not consistent with ERISA’s requirements, they may not be prudent investments. For example, the Department of Labor initiated a series of investigations against plans and advisors in 2019 because they had invested in certain pooled investments. DOL believed the managers of those investments had disclosed that they would sacrifice returns or increase risks to achieve sustainability goals. While these investigations do not appear to have resulted in significant violations, they do illustrate the kind of factors that could support an allegation that the fiduciary subordinated the participants’ interests to collateral goals.
- **Monitoring**—Fiduciaries have a duty to monitor periodically the investments they make. Given that regulators in the United States are only beginning to consider standardizing disclosures related to ESG factors, fiduciaries should ensure they are monitoring their investments to understand any material changes in how the investment is using ESG-related factors. The U.S. Securities and Exchange Commission is taking public comments in preparation of developing a standard on ESG reporting, and officials have indicated that the Commission will move expeditiously on proposing regulations following the comment period.<sup>39</sup>

All investments should be reviewed on their merits to the plan. This permits fiduciaries to include sustainable investing in their process, and to select investments that meet the plan’s criteria for the investment menu. It does not permit prudent fiduciaries to exclusively consider ESG-related investments at the expense of non-ESG options.

ESG-related investments should be subjected to the same fiduciary process as all other plan investments. It would be imprudent to select an investment likely to increase risks or reduce returns regardless of whether it is ESG-related; for the same reasons, an investment favorably reviewed by a prudent fiduciary process is not imprudent simply because it is ESG-related.

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<sup>39</sup> “SEC to Move ‘Promptly’ on ESG Rulemaking in 2021, Official Says,” by Andrew Ramonas, Bloomberg Law, April 30, 2021.