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DOL Proposes Rule Restricting ESG Investing

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On June 23, 2020, the U.S. Department of Labor (the "DOL") issued a proposed rule (the "Proposed Rule") that would make it more difficult for employee benefit plans subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), to select investments based on environmental, social and corporate governance ("ESG") factors. (The Proposed Rule also covers other non-pecuniary investment strategies, such as impact investing, but the principal focus seems to be ESG investment strategies.) Because it is possible that the Proposed Rule could be finalized before the end of the year, ERISA plan sponsors and investment managers, as well as the sponsors of ESG-focused investment funds (and other non-pecuniary investment strategies), should consider the potential impact of the Proposed Rule on their investment allocations and strategies.

Background

Under ERISA, a plan fiduciary must discharge its duties in the sole interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits to the plan's participants and beneficiaries. In the mid-1990s, the DOL stated that these obligations do not prohibit a plan fiduciary from using non-pecuniary considerations relating to an investment as a deciding factor where two investments are economically equal (the "all things being equal" test or the "tie-breaker" standard). Over the years, the DOL has alternately restricted and expanded the application of this test based on the views of the then-current administration.

The Proposed Rule

The Proposed Rule, first and foremost, emphasizes the paramount importance of economic factors (i.e., investment risk and return) when selecting plan investments. Plan fiduciaries must give appropriate consideration to facts and circumstances relevant to the investment and evaluate investments and courses of action based solely on pecuniary factors that have a material effect on the risk and return of an investment based on appropriate investment horizons and the plan's funding and investment objectives. Among other things, plan fiduciaries should determine whether the proposed investment is reasonably designed, as part of the portfolio, to further the purposes of the plan, the composition of the portfolio with regard to diversification, the liquidity and current return of the portfolio and the expected cash flow requirements of the plan, the projected return of the portfolio and the plan's funding objectives, and how an investment compares to other available investments.

The Proposed Rule emphasizes that plan fiduciaries may not subordinate or sacrifice the financial interests of participants and beneficiaries to promote non-pecuniary objectives. The Proposed Rule clarifies that ESG factors may be considered pecuniary factors only if they present economic risks or opportunities that qualified investment professionals would treat as material investment risk and return

considerations under generally accepted economic theories. Plan fiduciaries must weigh any such ESG factors prudently to reflect their proportionate impact on risk and return. In other cases, a plan fiduciary may consider ESG factors only when deciding between economically indistinguishable investments (the "all things being equal" test).

Although the Proposed Rule does not discard the "all things being equal" test, for the first time, the DOL is clearly shifting the burden of proof to ERISA fiduciaries making ESG investments in reliance on this test. Plan fiduciaries would be required to document any occurrences where such a tie is purported to exist, including the basis for determining that no distinguishing factor could be found between the competing investments and why the investment was chosen based on the purposes of the plan, diversification of investments, and the interests of the plan participants and beneficiaries. In this regard, the DOL has expressed a high degree of skepticism that such "ties" will actually prove to exist when scrutinized.

The Proposed Rule would also add increased obligations for 401(k) plan fiduciaries that propose to include ESG funds in the plan's investment lineup. Acknowledging that "ties" do not necessarily apply in the context of a 401(k) plan, the DOL would instead require that a 401(k) plan fiduciary document use objective, risk-return criteria such as benchmarks, expense ratios, fund size, long-term investment returns, volatility measures, investment manager investment philosophy, and experience and mix of asset types in selecting and monitoring all plan investments (including any ESG fund). Also, the Proposed Rule provides that an ESG fund may not be used as the plan's qualified default investment alternative ("QDIA").

The DOL is soliciting comments on the Proposed Rule through July 30, 2020. Although far from certain, it is possible that a final rule may be issued this fall and could become effective as soon as January 1, 2021.

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