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DEPARTMENT OF LABOR ISSUES PROPOSED REGULATIONS TARGETING ESG INVESTMENTS

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The U.S. Department of Labor has issued proposed regulations to clarify that retirement plan fiduciaries' investment duties under ERISA require that selections of plan investments must be based solely on risk-adjusted economic valuations, and not non-pecuniary considerations. The proposed regulations address environmental, social and governance (ESG) investments, and state with no equivocation that the paramount goal for fiduciaries under ERISA retirement plans is the optimization of economic returns.

Under the most recent sub-regulatory guidance, the DOL appeared to take a more moderate view of ESG investments. Field Assistance Bulletin 2018-01 stated that plan fiduciaries "must not too readily treat ESG factors as economically relevant" and advised that "[i]t does not ineluctably follow from the fact that an investment promotes ESG factors . . . that the investment is a prudent choice for retirement or other investors." While FAB 2018-01 warned plan fiduciaries against assuming ESG factors are economically relevant, it stated that, a properly diversified investment slate could include ESG investments.

The proposed regulations contain express language requiring that fiduciaries focus exclusively on pecuniary factors in choosing retirement plan investments. "Plan fiduciaries are not permitted to sacrifice investment return or take on additional investment risk to promote non-pecuniary benefits or any other non-pecuniary goals." The additions to the "investment duties" regulations are incorporated into the duty of loyalty rules under ERISA § 404(a)(1)(A), as well as the duty of prudence standards. Thus, fiduciaries would be prohibited from "subordinating" the interests of plan participants and beneficiaries in retirement income and financial benefits under the plan to non-pecuniary goals.

Under the new rules, the presence of ESG funds on a retirement plan's investment slate will require that such investments be "economically indistinguishable" from alternative investment options, a situation which the DOL considers will rarely occur. Thus, the proposed regulations require fiduciaries selecting ESG investments to satisfy heightened documentation and due diligence standards. In the context of choosing a QDIA, the proposed DOL rules expressly forbid selecting an ESG fund even if such a fund is selected by fiduciaries only on the basis of objective risk-return criteria consistent with the pecuniary standards under the new rules.

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Finally, the preambles indicate a strong predilection on the part of the DOL towards low-cost or passively managed index funds. Thus, the proposed regulations suggest that the DOL's intended enforcement reach may include scrutiny of actively managed strategies, not just ESG funds. Ultimately, the new rules when final potentially require plan fiduciaries to document and defend their investment policies more robustly, and to reexamine their investment slate in light of the broader array of available investment alternatives, including the low-cost or passively managed index funds apparently favored by the DOL.

Department of Labor, Employee Benefits Security Administration, 29 CFR Part 2550, Financial Factors in Selecting Plan Investments, 85 Fed. Red. 39113 (June 30, 2020).