KBRA KROLL BOND RATING AGENCY

DOL's Proposed Rule Sets Limits to ESG Investing Under ERISA

The U.S. Department of Labor (DOL) recently issued a notice of proposed rulemaking (NPRM) on the scope of fiduciary duties, with implications for integrating environmental, social, and governance (ESG) factors in investment activities. The proposed rule, Financial Factors in Selecting Plan Investments, was developed by DOL's Employee Benefits Security Administration (EBSA) and aims to clarify regulation around investment duties. However, multiple stakeholders have criticized the proposed rule, commenting on the confusion and unnecessary burden it could create. Kroll Bond Rating Agency (KBRA) has been monitoring DOL's NPRM ruling to assess its potential ramifications and impact on ESG investments.

Key Amendments

The proposal made additions to the current regulation:[1]

- Financial returns, not non-pecuniary goals, must drive investment decisions.
- ESG factors can be considered as 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."[2]
- A documentation requirement for when a fiduciary "breaks the tie" between two "economically indistinguishable" investments by relying on a non-pecuniary factor.
- A requirement for fiduciaries to consider "other available investments" to satisfy prudence and loyalty duties under the Employee Retirement Income Security Act (ERISA).
- "ESG-themed funds" may not be used as a qualified default investment alternative (QDIA) in an ERISA plan.

Financial Factors in Selecting Plan Investments

DOL issued the proposed rule on June 23 to amend the "Investment Duties" regulation under ERISA to require a retirement plan fiduciary to make any investment decision based on financial performance alone. The NPRM would prohibit decision-making based on any factors (including ESG) that do not have a material economic impact on the investment. The purposed rule aims to "set forth a regulatory structure to assist ERISA fiduciaries in navigating these ESG investment trends and to separate the legitimate use of risk-return factors from inappropriate investments that sacrifice investment return, increase costs, or assume additional investment risk to promote non-pecuniary benefits or objectives."[3] If two alternative investments appear economically equal, the fiduciary may choose one of the investments based on "a non-pecuniary factor" and must document it appropriately.

The proposed rule focuses on the fiduciary duties of prudence and loyalty under ERISA section 404(a)(1)(A) and (B) to private pension plan investments. It is designed to "make clear that ERISA plan fiduciaries may not invest in ESG vehicles when they understand an underlying investment strategy of the vehicle is to subordinate return or

[1] https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/financial-factors-in-selecting-plan-investments
[2] https://www.federalregister.gov/d/2020-13705/p-54
[3] https://www.federalregister.gov/d/2020-13705/p-45

increase risk for the purpose of non-financial objectives."[4] The DOL stresses the fiduciaries' duty to act prudently and make investment decisions based on the plan's financial returns. Fiduciaries must maximize the funds available for the plan's beneficiaries and participants, focusing on their long-term best interests and providing a secure retirement for American workers. Private pension funds should not pursue other non-financial objectives, such as environmental or social impact.

The NPRM highlights the lack of consensus about what constitutes an ESG investment. Moreover, it urges fiduciaries to be skeptical of ESG ratings or other similar scoring systems that incorporate factors that may not be financially material and to avoid using them to select investments.[5] DOL also expressed that the proposed rule would impose no significant additional costs and will directly affect approximately 27,000 pension plans.[6]

Public Comments on the Proposal

Once the notice of proposed rulemaking was published, stakeholders had a 30-day period to submit comments. Asset managers, pension funds, congressional members, and others submitted comments, mostly opposing the proposal.[7] A recent report analyzed the more than 8,600 public comments and found overwhelming opposition to the proposed rule, with more than 95% of comments opposing it.[8] Many called on DOL to withdraw the proposed rule entirely. Multiple stakeholders pressed for an extension of the deadline, claiming that the comment period was less than half of what other proposals were granted in the past.[9] Moreover, they argued that 30 days is not enough time to fully assess and properly consider the regulation's full impact. Some commenters said that DOL did not engage with industry or seek public input on financial factors in investment decisions.

The proposal largely assumes that ESG factors are immaterial and that ESG investments underperform compared to non-ESG investments. Many stakeholders argued that DOL's proposed rule ignores research showing the positive relationship between ESG factors and financial performance. Stakeholders are also concerned that fiduciaries will now be subjected to additional burdens if they want to use ESG criteria in their investment decisions, which will result in discouraging ESG-focused investment. Many letters commented on how incorporating ESG issues is a fundamental fiduciary duty under ERISA since many ESG factors are likely to have a material financial impact. Commenters also cited that the proposed rule could increase the risk of litigation. Lastly, multiple stakeholders argued against the proposed rule for excluding ESG investments from QDIAs, maintaining this may harm beneficiaries by eliminating the possibility "that some ESG funds may, in fact, be as or more appropriate for participants than traditional options offers as the default."[10]

However, DOL's effort to provide further clarity for ERISA fiduciaries on ESG investing was appreciated by some. Many letters agreed that ERISA's fiduciary requirements should put economic interests above non-pecuniary interests and that returns should never be sacrificed to pursue other interests. Those who favored the regulation applauded that DOL addressed increased concerns about plan fiduciaries making investment decisions to drive a political agenda. Regarding the proposed rule including language that does not allow a plan's QDIA to be an ESG fund, some letters reaffirmed this arguing "ESG criteria in the context of a QDIA should be subject to significantly heightened scrutiny."[11] Additionally, since there is no clear definition of what these factors entail and no regulatory

[4] https://www.federalregister.gov/d/2020-13705/p-41
[5] https://www.federalregister.gov/d/2020-13705/p-61
[6] https://www.federalregister.gov/d/2020-13705/p-93
[7] https://www.dol.gov/agencies/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AB95
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[10] https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB95/00221.pdf
[11] https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB95/00587.pdf

standard of ESG investments, some suggested not accepting an ESG index as proper documentation of an investment tiebreak.[12]

Recent Developments

The proposed rule focuses on what factors fiduciaries should consider when making investment decisions. However, fiduciary obligations under ERISA extend to proxy voting as well. DOL also published on August 31, 2020, a proposed rule that would allow fiduciaries to cast proxy votes only when the matter has a financial impact on the plan.[13] DOL voiced concerns that fiduciaries and proxy advisory firms "may be acting in ways that unwittingly allow plan assets to be used to support or pursue proxy proposals for environmental, social, or public policy agendas that have no connection to increasing the value of investments used for the payment of benefits or plan administrative expenses, and in fact may have unnecessarily increased plan expenses."[14] Comments on that NPRM must be submitted by October 5.

Conclusion

KBRA will continue to monitor these dynamics as events surrounding ESG regulation continue to unfold. ESG factors and their financial materiality are becoming increasingly important to investors. DOL's Financial Factors in Selecting Plan Investments proposed rule could have far-reaching implications for the investment community as well as on any investments that aim to create a positive social or environmental impact. KBRA will follow these and any other future policy changes to evaluate their intended and unintended consequences, as well as their relevance to credit.

[12] https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB95/00292.pdf
[13] https://www.dol.gov/newsroom/releases/ebsa/ebsa20200831
[14] https://www.federalregister.gov/d/2020-19472/p-67

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