ESG U.S. Regulatory Update: Beyond the Headlines

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Department of Labor-Use of ESG in Retirement Investments

It's not what you say, it's how you say it.

Recent headlines tell us that the Department of Labor's new rule proposal "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights"[1] is a 180 degree departure from the rules the DOL adopted under the previous administration regarding fiduciary use of ESG investments in ERISA plans (the "Financial Factors Rule") and fiduciary consideration of ESG shareholder proposals (the "Proxy Voting Rule")[2]. However, if you ignore the noise and focus on the substance of the new proposal, it's clear that the core fiduciary principle among the rulemaking remains the same: ERISA fiduciaries may not sacrifice investment returns or assume greater investment risks as a means of promoting collateral, non-financial ESG policy goals.

So the headlines are wrong? Well, yes, and no...

We all know the adage that it's not what you say, it's how you say it. In other words, when there is a disconnect between your words and your tone, interpretation sides with tone. At that time, the DOL's proposing release for the Financial Factors Rule was hostile to ESG investing and drew hundreds of comments from industry participants. They took the hint, and the final Financial Factors Rule makes no mention of ESG, and in fact permits the use of ESG investing in ERISA plans. But the tone of the proposing release had left its mark, and the discussion of ESG investing in the preamble to the final rule was "confusing." Damage done. A cloud of mistrust hovered over the final rule, and there was palpable concern among ERISA fiduciaries regarding the use of ESG factors and investments in ERISA plans. There was similar concern with the DOL's "anti-ESG" messaging in the Proxy Voting Rule.

The new proposal: an attempt to clarify

The new proposal addresses those concerns head on: "[the proposed rule is] intended to address uncertainties regarding aspects of the current regulation and its preamble discussion relating to the consideration of ESG issues, including climate-related financial risk, by fiduciaries in making investment and proxy voting decisions, and to provide further clarity that will help safeguard the interests of participants and beneficiaries in the plan benefits."[3]

The proposed amendments include references to specific climate related risks and opportunities that could be deemed material factors for consideration in a fiduciaries risk-return analysis. The proposal does not require fiduciaries to consider ESG factors but sends clear messaging that consideration of ESG factors can appropriately be part of the fiduciary's prudent analysis.

And what of collateral, non-financial ESG policy goals? Here's where the rulemaking does differ. The proposed rule would amend the Financial Factors Rule in two ways that are consistent with core fiduciary principles, but are also meant to set a positive tone regarding ESG. The first is to allow consideration of collateral ESG goals under the so-called "tie breaker" rule when a fiduciary prudently determines that competing investments, or investment courses of action "equally serve the financial interests of the plan." Secondly, the proposed rule allows a fiduciary to consider ESG investments with collateral, non-financial ESG goals when selecting qualified default investment alternatives for a plan, provided that the that the fiduciary deems the investment financially prudent.

"Pro-ESG" message received.

[1] https://www.govinfo.gov/content/pkg/FR-2021-10-14/pdf/2021-22263.pdf 86 FR 57272 (October 14, 2021) ("Proposed Rule Release")
[2] "Financial Factors in Selecting Plan Investments" 85 FR 72846 (November 13, 2020) and "Fiduciary Duties Regarding Proxy Voting and Shareholder Rights" 85 FR 81658 (December 16, 2020).
[3] Proposed Rule Release at 57276.

However, fiduciaries should proceed with some caution and avoid misinterpreting the encouraging tone of the proposed amendments in a way that loses sight of the core fiduciary principles under the duties of prudence and loyalty. Nothing in the proposed rulemaking changes the DOL's longstanding position that ERISA fiduciaries may not sacrifice investment returns or assume greater investment risks as a means of promoting collateral social policy goals. On this, both the Trump and Biden administrations can agree – which could be the most provocative headline of all!

SEC – It's what you say and how you say it

The Securities and Exchange Commission (SEC) has also been busy on the ESG front. The SEC is focused on disclosures and there is a common theme underlying their efforts: say what you do and do what you say. No more, when it comes to mutual fund names, and no less, when it comes to public issuer disclosures. They've made clear that overstatement of the impact or use of ESG- related factors and investment processes, aka "greenwashing," has the spotlight. But they also want to ensure that investors are receiving all material information when making investment decisions, including material information regarding climate change.

To that end, the SEC has solicited input from institutional investors, asset managers, consultants and other stakeholders as they work toward new rulemaking:

- With respect to mutual funds, the SEC requested public input as to whether their current rulemaking regarding fund names remains effective in preventing misleading or deceptive names given the subjectivity of terms such as "ESG", "Green", or "Sustainable".[4] They are considering how best to overlay the current principled-based names rule with the individualized nature of ESG investing.
- With respect to public issuers, the SEC has requested public comment on the development of a rule which would require the disclosure of consistent, comparable and decision- useful information related to an issuer's contribution to climate change.[5] They are considering the implications of a principles-based disclosure regime or a prescriptive one. They could propose a hybrid approach which would take into consideration the significant differences in industries' contributions to greenhouse gas emissions.

In both cases, the SEC has signaled that there will be proposed rulemaking in the near future, perhaps by year-end and almost certainly in early 2022.

Investors and regulators seem to be aligned in understanding that ESG factors can influence investment decisions. We are hopeful that the tone, tenor, and wording of any new regulation will align to allow industry participants to feel comfortable moving forward with prudent ESG investing.

Views are as of November 15, 2021, and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security or sector.

[4] Request for Comments on Fund Names, Investment Company Act Release No. 33809 (March 2, 2020), 85 FR 13221 (March 6, 2020).
[5] Allison Herren Lee, Cmr., Securities and Exchange Commission, Public Input Welcomed on Climate Change Disclosures (March 15, 2021).

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