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ESG Essentials: What You Need To Know Now

Episode 12 – A Swinging Pendulum: Taking Stock of ESG and DOL Changes in Retirement Plans

Colvin: Welcome to the latest episode of "ESG Essentials: What You Need to Know Now," a podcast from Fox Rothschild. I'm your host, David Colvin, co-chair of the firm's ESG Practice Group. And as many of our returning listeners know, Fox's short series of topical and timely podcasts cover core ESG concepts and explore important issues for businesses that are concerned with developing and deploying an ESG profile; responding to increased scrutiny from regulators, investors or consumers regarding their environmental and social impact; and minimizing the potential legal, business and reputational risk that can be associated with ESG.

In today's episode, we'll be talking about the ESG-focused regulations recently adopted by the United States Department of Labor. And for that conversation, I'm very pleased to be joined by my colleague José Jara, who's a member of the firm's Labor and Employment Department and a resident of the firm's Morristown office.

José focuses his practice on the Employee Retirement Income Security Act, which you may know as ERISA, and employment litigation and related counseling. José has extensive experience in representing corporations, associations, pension funds, boards of trustees, employee stock ownership plans, and defined benefit and defined contribution plans.

José I'm pleased to welcome you to the podcast. Thanks for being here.

Jara: Thank you David, for having me join the podcast, and thank you to the DOL for finalizing these ESG regs.

Colvin: So, we know that the DOL, or the Department of Labor, just finalized these regs as it pertains to ESG. The regs themselves are entitled "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights." Can you just provide the audience with a little bit of background and primer on ERISA itself so that we can put the regulations into their proper context?

Jara: Sure. Absolutely. So, as David mentioned, ERISA is the Employee Retirement Income Security Act, and this is the act that protects employee pension plans and other benefits. What it does: It sets forth general fiduciary duties with respect to the management of these pension plans. What I mean by that is defined contribution plans or what most folks know as your 401k plan, but it also includes defined benefit plans, the traditional plans where an employee works for 20 years and then gets a retirement at the end based on the years of service.

But essentially, ERISA's goal is to ensure employees have savings for retirement. So, one of the key things of ERISA is that it defines fiduciaries. And who are fiduciaries? Well, fiduciaries are folks that have the discretionary authority or control over the management of the plan or the investments of a plan. And so, once you designate who is a fiduciary, the statute itself requires that the fiduciary act in a

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certain way. And the main ones for the regulations are that the fiduciary must act exclusively for providing benefits for participants and beneficiaries, also known as the duty of loyalty. Court cases have said that fiduciaries must act single, with an eye single, to participants and beneficiaries.

The other critical component that ERISA prescribes is that the fiduciaries must act prudently. Meaning that they must act with the care, skill and prudence and diligence under the circumstances that prevailing. I highlight that under the circumstances. I'll talk about that in a little bit. And then fiduciaries must also diversify plan assets to minimize large losses.

Those are the key sections of ERISA in terms of investment. But, ERISA is really a process-driven statute. What processes do fiduciaries have and take in terms of selecting an investment?

Critical to this analysis is the rate of return of a fund, the risk of a fund, but their actions are not judged in hindsight, because as I mentioned before, under the circumstances then prevailing is, at the time, what information does a fiduciary have to make an informed decision that an investment is prudent or not?

So, this has been a long battle with ERISA. It's very gray area in terms of investments, so it's very challenging for fiduciaries in that regard. But that's essentially the rules on the ERISA that center on investments in the plan.

Colvin: Okay. And so, with that ERISA background in mind, many of our listeners may not know -- some may -- that the regulations just passed or implemented by the Department of Labor followed an executive order that was signed by President Biden in May of 2021. And that executive order directs the federal government and its agencies to implement policies to help safeguard the financial security of America's families, its workers and its businesses from not only climate-related financial risks that may threaten the life savings and pensions of U.S. workers and families, but other risks as well.

Can you talk a little bit, José, is this the first time that the Department of Labor has addressed ESG investments in retirement plans that are subject to ERISA?

Jara: Yeah, so let me begin first by saying, you know, the ESG investments are more popular now, right? And I saw a Bloomberg Intelligence report that stated that ESG assets have surpassed $35 trillion in 2020 and may exceed $50 trillion by 2025. So certainly, those numbers have increased the attention of the DOL along with the president's Order.

But to directly address your question, no, this is not the first time the DOL has addressed these types of investments in retirement plans. And in fact, they've been pretty busy over the past four decades in trying to -- and probably unsuccessfully -- to provide clear and consistent guidance.

Just to give you a little bit of that background, the DOL issued Interpretive Bulletin in '94 trying to clear up any misconception on what they called, back then, "economically targeted investments," that are incompatible with ERISA's fiduciary obligations. So, the DOL explained that ERISA does not prevent fiduciaries from investing in these types of assets so long as the expected rate of return is commensurate with the rate of return of alternative investments with similar risk characteristics that are available to the plan. However, the bulletin did not make clear that the focus of fiduciaries is in the

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plan's financial returns and the risk to beneficiaries -- that the financial returns and the risk is paramount, right? So, they didn't make that clear. So in 2008, the DOL replaced the Interpretive Bulletin from '94 to make it clear that fiduciaries' consideration of non-economic factors in selecting plan investments should be rare. And so they pulled back with the 2008 regulations.

Colvin: Right.

Jara: And then the DOL realized that this kind of unduly discouraged fiduciaries from considering ESG. So, they replaced that Interpretive Bulletin in 2015. Now, the DOL attempted to clarify that fiduciaries should appropriately consider factors that potentially influence risk and return, and that ESG factors may have a direct relationship to the economic value of a plan's investment.

Then we come full circle during the prior administration. The DOL issued in 2020 some final regulations that fiduciaries must solely focus on what they called "pecuniary factors," meaning a factor that a prudent fiduciary determines will have a material effect on risk and return on investment based on its horizon and consistent with the plan's investment and funding objectives.

So, the rule was intended to prevent fiduciaries from taking on additional investment risks to satisfy these non-pecuniary goals.

Colvin: Right.

Jara: So basically, they've been going back and forth, back and forth, and as you mentioned through the president's Order, the DOL in March of 2021 announced that it will not take enforcement action based on these regulations. And they claimed that the regulation had a chilling effect on the appropriate integration of ESG factors on investment decisions. They issued the proposed regs in 2021 and they finalized them right before Thanksgiving. So, that's the history.

Colvin: And that's quite a history, right, in terms of how the pendulum has swung back and forth in terms of what fiduciaries should be considering, whether it's strictly economic in nature, or whether non-economic factors can be considered as well.

So, let's talk a little bit more specifically about these regulations. Essentially, what are the main points that our listeners should be aware of in terms of what these new regulations address?

Jara: Sure, sure. And I'm only going to address the points relating to ESG investments.

There are also some proxy voting provisions in these regulations but I'm not going to discuss those. These regulations, by the way, will become effective on January 30, 2023. And it basically allows for consideration of ESG factors. The regs attempt to clarify how a risk of fiduciary duties of prudency and loyalty apply to the selection of investments.

The regs emphasize that a fiduciary's focus must be on relevant risk and return factors, and not sacrificing investment returns or take on any additional risk. However, the regs make it clear that a fiduciary, in analyzing these factors, may review factors such as the economic effects of climate change or any other ESG factors on a particular investment.

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So, that's one thing that they just wanted to make clear: That the fiduciary can consider some of these other economic effects.

Colvin: That's really a direct response to the Trump administration's stance with respect to these issues. Is that fair?

Jara: That's right. Absolutely. Absolutely. And that's their main point. The other ones in the regs are changes to the Qualified Default Investment Alternative provisions, or the QDIA provisions. And that's basically an investment in a 401K plan when an employee contributes to a plan but he or she doesn't have any specified investment, so it just goes by default into one of these investment options. So what the final regs do: They remove the special rules that the prior regs had for QDIAs, which made it very burdensome to have an ESG type of investment as a QDIA.

And the new regs say, no, the standard for QDIAs are not special standards. They're the same for everything else. And that the fiduciary for QDIA should focus on the risk and return factors and not sacrifice investment returns, or take on additional risks.

Lastly, I think there was another one, the duty of loyalty. Where a fiduciary is in a position of considering equally competing investments, they made it clear that a fiduciary is not prevented from selecting an investment based on collateral benefits. That means benefits other than investment returns. And they also lessened the documentation requirement imposed by the prior regulations. Comments submitted on the proposed regs included that.

So, say you have a participant in the plan that has a preference for an ESG investment. That accommodating that request would probably lead to greater participation in the plan and possibly higher deferral rates. So, that would be to the goal of ERISA in having greater retirement security. The DOL said that a fiduciary would not violate the duty of loyalty solely because they take a participant's non-financial preference into account.

I caution folks that... I would say taking a participant's preference could be one factor to consider, but I would say just one factor. Just that's the same... I would analogize this to, say, the DOL's angst against crypto security investments. Right? Similar factors that a fiduciary would consider for an ESG investment would be the same thing on the cryptocurrency side whether the risk and return and things like that. But basically, that's what these final regulations pretty much state.

Colvin: So, appreciating that the Department of Labor has now opened the door to these types of investments -- and I also acknowledge and appreciate that the pendulum could swing back at any point in time, and the door could close. But with the door being open, at least for the time being, do you expect that that will encourage or motivate plan fiduciaries to offer ESG-type investments in retirement plans going forward? Or, do you think a lot of this is just noise in terms of, it's not really going to change the day-to-day offerings that plan fiduciaries are making with respect to retirement plans?

Jara: Yeah, that's a tough question, David.

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I'm not really sure. A part of me says, look, some folks, their company culture and participants, they may want to have these types of investments, and it's something that a fiduciary should consider. But in today's ERISA world, in regard to investments, it's extremely litigious.

And in specific, I'm referring to what they call the excessive fee cases, where basically, if depending on the investment options that you have in your plan, and depending on the fees that those plans offer, there is a breach of fiduciary duty claim assessed against the fiduciaries for not getting a better investment option, right?

So what they do is, they'll compare mutual funds or they'll compare whether you should have had, you know, because of the plan size, you should have negotiated institutional share prices as opposed to retail share prices. Now, while you consider the ESG factors or the ESG investment, part of that analysis is also going to be, "Alright, what are the fees involved in this investment? Is it because it's ESG specific? Would it be more costly or would it be less costly?" These are considerations that plan fiduciaries must take. But, in the ERISA world, especially if you are a bigger plan with larger assets, you are a target.

And some of these cases are hard to dismiss at the early stages of litigation. In fact, in January of this year, the Supreme Court in the Hughes v. Northwestern case heard a case on this specific issue. And the Supreme court basically held that plan fiduciaries must conduct their own independent evaluation to determine which investments may be prudently included in the plan's menu of options. And if the fiduciaries fail to remove an imprudent investment from the plan within a reasonable time, they breach their duty. The court did end its opinion acknowledging that the duty of prudence turns on the facts and circumstances prevailing at the time the fiduciary acts – so the appropriate inquiry will be context specific.

And look, the effect of these type of cases have even affected the fiduciary liability insurance market. In your world, David, you know, D and O insurance, and for labor and employment folks, EPLI insurance is very critical. And for fiduciaries in the ERISA space, fiduciary liability insurance is critical to protect fiduciaries from any of these types of claims. But, the premiums have gone up 20% to 30%.

Colvin: Right.

Jara: The retention levels have gone up into the millions. And then if you want to renew your policy, you have to go through an exhaustive underwriting process. So, with that said, I would say just take caution.

Colvin: Yep. So, let me pick up on one thing you said with respect to fees and costs. So, for investments and funds that are either singularly or largely focused on ESG factors, do those funds tend to carry higher fees and costs than investments and funds that don't? I mean, is there any correlation between the ESG focus and higher cost and fees, or is it really fund and investment dependent?

Jara: Yeah, I mean, look, it's a case-by-case basis with the investments out in the world. I would always say, in terms of these cases, right, you can have one mutual fund that focuses on ESG, the other one doesn't. But you can always find another fund that charges different fees, right?

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So what are the other qualities? The DOL standard really is, when you review some of these options, you review not only the fee. You can't review fees in a vacuum they say, right? So, it's like, what are these other factors that they're looking at?

And look, again, with these regs, I'm not recommending to do anything. But I actually do think that with these regulations, this is the prime time for fiduciaries to review their investments. It's a good time for them to review what process they have for making investments. Do they have consultants coming in, providing reports? Do they review their investments quarterly? Do they have a watch list for investments that are poor performing? And along with this entire process, hey, if your participants are interested or if your company culture is of the type, you may consider an ESG type of investment to be included in your portfolio. And in fact, you know, at least you have here the backing of the DOL at the time.

Colvin: I think that's really good advice in terms of recommending sort of how plan fiduciaries may want to be thinking and reacting to the new regulations. At least taking stock of what they're already doing and reviewing that as a potential option for their beneficiaries.

Listen, I think you mentioned earlier, it's January 30 of '23 when the regulations will be "live," so to speak?

Jara: That's correct. Yep.

Colvin: Is there anything between now and then that could disrupt the regulations from being implemented and from going live?

Jara: No. Full speed ahead. You know, right now is the time. You know, the new year is coming around. This is a good time for fiduciaries to review their processes that need to get updated. And in fact, some of these plans have what they call "investment policy statements" that provide guidelines on what type of investments the plan should invest in. And so at a minimum, it may require a fiduciary to have that investment policy statement reviewed and see if it should be amended to incorporate maybe some of these concepts that are in the regulations.

Colvin: That's excellent guidance for plan fiduciaries in terms of what they should be thinking about now as we move into the new year. And I think this has been really informative and helpful, José.

I think that understanding where the Department of Labor is headed as it pertains to ESG-focused investing in funds is just one piece of the ESG puzzle, but certainly something that folks should be taking note of, and I really appreciate you taking the time to inform our audience and to be with me today. I appreciate it.

Jara: No, thank you David. Thank you for having me. Appreciate it. Thank you.

Colvin: All good. So for our listeners out there, thank you for joining us and please stay tuned for our next podcast, which will be dropping soon. Until then, be well, stay safe and we'll talk to you soon.

Thank you.

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