DOL has a new vision for ESG: Which stakeholders need to take notice?

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Big changes may lie ahead for retirement investment stakeholders as the U.S. Department of Labor (DOL) continues to focus on the role that climate change, and other social and governance factors, may have in impacting retirement security under the Employee Retirement Income Security Act of 1974, as amended (ERISA).

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In addition to proposing a rule in October 2021 that could open the door for ERISA plan fiduciaries to incorporate more environmental, social, and governance (ESG) investing, the agency also just released a request for information exploring whether it should go further in regulating the intersection of climate change and retirement savings. Plan fiduciaries and other stakeholders may be impacted by the ultimate rules and policy pronouncements that come from these actions.

DOL, ERISA, and ESG: Background

Over the last 20 years, the DOL has issued various interpretations regarding whether and how ERISA fiduciaries could consider ESG factors when making investment decisions impacting ERISA retirement plans. Though the tone of the guidance has ping-ponged with changing administrations, the DOL has consistently affirmed that plan fiduciaries must make investment decisions in accordance with ERISA's fiduciary duties of loyalty and prudence.

In other words, fiduciaries of ERISA plans cannot value ESG components solely to pursue a noneconomic or political agenda. Instead, ESG factors must be material economic (and retirement-focused) investment criteria.

The DOL again weighed in on this issue in the fall of 2021 by issuing a proposed rule, titled "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights" (the Proposed Rule, https://bit.ly/3q7Aa07), which has largely been viewed (in its proposed form) as making it easier for ERISA fiduciaries to consider ESG factors without violating ERISA's fiduciary duties.

While the Proposed Rule remains consistent with historical DOL guidance by explaining that ERISA investment decisions "must be based on risk return factors that the fiduciary prudently determines are material to investment value," the Proposed Rule also appears to ease the way for consideration of ESG factors by noting that the fiduciary's considerations may include climate change, governance, and workforce practices.

If the Proposed Rule is adopted as proposed, it would represent a marked change from prior DOL guidance on ESG investing and especially an ESG rule (the Financial Factors rule, https://bit.ly/3IV9alg) adopted by the DOL at the end of the Trump administration, which was more cautious about the appropriate role of ESG in ERISA investing. The Proposed Rule appears to frame ESG factors as something that can, and possibly even should, influence a prudent and loyal (within the meaning of ERISA's fiduciary duties) investor's decision-making.

In response to the Proposed Rule, the DOL's comment mailbox flooded with close to 900 comment letters, ranging from individuals to large institutions, lobbying groups and industry groups.

While the DOL is still reviewing these comment letters, on Feb. 11, 2022, the DOL issued a "Request for Information on Possible Agency Actions to Protect Life Savings and Pensions from Threats of Climate-Related Financial Risk" (the Climate RFI, https://bit.ly/3sPGIlx). The Climate RFI lists 22 specific questions seeking information about ways that climate change may impact the retirement industry and whether the DOL should take additional, broader action to protect ERISA plans from climate change risks. The Climate RFI requests comments by May 16.

Which stakeholders might be impacted by the DOL's ESG rule and recent request?

At a minimum, the DOL's rulemaking in this area could impact in-house ERISA fiduciaries that make investment decisions (e.g., in-house fiduciary committees) — even if the plan does not include an ESG-themed fund. In addition, the DOL's action could impact investment consultants and asset managers — even if the asset pool in question is not ESG-specific. Finally, other service providers, such as recordkeepers and auditors, may be impacted by DOL action in this area.

Plan sponsor investment fiduciaries. The first category of potentially impacted stakeholders is in-house ERISA fiduciaries, often called plan sponsor investment fiduciaries. These include in-house fiduciary committees, multiemployer plan trustees, and other professionals that have the responsibility, on behalf of the plan sponsor, to select a plan's investments.

The Climate RFI lists 22 specific questions seeking information about ways that climate change may impact the retirement industry and whether the DOL should take additional, broader action to protect ERISA plans from climate change risks.

Clearly, the DOL's interpretations will impact any plan that currently includes an ESG investment fund. As noted above, the DOL's current proposal is generally viewed as easing the barriers to ESG investing by retirement plans. For those plans that include ESG funds, the DOL's new rule will need to be evaluated and applied to ensure that the ESG fund usage (and the process and documentation around that usage) meets the DOL's interpretations of prudence and loyalty.

The DOL's ESG interpretation might also impact plans that do not currently offer ESG funds. First, the DOL's rulemaking amends the duties of prudence and loyalty. Although ESG is a focus, the rule technically interprets the ERISA investment fiduciary duties in general, not limited to ESG.

Second, some view the DOL's proposed rule applying where ESG is considered as only a factor in decision-making, even if the overall fund selected is not an ESG-specific fund. For example, governance evaluations of a manager or security could be impacted by the DOL's rule even if the overall investment option under consideration is not an ESG fund.

Third, plans not currently offering an ESG investment fund could find themselves receiving increasing requests to add ESG funds. There are a number of surveys that identify increasing interest in ESG investing (*See* https://bit.ly/37g3XNz, https://bit.ly/3pLnMm8, and https://pwc.to/3HQ9xm8) In-house fiduciaries may find themselves facing more participant or even plan sponsor interest in adding ESG to ERISA plans.

Notably, the Climate RFI contained many targeted questions that might affect plan sponsor fiduciaries. Some of the questions that are most relevant to plan sponsors include:

- Should the [DOL] use Form 5500 Annual Returns/Reports ("Form 5500") to collect data on climate-related financial risk to pension plans?
- Should administrators of ERISA plans be required to publicly report on the steps they take to manage climate-related financial risk and the results and outcomes of any such steps taken in a form that is more easily accessible to the public, and timelier, than the Form 5500?

These questions can raise concerns for plan sponsors, as the limited climate risk exposure information that is currently available to plan sponsors is not necessarily comparable across issuers, sectors or industries. Vendor data is often expensive to obtain and includes differing estimates or projections. The U.S. Securities and Exchange Commission is currently developing proposals for issuers with respect to climate risk disclosure, but in the absence of regulation to that effect, climate risk disclosure requirements on plans could be challenging to meet.

Plan advisors and consultants. The DOL's recent rulemaking actions seem to ease a fiduciary's consideration of ESG factors in ERISA plans, and as a result, there could be increased demand for analysis and metrics related to ESG. Plan consultants that assist ERISA plans may find they need to develop (or enhance) metrics, tools, and analysis to assist with such ESG considerations.

In-house ERISA fiduciaries may struggle to understand whether and how to incorporate and document ESG factors without violating ERISA's fiduciary duties, and plan consultants can play an important role in navigating these issues. In-house fiduciaries may also look to advisors and consultants to evaluate asset managers' ESG claims to ensure they are accurate and not "greenwashing," or engaging in disinformation to seem environmentally responsible. Investment consultants may find themselves increasingly asked to validate ESG claims.

Importantly, this need may not be limited to ESG-specific funds. As discussed above, the DOL's rule could be viewed as affecting ESG investment factors applied to even non-ESG funds. In-house ERISA fiduciaries may increasingly turn to consultants to help them navigate how to analyze, and document, more limited ESG factor evaluation.

In this regard, the Climate RFI asked targeted questions that might be relevant to plan consultants as they consider such ESG metrics and analysis. For example:

- What are the best sources of information for plan fiduciaries to utilize in evaluating [climate-related financial] risks with respect to plan investments?

- Are there difficulties or challenges in obtaining such information or comparing information from different sources?

Asset managers. The DOL's interpretations could impact any asset managers (including insurance companies) that manage ERISA plans or separately managed accounts, or offer ESG-specific products to ERISA clients. For ESG-specific funds, these managers may find that the DOL's actions will lead to increased retirement plan interest in such products.

In addition, there may be increased requests for investors (including plans and their consultants) to provide information and metrics to evaluate ESG strategies and manager ESG claims (and including ensuring they are accurate and not greenwashing). This increased interest may also come from investment options that are not ESG-specific funds. As discussed above, ERISA plans may increase their interest in (and inquiries around) ESG factors (not specific to ESG funds). For example, there may be increased investor questions around ESG discussions in prospectuses, even for funds that are not ESG-specific.

With respect to the Climate RFI, certain DOL questions may be highly relevant to these stakeholders, such as the following question:

- What efforts, if any, should [the DOL] make to coordinate with the Securities and Exchange Commission on its efforts to inform and protect investors, especially individual investors such as plan participants, from potentially misleading statements about fund adherence to policies that address climate-related financial risk (often referred to as "greenwashing")?

Auditors and recordkeepers. As noted above, some of the DOL's questions in the Climate RFI related to Form 5500 reporting and other disclosure requirements. For example, the DOL is seeking input on whether and how the DOL should require plans to disclose their climate exposure on the 5500 or other disclosure documents. Because of this, and other factors, the DOL's ESG regulatory action could impact stakeholders involved in plan recordkeeping and auditing, especially related to ESG reporting.

Conclusions

The DOL is likely to continue to focus on the intersection of ESG factors and ERISA plans, and this focus may impact plan sponsors, in-house fiduciaries, consultants and asset managers and other service providers, including possibly providing more flexibility with respect to ESG considerations. Stakeholders should consider these changes in their strategic planning, as investor interest in ESG products continues to grow.

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