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Final ERISA Rules Circle Back to Allow ESG Investing

POSTED:

Nov 17, 2020

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The Proposal

On June 23, 2020, the U.S. Department of Labor (DOL) proposed new regulations to govern decisions by fiduciaries at private pension funds when considering environmental, social and governance (ESG) factors in making investment decisions under the Employees Retirement Income Security Act (ERISA). Citing prior conflicting DOL guidance, the proposal questioned materiality of ESG factors and built the proposal on a stated belief that "ESG investing raises heightened concerns under ERISA… the growing emphasis on ESG investing may be prompting ERISA plan fiduciaries to make investment decisions for purposes distinct from providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan." The proposed rules sought to remedy this alleged problem. The proposal was published in the Federal Register.

What is ESG Investing?

One of the difficulties in discussing or regulating ESG investment is that the term "ESG" is often used as an umbrella concept for a number of investment practices that have evolved over the past half century. In its final rule, the DOL observed that "use of terms such as ESG, impact investing, sustainability, and non-financial performance metrics, among others, encompass a wide variety of considerations without a common nexus and can take on different meanings to different people."

Given this potential for confusion, the DOL ended up using the word "pecuniary" (instead of ESG) as the operative regulatory term in its final rule. That appears to reflect feedback from investment industry comments on the proposal. Most commenters referenced currently prevailing ESG investing practices which integrate financially material risk and return factors into the analytical process, regardless of whether the factors show up in financial statements (e.g., product safety, workforce turnover, exposure to physical climate change risks, hazardous waste disposal practices, board member skill sets and independence). For an example of how and why mainstream institutional investors have begun to integrate ESG factors into sustainable investment strategies, check out this brochure from J.P. Morgan.

Investment Industry Response

Pushback to the proposed rule from all corners of the investment industry was

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swift and strong. For example, comment letters criticizing the proposal were received from Vanguard, Fidelity, BlackRock, State Street Global Advisors, T. Rowe Price, Legal and General, Putnam Investments, Defined Contribution Institutional Investment Association, American Bankers Association and Morningstar. Comments can be viewed here.

The DOL received more than 8,700 comments on the proposal, with 95 percent in opposition. Even 94 percent of comments from the investment and financial services industry were opposed to the proposal. A summary of the comments is available here. The DOL did not receive a single comment in support of the proposal from any investment-related organizations, pension plans or asset owners.

Observations raised by the objectors included:

- Integration of material ESG factors into investment analysis has become a widely accepted practice of mainstream investment firms and ESG portfolios have enjoyed increasing investor cash flows.
- The DOL ignored the overwhelming majority of recent research findings from credible sources that demonstrated there is no financial penalty associated with integration of material ESG considerations into investment analysis and that many ESG investment approaches have outperformed their peers.
- By discouraging consideration of ESG issues, the proposal would harm fund members by requiring ERISA managers to remain blind to material investment risks and opportunities.
- Excluding ESG investment options from defined contribution plans could result in higher portfolio risk exposures and lower returns for pension plan members.
- Singling out ESG for disparate treatment is inappropriate and inconsistent with ERISA.

Revisions in Final Rule

The final rule was published in the Federal Register on November 13, 2020, with an effective date of January 12, 2021. The final rule is available on the Federal Register website. While the preamble to the final rule retains some background comments that question sustainable/ESG investing, the DOL substantially walked back a number of assumptions underlying the original proposal. For example, the DOL concludes:

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“The final rule recognizes that there are instances where one or more environmental, social, or governance factors will present an economic business risk or opportunity that corporate officers, directors, and qualified investment professionals would appropriately treat as material economic considerations under generally accepted investment theories."

This essentially restates the regulatory guidance in place before the proposed rule was published. The DOL also covers familiar ground by emphasizing in the final rule that “an ERISA fiduciary’s evaluation of plan investments must be focused solely on economic considerations that have a material effect on the risk and return of an investment based on appropriate investment horizons, consistent with the plan’s funding policy and investment policy objectives.”

Unlike the proposal, the final rule does not single out ESG investing for differential treatment. The preamble confirms that “the Department is persuaded by its review of the public comments that ‘ESG’ terminology, although used in common parlance when discussing investments and investment strategies, is not a clear or helpful lexicon for a regulatory standard.” As a result, the final rule adopts “pecuniary factors” as its operative concept and defines it to differentiate between investment approaches focused on “financial value” versus “moral values.” The definition should also be familiar to ERISA fiduciaries:

“The term ‘pecuniary factor’ means a factor that a fiduciary prudently determines is expected to have a material effect on the risk and/or return of an investment based on appropriate investment horizons consistent with the plan’s investment objectives and the funding policy….”

The final rule is also more accepting of defined contribution plan investment options that take material ESG factors into consideration. When developing a pool of diversified investment alternatives from which plan members may choose, the DOL makes it clear that “a fiduciary is not prohibited from considering or including an investment fund, product, or model portfolio merely because the fund, product, or model portfolio promotes, seeks, or supports one or more non-pecuniary goals, provided that the fiduciary satisfies the prudence and loyalty provisions in ERISA and the final rule, including the requirement to evaluate solely on pecuniary factors, in selecting any such investment fund, product, or model portfolio.”

The final rule’s standard for qualified default investment alternatives (QDIA) is more rigorous. Nevertheless, it leaves the door slightly open for selection of

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carefully vetted QDIA options that only consider financially material ESG factors due to their role as risk-return "pecuniary factors," if there is a well-documented selection and monitoring process that includes comparisons with similar conventional alternatives. The final rule only precludes QDIA options "if the fund, product, or model portfolio's investment objectives or goals or its principal investment strategies include, consider, or indicate the use of one or more non-pecuniary factors."

The final rule also highlights overall importance of investment due diligence and documentation. The preamble contains this guidance for ERISA fiduciaries:

"[The] fiduciary is required to have a soundly reasoned and supported investment decision or strategy to satisfy the ERISA prudence requirement… Although not retained as express regulatory text in the final rule, the Department believes that it would be consistent with ERISA and the final rule for a fiduciary to treat a given factor or consideration as pecuniary if it presents economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories."

Implications for ERISA Fiduciaries

While the final rule circles back toward prior regulatory guidance, ERISA fiduciaries may still want to review existing investment policies, adviser and manager ESG expertise, related contract provisions and investment monitoring processes. The deluge of mainstream investor comments on the proposed rule citing recent favorable research findings that support integration of material ESG considerations, as well as the DOL's apparent realization that many of its initial assumptions underlying the proposed rule were outdated, might be seen as raising a yellow flag for investor fiduciaries.

Based on this guidance, fiduciaries should proceed cautiously and with formal documented processes demonstrating their evaluation of pecuniary factors. Fiduciaries may want to consider whether there are new opportunities to capture improved returns or reduce risk exposures through carefully selected ESG investment approaches. Fiduciaries may also want to consider whether there are ESG investment alternatives that better serve the interests of defined contribution plan members. In addition, it may be appropriate to evaluate whether the plan's service providers have both the needed expertise and contractual duty to provide up-to-date advice on ESG investing.

The preamble cautions that "the Department did not intend the reference to

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'generally accepted investment theories' to foreclose ERISA fiduciaries from considering emerging theories regarding prudent investment practices or otherwise freeze investment practice as of the date of the rule." The duty of prudence is a forward-looking obligation. It requires attention to and evaluation of emerging knowledge and investment practices. With an expected upcoming change in federal administrations and the potential for further modifications of ERISA investment regulations, this is an area that merits close attention from investor fiduciaries and their advisers.

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