TIAA

An update on ESG investment options on plan menus

The latest from Washington on meeting your fiduciary responsibilities

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"ESG" vs. "Socially Responsible" funds

In this paper, we refer to "ESG funds" to mean funds that explicitly consider Environmental, Social or Governance factors. In many cases, these ESG factors are expected to be pecuniary, that is, the fund manager believes the ESG factors will positively impact returns. In contrast, some funds are marketed as "socially responsible," meaning that the fund is managed with the goal of having a positive sustainable or societal impact. Although there is obviously overlap between these categories of funds, we use the term "socially responsible" to refer to funds that deliberately seek collateral goals beyond maximizing investment return.

In this update, prepared by Davis & Harman LLP and presented by TIAA, we describe the latest for plan sponsors and their advisers on regulatory developments that may impact their responsibilities when evaluating socially responsible or ESG-themed funds for inclusion on a retirement plan's investment menu. We describe changes put forth by the Department of Labor under President Trump, and what the Biden Administration has done since inauguration to pause the enforcement of those changes. We also provide a preview of what may be next on this important issue.

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In November 2020, the U.S. Department of Labor (DOL) published final amendments to its regulation that addresses a fiduciary's duties when selecting investments with respect to a retirement plan. These new amendments, which we refer to as the "Financial Factors Regulation," are relevant for plan sponsors and advisers that evaluate environmental, social or governance (ESG) funds for inclusion on a 401(k) or 403(b) plan investment menu.

The new amendments went into effect on January 12, 2021. However, on March 10, 2021, the DOL, now under President Biden's supervision, issued a statement that it will revisit the Financial Factors Regulation and until it publishes further guidance, DOL will not enforce the rule or otherwise pursue enforcement actions against any plan fiduciary based on a failure to comply with the rule.

This back and forth could result in some uncertainty for fiduciaries about exactly how to meet their obligations. The Financial Factors Regulation does not, however, prohibit ESG-themed funds from being included on a plan menu, and it is, in many ways, similar to prior DOL guidance that applied to a fiduciary's evaluation of ESG investments. Thus, although the Financial Factors Regulation may have led some fiduciaries to conclude that some changes to their investment evaluation process are required, we do not expect

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that those changes, or what the Biden Administration might do in the future, would be significant for fiduciaries whose existing evaluation process is consistent with the law and guidance in effect prior to the effective date of the Financial Factors Regulation.

This update is primarily aimed at fiduciaries of ERISA-governed participant-directed defined contribution plans, including 401(k) and 403(b) plans, who must make choices about the investments available to participants and beneficiaries on the plan's "menu." The Financial Factors Regulation is also applicable to investment managers of defined benefit plans, collective investment trusts and other plan asset vehicles. Similarly, while plan sponsors of governmental, church and other non-ERISA plans are not bound by DOL's rules, many follow ERISA guidance as a best practice.

Why did the Trump Administration issue the Financial Factors Regulation?

The questions DOL addressed in the Financial Factors Regulation are hardly new. From the time ERISA was passed in 1974, DOL has opined on how ERISA's duties of prudence and loyalty impact how fiduciaries should make investment decisions. In 1979, DOL issued a regulation to help fiduciaries apply ERISA's prudence rule to an investment or an investment course of action. This regulation, which is what DOL modified in the Financial Factors Regulation, is "principles-based," meaning it does not require or prohibit particular investments but rather directs fiduciaries to determine whether an investment is reasonably designed, as part of a portfolio, to further the purposes of the plan, taking into account the risk of loss and opportunity for gain. DOL has also addressed how ERISA's duty of loyalty—requiring fiduciaries to act solely in the interests of participants and beneficiaries and for the "exclusive purpose" of providing benefits and defraying reasonable expenses—applies to investment decisions. For example, DOL has responded to questions from Taft-Hartley funds about investing in subsidized mortgage loans in communities with large union membership or focusing a plan's investment on construction projects that exclusively used union labor.

Thus, in the early days of ERISA, there was more of a focus by DOL on union plans that may wish to target certain investments where such investments may also assist the union or its members while providing a reasonable return to the plan. As the concepts of socially responsible and ESG investing gained attention, however, DOL turned its focus. Since 1994, DOL has periodically issued guidance on ESG investment issues in the context of plan investments. Through that guidance, Democratic and Republican administrations have expressed different views on the value that ESG factors may have on investment decisions. While there has been a back and forth on the issue of considering ESG factors between the four Administrations (Clinton, Bush, Obama and Trump) that have addressed this issue, there has also been substantial agreement. In fact, DOL has been consistent in its basic position that a fiduciary must act solely in the interest of a plan and its participants, and that plan fiduciaries are not permitted to sacrifice investment returns or take on additional investment risk as a means of using plan investments to promote collateral social policy goals. All of that guidance, however, has taken the form of "sub-regulatory" guidance, that is, interpretive bulletins, advisory opinions and field assistance bulletins. Until the Financial Factors Regulation, DOL had never released a regulatory proposal to allow the public to comment.

In an executive order issued in 2019 related to energy, President Trump directed DOL to review data on discernible trends with respect to such plans' investments in the energy sector. As an outgrowth of that effort, DOL decided to propose a regulation that would address ESG investing in plans. DOL concluded that it should codify a position on ESG investing in regulations rather than continue its pattern of issuing sub-regulatory guidance. When DOL released its proposed Financial Factors Regulation in June 2020, DOL described its concern that 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." In fact, the proposed regulation was widely viewed as a direct attack on the concept of ESG investing, and many of the comments DOL received during the comment process expressed concern that the proposed regulation improperly singled out ESG factors. The text of the final Financial Factors Regulation ultimately removed all explicit references to "ESG" factors that were in the proposed rule.

Why did the Biden Administration announce a temporary non-enforcement policy for the Financial Factors Regulation?

President Biden made climate change a signature issue in his campaign. On his first day in office, he issued an Executive Order (EO) titled "Protecting Public Health and the Environment and Restoring Science to Tackle the Climate Crisis." This EO directed all agencies to immediately review all regulations issued during the Trump Administration that impact the climate change agenda. Because it could impact ESG investing, the Financial Factors Regulation is one of the regulations included in the review. Shortly thereafter, DOL officials began conducting listening sessions with stakeholders. DOL Secretary Nominee Marty Walsh was asked about the Financial Factors Regulation during his Senate confirmation process, and he said that, if confirmed, he would "prioritize a reexamination of these issues."

In its March 10, 2021, announcement, DOL cited the Executive Order as the driving reason behind announcing a temporary nonenforcement policy. DOL stated that it heard from a wide variety of stakeholders who questioned whether the Financial Factors Regulation was "rushed unnecessarily and failed to adequately consider and address the substantial evidence submitted by public commenters on the use of environmental, social and governance (ESG) considerations in improving investment value and long-term investment returns for retirement investors."

Although DOL stated that it will not enforce the Financial Factors Regulation until it can revisit the rule, DOL did state that it is not precluded from enforcing any statutory requirement of ERISA, including the duties of prudence and loyalty. In addition, DOL's action does not bind private parties who wish to assert violations of ERISA's fiduciary requirements.

The next section of this paper briefly summarizes the Financial Factors Regulation, as we would expect many aspects of this rule will not be changed by DOL going forward.

Related proxy voting regulation

In addition to the Financial Factors Regulation, DOL issued in 2020 a regulation relating to a fiduciary's exercise of shareholder rights, including the voting of proxies. The two regulations are closely related and use similar standards. DOL's action under the Biden Administration on March 10, 2021, to halt any enforcement on the Financial Factors Regulation also applied to this proxy voting rule.

Key aspects of the 2020 Financial Factors Regulation

Investment evaluations must be based only on pecuniary factors. The Financial Factors Regulation newly incorporates ERISA's duty of loyalty (or "exclusive purpose" requirement) into DOL's existing investment duties regulation and specifies the minimum requirements that a fiduciary must meet to satisfy the duty of loyalty.

- ***First***, the rule requires a fiduciary's evaluation of an investment to be based only on ***pecuniary factors*** (unless the tie-breaker test described below is used). The final regulation defines a pecuniary factor as "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 established pursuant to section 402(b)(1) of ERISA." The "pecuniary factor" concept is clearly the key concept in the regulation.
- ***Second***, and relatedly, the final rule states that a fiduciary "may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives, and may not sacrifice investment return or take on additional investment risk to promote non-pecuniary benefits or goals."
- ***Third***, the rule explicitly requires fiduciaries, in evaluating investments, to compare the investment under consideration to "the opportunity for gain (or other return) associated with reasonably available alternatives with similar risks."

Importantly, the new regulation does not prohibit ESG-themed funds from being included on a plan menu, and is in many ways similar to prior DOL guidance that applied to a fiduciary's evaluation of ESG investments.

Tie-breaker test. If a fiduciary cannot distinguish investment alternatives on the basis of pecuniary factors alone, the Financial Factors Regulation allows fiduciaries to use non-pecuniary factors as the deciding factor. If non-pecuniary factors are used as a tie-breaker, the fiduciary must ***document*** certain items, including how the chosen non-pecuniary factor(s) are consistent with the interests of participants and beneficiaries in their retirement income or financial benefits under the plan.

Special rules for selecting investment alternatives for a plan menu. The Financial Factors Regulation clarifies that, if a fiduciary satisfies its duties of prudence and loyalty when selecting or choosing to retain a designated investment alternative (DIA) in a 401(k) or 403(b) plan, then the fiduciary is not prohibited from including an investment fund, product or model portfolio as a DIA solely because it "promotes, seeks or supports one or more non-pecuniary goals."

QDIAs. Although an ESG-themed fund may be selected or retained as a DIA in accordance with the special rule described above, the Financial Factors Regulation prohibits fiduciaries from using an investment fund, product, or model portfolio as a QDIA (or as a component of a QDIA) if the investment objectives or goals, or principal investment strategies, "include, consider or indicate the use of one or more non-pecuniary factors."

Effective date. The Financial Factors Regulation is effective January 12, 2021, with respect to all investments made and investment courses of action taken on or after that date. Plans that need to make any changes to their QDIAs in order to comply with the Financial Factors Regulation must do so by April 30, 2022. Of course, if DOL makes changes to the regulation, which seems likely, new effective dates will be issued.

What's next?

Although DOL has indicated it will "revisit" the Financial Factors Regulation, it is important to keep in mind that, despite the back and forth on this issue from multiple administrations, there are some aspects of the Financial Factors Regulation that are very similar to ESG-related guidance and longstanding principles that DOL has provided in the past. We would not expect these core principles to change, including that fiduciaries may not subordinate the interests of participants or sacrifice investment returns for unrelated objectives. No administration has placed a ban on the use of ESG factors in investment decision making, and the explanatory discussion DOL released in connection with the Financial Factors Regulation makes clear that environmental, social and governance factors—or any other factor—may be considered if the fiduciary has prudently determined that the factor is expected to have a material effect on the risk and/or return of an investment or investment course of action. Similarly, fiduciaries are not prohibited from considering participant preferences for particular types of investments, as long as the fiduciary follows a prudent process in selecting and monitoring the investments on the plan menu.

Accordingly, a few principles that prudent fiduciaries have always followed continue to be appropriate as we await further guidance from DOL:

- Fiduciaries should always keep in the front of their minds the interests of participants and beneficiaries when making decisions.
- All investments on the plan's menu, including socially responsible funds and ESG-themed funds, should be selected and monitored using the prudent process the fiduciary has established.
- Fiduciaries should document the basis for their decisions.

The Biden Administration's DOL has a wide variety of options moving forward. To fundamentally change the Financial Factors Regulation (and related proxy voting rule) would require a new notice and comment rulemaking process because the Financial Factors Regulation is a final rule that is in effect—even if DOL is not currently enforcing it. Some of the changes DOL might consider in that potential rulemaking include the following:

- Placing more significant emphasis on the notion that ESG factors can, in fact, have a material impact on the risk and/or return of an investment. While the Trump Administration rule did acknowledge that ESG factors can be "pecuniary," there was also a good amount of discussion in the final rule to the contrary.
- Allowing the consideration of non-pecuniary factors as legitimate "tie-breakers" between comparable investments without extra documentation requirements.
- Placing more emphasis on the prudence of offering participants the option of allocating their retirement assets to funds that meet participants' own social goals, in order to encourage savings.
- Providing more guidance on the importance of taking long-term trends, such as climate change, into account when selecting investments.
- Making equivalent changes to the related proxy voting regulation.
- Expressly permitting any otherwise permissible options that consider non-pecuniary factors to be offered as QDIAs.

*Should you have any questions, please contact your TIAA consultant relations director or learn more at **https://www.tiaa.org/public/plansponsors/assetmanagement/responsible-investing**.*

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