DEPARTMENT OF LABOR RELEASES GUIDELINES ON SOCIALLY DRIVEN INVESTING

The Department of Labor has recently published revised guidance on selection of investment managers by ERISA fiduciaries, to be effective January 12, 2021 at 85 FR 72846. The guidance severely restricts the ability of ERISA fiduciaries to engage in so-called socially-driven, or ESG investing.

"ESG Investing" is a catch-all term for a recent trend in investments of providing investment products which are meant not just to provide the highest return given a certain level of risk, but also to provide environmental, social, or corporate governance benefits. An example would be an investment fund that takes on additional risk by avoiding investment in carbon-emitting industries such as oil production. The investor takes on additional risk, and possibly lower return, however the investment has the secondary effect of promoting a social good the investor is interested in.

The Department of Labor has determined that ESG investing raises concerns under ERISA. The fiduciaries of pension plans and other benefit plans covered by ERISA are bound to a narrower objective than promoting the general good: Prudent management to maximize the funds available to pay benefits under the plan. The Department has stated that "Providing a secure retirement for American workers is the paramount, and eminently worthy, "social" goal of ERISA plans; plan assets may never be enlisted in pursuit of other social or environmental objectives at the expense of ERISA's fundamental purpose of providing secure and valuable retirement benefits." 85 FR 872848.

The new regulation, which revises portions of 29 C.F.R. § 2550.404a-1, provides that ERISA fiduciaries must choose investments based only on "pecuniary factors." Pecuniary factors are factors that will have a material effect on the risk or return of the investment. In reviewing investments, a fiduciary can consider only the effect that a proposed investment will have on the bottom line for the Fund. The Trustee cannot, generally, consider other factors such as whether the investment promotes some social good or other nebulous goal.

The only exception to the above rule is that when a fiduciary is unable to distinguish between two investment choices based on pecuniary factors alone, the fiduciary may select using non-pecuniary factors, but only if the fiduciary creates written documentation explaining why reliance on non-pecuniary factors is necessary. That is to say, if an Investment Consultant or Board of Trustees wants to engage in ESG investing, they must first determine that doing so would not cost the Fund any return, and additionally must create a written documentation of their determination.

Additionally, for participant-directed defined contribution Funds, a fiduciary must use only pecuniary factors in selecting potential investments.

The upshot of this new regulation is that ERISA plans should not engage in any sort of ESG investing, or if it does so it must make sure to comply with the requirements set forth in the regulations. Boards of Trustees, as well as other fiduciaries, should review this guidance with their investment consultants in order to confirm that all investment managers have been selected only based on their potential risk and return, and not on any other environmental, social, or governance factor. In addition, if an investment manager states that a given investment will have social benefits, such as promotion of the union movement, the Trustees should ensure that any ultimate determination is based only on pecuniary factors.

If you have any additional questions, contact Asher, Gittler & D'Alba.

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