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The ESG Rule That Wasn't

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On June 23, 2020, the Department of Labor (DOL) issued a proposed rule called "Financial Factors in Selecting Plan Investments." While the rule did not specifically reference Environmental Social and Governance (ESG) investing in its title, it became known as the "Proposed ESG Rule," due to its focus on this particular class of investment. However, the rule drew criticism for being a solution in search of a problem; despite some penetration in governmental defined benefit (DB) plans, ESG use in ERISA defined contribution (DC) plans - the target of this legislation - is practically non-existent. Additionally, the timing of the rule being released late in an election cycle, as well as an unusually short comment period of 30 days, had many concerned that the DOL was singling out ESG investments for political purposes.

After nearly 146 mentions of ESG investing in the Proposed Rule and 140 pages of responses to public comments, the DOL released an eight page Final Rule on October 30, 2020, containing no use of the term ESG at all, thus reflecting the DOL's softening position on ESG investing.

WHAT HAPPENED?

Over 1,100 written comments and 7,600 form letters from the public regarding the Proposed Rule were sent to the DOL, 95% of which were reported to be critical. The DOL has consistently stated that they take public comments seriously, and there is perhaps no clearer example than the changes that were made from the Proposed Rule to the Final Rule. The DOL acknowledged that "ESG terminology was not appropriate as a regulatory standard," due to "the lack of a precise or generally accepted definition of "ESG," either collectively or separately as "E, S, and G."

WHAT CHANGED?

The DOL's Final Rule contains the significant modifications from the Proposed Rule. The first being that the Final Rule eliminated a controversial provision in the Proposed Rule that would have specifically prohibited the use of an ESG fund as a Qualified Default Investment Alternative (QDIA). Despite the change, the DOL still prohibits the use of an investment as a QDIA if its objectives, goals, or principal investment strategies include, consider, or indicate the use of one or more non-pecuniary (non-financial) factors.

Similar to the Proposed Rule, the Final Rule prohibits sacrificing investment return or assuming additional investment risk to promote non-financial goals. However, unlike the Proposed Rule, the Final Rule does not single out ESG or ESG-related investments as funds that promote non-pecuniary goals. In evaluating the selection of an investment, ESG or otherwise, the Proposed Rule stated that the investment had to be compared to "available alternative investments," implying that fiduciaries would need to scour the universe of investment alternatives. The Final Rule makes it clear that this implication was not the DOL's intent, limiting the comparison to “reasonably available alternatives with similar risks.” Additionally, in the Proposed Rule, the DOL required investments to be “economically indistinguishable” in order for a tiebreaker involving non-pecuniary factors to be used. In the Final Rule, that was softened to “pecuniary factors.”

Finally, the DOL removed a documentation requirement that specifically referenced the documentation of ESG investment choices.

WHAT DOES THIS MEAN FOR RETIREMENT PLAN SPONSORS?

The watering down of the Final Rule is welcome news to many retirement plan sponsors and those who work with them, as the Proposed Rule was generally viewed as a heavy-handed solution to a problem that barely existed in the DC retirement plan marketplace, as only two-tenths of one percent (0.2%) of all plan assets are currently invested in ESG options.

However, one aspect plan fiduciaries should consider in regard to the removal of all ESG references from the Final Rule is that the provisions of the Rule now apply in the context of any investment. For example, a healthcare institution looking to include a healthcare sector fund in its investment array must have reasons beyond participant interest and the concept of representing the industry, in order to comply with the Final Rule, even though the healthcare fund is not an ESG investment.

CONCLUSION

The Final Rule is scheduled to become effective 60 days after the date it is published in the Federal Register, which occurred on November 13, 2020. Thus, the rule will presumably become effective on January 12th, 2021. However, there is a special provision allowing plans until April 30, 2022 to make any necessary QDIA changes to comply with the Final Rule.

In an election year, the publishing date in the Federal Register is important. Since the rule was published prior to November 20, a new presidential administration would typically need to use notice and comment rulemaking to suspend or modify the regulation, a potentially time-consuming process. Unlike other fiduciary rules, which are often impacted by administration changes, this Final Rule is likely to become effective as written, due to its softening position on ESG funds. However, plan sponsors should continue to pay close attention to this and all retirement plan legislation.

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For more information on our services, please contact **Mike Volo,** Senior Partner, at **781.997.1426** or **mvolo@cammackretirement.com**.

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